ANNUAL REPORT 2011

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1. HIGHLIGHTS

Effective January 1, 2011, Air Canada began reporting its financial results in accordance with IFRS, including comparative figures for 2010. The financial and operating highlights for Air Canada for the periods indicated are as follows.

(Canadian dollars in millions, except where indicated)	Fourth Quarter			Full Year		
	2011	2010	Change $	2011	2010	Change $
Financial Performance Metrics						
Operating revenues	2,699	2,616	83	11,612	10,786	826
Operating income (loss) before the provision adjustment for cargo investigations, net(1)	(98)	15	(113)	179	232	(53)
Operating income (loss)	(98)	61	(159)	179	278	(99)
Non-operating income (loss)	38	28	10	(429)	(303)	(126)
Income (loss) before income taxes	(60)	89	(149)	(250)	(25)	(225)
Net income (loss) for the period	(60)	89	(149)	(249)	(24)	(225)
Operating margin before the provision adjustment for cargo investigations, net %(1)	(3.6)%	0.6%	(4.2) pp	1.5%	2.2%	(0.6) pp
Operating margin %	(3.6)%	2.3%	(5.9) pp	1.5%	2.6%	(1.0) pp
EBITDAR before the provision adjustment for cargo investigations, net(1) (2)	162	328	(166)	1,242	1,386	(144)
EBITDAR(2)	162	374	(212)	1,242	1,432	(190)
EBITDAR margin before the provision adjustment for cargo investigation, net %(1) (2)	6.0%	12.6%	(6.6) pp	10.7%	12.9%	(2.2) pp
EBITDAR margin %(2)	6.0%	14.3%	(8.3) pp	10.7%	13.3%	(2.6) pp
Cash, cash equivalents and short-term investments	2,099	2,192	(93)	2,099	2,192	(93)
Free cash flow(3)	(69)	122	(191)	366	746	(380)
Adjusted net debt(4)	4,576	4,874	(298)	4,576	4,874	(298)
Net income (loss) per share – Diluted	$ (0.22)	$ 0.27	$ (0.49)	$ (0.92)	$ (0.12)	$ (0.80)
Adjusted net loss per share – Diluted(5)	$ (0.64)	$ (0.17)	$ (0.47)	$ (0.72)	$ (0.58)	$ (0.14)
Operating Statistics			Change %			Change %
Revenue passenger miles (millions) (RPM)	12,065	11,756	2.6	54,223	51,875	4.5
Available seat miles (millions) (ASM)	15,290	14,918	2.5	66,460	63,496	4.7
Passenger load factor %	78.9%	78.8%	0.1 pp	81.6%	81.7%	(0.1) pp
Passenger revenue per RPM ("Yield") (cents)(6)	19.5	19.1	1.9	18.7	18.1	3.3
Passenger revenue per ASM ("RASM") (cents)(6)	15.4	15.1	2.0	15.3	14.8	3.2
Operating revenue per ASM (cents)(6)	17.7	17.3	2.2	17.5	17.0	2.9
Operating expense per ASM ("CASM") (cents)	18.3	17.4	4.9	17.2	16.6	3.5
CASM, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations (cents)(7)	12.6	12.8	(1.5)	11.7	12.0	(2.9)
Average number of full-time equivalent (FTE) employees (thousands)(8)	23.6	23.3	1.5	23.7	23.2	2.1
Aircraft in operating fleet at period end(9)	331	328	0.9	331	328	0.9
Average fleet utilization (hours per day)(10)	9.4	9.4	(0.3)	10.1	9.8	2.7
Revenue frequencies (thousands)	133	131	1.3	551	537	2.5
Average aircraft flight length (miles)(10)	857	850	0.8	892	868	2.7
Economic fuel price per litre (cents)(11)	88.6	67.5	31.3	85.2	66.4	28.3
Fuel litres (millions)	912	906	0.7	3,937	3,791	3.9

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

(2) EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent) is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of the MD&A for a reconciliation of EBITDAR before a provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).

(3) Free cash flow (cash flows from operating activities less additions to property, equipment and intangible assets) is a non-GAAP financial measure. Refer to section 9.5 of the MD&A for additional information.

(4) Adjusted net debt (total debt less cash, cash equivalents and short-term investments plus capitalized operating leases) is a non-GAAP financial measure. Refer to section 9.3 of the MD&A for additional information.

(5) Adjusted net income (loss) per share (diluted) is a non-GAAP financial measure. Refer to section 20 of the MD&A for additional information.

(6) A favourable revenue adjustment of $40 million related to Air Canada's transatlantic joint venture with United Airlines and Deutsche Lufthansa AG, which was finalized in December 2010 but with effect as of January 1, 2010, and to other interline agreements was recorded in the fourth quarter of 2010. For comparative purposes, these measures were adjusted to exclude the impact of the $40 million favourable adjustment recorded in the fourth quarter of 2010, which related to activities attributable to the first three quarters of 2010.

(7) Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, is a non-GAAP financial measure. Refer to section 20 of the MD&A for additional information.

(8) Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as at Jazz Aviation LP ("Jazz")) operating under capacity purchase agreements with Air Canada.

(9) Includes Jazz aircraft covered under a capacity purchase agreement with Jazz (the "Jazz CPA"). Excludes aircraft operated by other third party carriers pursuant to capacity purchase agreements with Air Canada. Refer to section 8 of the MD&A for additional information.

(10) Excludes charter operations. Also excludes third party carriers operating under capacity purchase arrangements, other than Jazz aircraft covered under the capacity purchase agreement with Jazz.

(11) Excludes third party carriers, other than Jazz, operating under capacity purchase agreements. Includes fuel handling and is net of fuel hedging results. Economic fuel price per litre is a non-GAAP financial measure. Refer to sections 6 and 7 of the MD&A for additional information.

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MESSAGE FROM THE PRESIDENT AND CHIEF EXECUTIVE OFFICER

Despite some enormous challenges, Air Canada made significant progress in 2011 pursuing strategic initiatives towards sustainable profitability in an industry that continues to transform globally. As with any difficult transition, there will be much complexity to tempt us to take our eye off the ball but, just as we did in 2011, we will maintain our focus on our four corporate priorities throughout 2012.

While we endured a dramatic spike in fuel costs and faced several well-publicized labour disputes, we nonetheless managed to achieve two key value drivers: the company's record $11.6 billion revenue performance and our annualized, recurring improvements of $530 million from our Cost Transformation Program ("CTP"), whose initial goal was $500 million. This combination of revenue improvement and cost control will remain an important value driver of Air Canada.

One of the significant challenges we faced in 2011 was a 27 per cent or $723 million increase in fuel expense over 2010, which negatively impacted our results despite a wide range of mitigation measures. In addition, the global economy to which our industry is highly correlated also slowed during the year. For 2011, we reported EBITDAR of approximately $1.2 billion, a 10 per cent decline from the record EBITDAR (before a net reduction of $46 million to a provision for cargo investigations) of the prior year. Our operating income was $179 million versus $232 million in 2010 (before a net reduction of $46 million to a provision for cargo investigations). For 2011 we reported a net loss of $249 million, which included $54 million in foreign exchange losses, compared to a net loss of $24 million a year earlier, which included $184 million in foreign exchange gains. Consequently, Air Canada's stock suffered in 2011 as did the value of most major carriers tracked by the NYSE Arca Global Airline Index, which fell 31.5 per cent.

However, looking past the headlines reveals some encouraging trends as the company performed well on several key operating metrics. In achieving record revenue for the year, we saw passenger revenue increase in every market segment and rise 8.3 per cent system-wide over 2010 on traffic growth of only 4.5 per cent. Passenger yield improved 3.3 per cent. Cargo revenue grew 3.3 per cent in a challenging environment where traffic fell 1.7 per cent. Such results are evidence of our disciplined approach to capacity management, which is further confirmed by an annual passenger load factor of 81.6 per cent – only one-tenth of a percentage point below our company's record load factor in 2010.

As mentioned, we surpassed our three-year goal of $500 million in permanent CTP cost savings and revenue enhancements. The benefits are apparent in the year-over-year reduction in unit costs of 2.9 per cent (excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations) – the second year in a row we have achieved such unit cost reductions. We ended the year with cash, cash equivalents and short-term investments of nearly $2.1 billion. This equates to 18 per cent of 2011 operating revenue, exceeding our target of 15 per cent of 12-month trailing operating revenue.

More difficult to quantify but equally valid in measuring our performance were the numerous awards Air Canada won. The list is impressive not only for its length and each award's significance, but also for its variety. For the second year in a row the independent research firm SkyTrax named Air Canada the "Best International Airline in North America" in its 2011 World Airline Awards, based upon a worldwide survey of more than 18 million travellers. We were voted by the readers of *Business Traveler* magazine as offering the "Best In-Flight Services in North America" and the "Best North American Airline for International Travel" for the fourth consecutive year and we were named by the readers of *Global Traveler* magazine the "Best Airline in North America" for the third consecutive year in its annual survey.

In addition, we were also recognized in areas specific to particular types of travellers and those with special interests. For example, Air Canada was named "Canada's Favourite Airline for Business Travel" in the annual Ipsos Reid Business Traveller Survey. It was the third consecutive year of improvement in Air Canada's ratings in the Ipsos national survey, with our airline preferred by 71 per cent of Canadian business travellers. For the fourth consecutive year, Air Canada received top honors for "Best Flight Experience to Canada" in *Executive Travel* magazine's Leading Edge Awards readers' 2011 survey. We were ranked among the Top Five Airlines for in-flight entertainment by independentTraveler.com and our *enRoute* inflight publication received multiple awards, including nine National Magazine Awards. Finally, we were also rated as one of the Top Five Most Attractive Companies to work for in Canada in a survey by Randstad Canada and ICMA International.

All these achievements were made possible by a disciplined approach to running the airline guided by four basic priorities. Each priority addresses a distinct aspect of our business and harnessed together they are propelling the company forward toward its goal of sustained, long-term profitability.

The first priority is *engaging our customers*, particularly those in the premium category, where revenue was 8.3 per cent higher in 2011 than 2010. We have enhanced our premium services with such measures as the creation of a VIP program, the introduction of e-upgrades to replace paper coupons, and new or upgraded lounges such as in Paris and Winnipeg. More generally, the results of our internal surveys have recorded increases in customer satisfaction since 2009, something we achieved by improving the customer experience at every interaction. At our call centers we have been adding resources to quicken response times; at airports our statistics for baggage handling are the best on record having improved 42 per cent from three years ago; on-board we are registering increased satisfaction with our meal services and entertainment system reliability; and we have created a new Customer Journey Management system to encourage customer-centric decision-making at our operations center. Additionally, we have fully embraced social media to communicate better with our customers, resulting in 200 per cent growth in Facebook followers and a 400 per cent increase in Twitter activity.

Our second priority, *the international powerhouse strategy*, reflects our conviction that Air Canada enjoys an enviable geographic advantage in the world with our hubs well-situated at global crossroads used by travellers crossing both the Atlantic and Pacific. Toronto in particular, where we have a 54 per cent share of passenger traffic, has the critical mass needed to attract a large share of travellers between the U.S. and destinations in Asia, Europe and Africa. We are leveraging this to transform our company into an international powerhouse and the results are promising given the 110 per cent growth we have experienced in passengers connecting from one international flight to another since 2009.

To advance these goals, we increased international capacity 6.6 per cent year-over-year through improved aircraft utilization and strategic deployment of our existing fleet. On the Atlantic, passenger revenue increased 3.6 per cent over 2010 due to traffic growth attributable in part to greater frequencies on seasonal routes to Athens, Barcelona, Madrid as well as increased flying on year round routes. Over the Pacific, revenue increased 8.3 per cent, reflecting increased capacity to China and the success of our Calgary-Narita route.

A key element supporting this strategy is our relationship with the Star Alliance, the world's largest airline alliance and of which Air Canada is a founding member. In addition, Air Canada belongs to a transatlantic revenue sharing joint venture with United Airlines, Lufthansa and several other leading Star Alliance carriers. On the ground in Toronto, progress has been made on improved customer flow and baggage management systems to facilitate connections. We anticipate a further simplification of baggage rules for U.S.-bound connecting customers in 2012 will further enhance Toronto's attractiveness as a North American connection point.

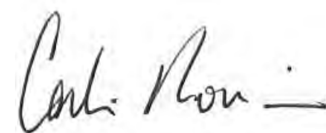
As noted above, we made good progress on our third priority, which is *our Cost Transformation Program*. To cite but one area of cost scrutiny, we continue to focus on our fuel efficiency program that resulted in savings of 21.6 million kilos of fuel relative to 2008, five million more than targeted.

With our CTP objective achieved, the company is transitioning to make this transformation a more permanent feature of the organization. One way we will do this is by replacing cost drivers with new revenue opportunities. For example, we increased ancillary revenue per passenger by 18 per cent in the last year through such measures as baggage fee adjustments, paid upgrades and an enhanced Buy on Board program. Other initiatives are also being considered.

The final priority is *culture change*. There is no doubt we made progress on this priority through the year and our employees continually demonstrated a strong commitment to our customers' comfort and safety, as attested to by our numerous awards. Nonetheless, transforming a corporate culture, especially at a 75 year old organization such as Air Canada, is never easy and the current round of labour negotiations certainly showed us that we still have work to do. Our objective with all of our labour agreements is to end up with something that is both fair to employees yet gives the company the flexibility to make necessary strategic decisions to allow us to properly compete on a level-playing field in a rapidly changing global industry.

In conclusion, we made steady progress on our priorities in 2011 despite the challenges posed by both higher fuel prices and labour contract negotiations. While taking care of customers was our chief focus, we were also able to direct our energies through our corporate priorities toward mitigation and cost-saving efforts and executing our international powerhouse strategy. We will continue through 2012 to act on these priorities, which are serving us well in an industry that is rapidly evolving. Moreover, we will continue to innovate, including by exploring opportunities to participate in the low-cost segment of the leisure market. The company views such participation as important and we continue to assess low-cost options in order to be satisfied that we can remain profitable in this market.

I want to thank those employees who maintained their focus in 2011 on taking care of our customers and delivering them safely and comfortably to their destinations through the year. Moreover, I thank our customers, shareholders and suppliers for their continued support and loyalty. As we celebrate our 75th year of operations we will certainly take the time to recall our proud heritage and our organization's many accomplishments, while ensuring we maintain a steely-eyed focus on the transformation necessary to achieve success tomorrow.



Calin Rovinescu
President and Chief Executive Officer

2. INTRODUCTION

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers to, as the context may require, Air Canada and/or one or more of Air Canada's subsidiaries.

This MD&A provides the reader with a view and analysis, from the perspective of management, of Air Canada's financial results for the fourth quarter of 2011 and the full year 2011. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2011. All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the Handbook of the Canadian Institute of Chartered Accountants – Part 1 ("CICA Handbook"), except for any financial information specifically denoted otherwise.

The CICA Handbook was revised to incorporate International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board, and requires publicly accountable enterprises to apply IFRS effective for years beginning on or after January 1, 2011. As a result of the adoption of IFRS, financial results for periods prior to the adoption of IFRS may no longer be comparable to financial results reported under IFRS. In addition, certain trends in operating results experienced under Canadian GAAP prior to the adoption of IFRS may no longer be extrapolated. In particular, the accounting standards for pension and other employee benefits, depreciation, amortization and impairment expense, and aircraft maintenance expense are significantly affected by the changeover to IFRS.

Starting in the first quarter of 2011, Air Canada revised the presentation of certain operating expenses on the statement of operations. These revisions include a new expense line category within operating expenses referred to as "sales and distribution costs" which includes sales commissions, credit card fees and other sales and distribution costs, including fees paid to global distribution system ("GDS") providers. The expense line category related to capacity purchase agreements has been expanded to include fees paid under all capacity purchase arrangements, including those paid to Jazz Aviation LP ("Jazz") pursuant to the capacity purchase agreement between Air Canada and Jazz (the "Jazz CPA") and those paid to other carriers operating flights on behalf of Air Canada under commercial agreements.

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 21 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 8, 2012.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of this MD&A.

Air Canada issued a news release dated February 9, 2012, reporting on its results for the fourth quarter of 2011 and for the full year 2011. This news release is available on Air Canada's website at **aircanada.com** and on SEDAR's website at **www.sedar.com**. For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at **www.sedar.com**.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

Air Canada's public communications may include written or oral forward-looking statements within the meaning of applicable securities laws. Such statements are included in this MD&A and may be included in other communications, including filings with regulatory authorities and securities regulators. Forward-looking statements may be based on forecasts of future results and estimates of amounts not yet determinable. These statements may involve, but are not limited to, comments relating to strategies, expectations, planned operations or future actions. Forward-looking statements are identified by the use of terms and phrases such as "anticipate", "believe", "could", "estimate", "expect", "intend", "may", "plan", "predict", "project", "will", "would", and similar terms and phrases, including references to assumptions.

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, pension issues, energy prices, employee and labour relations, currency exchange and interest rates, competition, war, terrorist acts, epidemic diseases, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), insurance issues and costs, changes in demand due to the seasonal nature of the business, supply issues, changes in laws, regulatory developments

or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in section 18 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of February 8, 2012 (or as of the date they are otherwise stated to be made), and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Assumptions were made by Air Canada in preparing and making forward-looking statements. Air Canada assumes that the Canadian economy will continue to recover and assumes Canadian GDP growth of 1.5% to 2.0% in 2012. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C$1.01 per U.S. dollar in the first quarter of 2012 and C$1.00 per U.S. dollar for the full year 2012 and that the price of jet fuel will average 88 cents per litre for the first quarter of 2012 and 87 cents per litre for the full year 2012.

3. ABOUT AIR CANADA

Air Canada is Canada's largest domestic, U.S. transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada.

In 2011, Air Canada, together with Jazz and other regional airlines operating flights on behalf of and under commercial agreements with Air Canada (which operate under the brand name "Air Canada Express"), operated, on average, 1,506 daily scheduled flights to 60 destinations in Canada, 57 destinations in the U.S. and 63 destinations in the Canada-Europe, Canada-Pacific, Canada-Caribbean/Central America and Canada-South America markets. Domestic, U.S. transborder and international departures accounted for approximately 67%, 25% and 8%, respectively, of the 1,506 average daily departures. In addition, Air Canada provides certain passenger charter services under the brand name "AC Jetz". In 2011, Air Canada carried almost 34 million passengers and provided passenger service to 180 direct destinations on five continents.

As at December 31, 2011, Air Canada operated a mainline fleet of 205 aircraft comprised of 89 Airbus narrowbody aircraft, 56 Boeing and Airbus widebody aircraft and 60 Embraer regional jets. In addition, under Air Canada's capacity purchase agreement with Jazz (the "Jazz CPA"), Jazz operated, for Air Canada, 126 aircraft comprised of 58 Bombardier regional jets and 68 Dash-8 aircraft.

Air Canada enhances its network through the Jazz CPA, pursuant to which Air Canada purchases the greater part of Jazz's fleet capacity based on predetermined rates and Air Canada determines the routes and schedule which Jazz operates on Air Canada's behalf. Under the Jazz CPA, Jazz operates with smaller jet and turboprop aircraft that have lower trip costs than conventional large jet aircraft, allowing Jazz to provide service to Air Canada's customers in lower density markets as well as in higher density markets throughout Canada and the United States.

Air Canada also offers scheduled passenger services on domestic and Canada-US transborder routes through capacity purchase agreements with other regional carriers, including Sky Regional Airlines, Inc. ("Sky Regional"), which operates, on behalf of Air Canada, between Toronto Island's Billy Bishop Airport and Montreal's International Trudeau Airport. In 2011, such other third party regional carriers under capacity purchase agreements with Air Canada operated 21 aircraft on behalf of Air Canada.

Air Canada is a founding member of the Star Alliance™ network. The Star Alliance network includes 28 member airlines. Through its membership in the Star Alliance network, Air Canada is able to offer its customers access to approximately 1,290 destinations in 189 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Air Canada participates in a transatlantic joint venture with United Air Lines, Inc., Continental Airlines, Inc. (United Air Lines, Inc. and Continental Airlines, Inc. are collectively "United Airlines") and Deutsche Lufthansa AG through which the carriers provide customers with more choice and streamlined service on routings between North and Central America, and Africa, India, Europe and the Middle East. This transatlantic joint venture, including its revenue share structure, was implemented effective January 1, 2010.

Through its long-term relationship with Aeroplan Canada Inc. ("Aeroplan"), Air Canada's frequent flyer program provider, Air Canada is able to build customer loyalty by offering those customers who are Aeroplan® members the opportunity to earn Aeroplan Miles when they fly with Air Canada. Aeroplan is also Air Canada's single largest customer. The relationship with Aeroplan is designed to provide a long-term stable and recurring source of revenue from the purchase by Aeroplan of Air Canada seats to be provided to Aeroplan members who choose to redeem their Aeroplan Miles for air travel rewards.

Air Canada also generates revenue from Air Canada Cargo and from tour operator services provided by its wholly-owned subsidiary, Touram Limited Partnership (doing business as "Air Canada Vacations").

Air Canada Vacations is one of Canada's leading tour operators offering a full range of leisure travel packages including cruises, tours, car rentals and excursions. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, North, Central and South America, South Pacific and Asia) by developing, marketing and distributing vacation travel packages. Air Canada Vacations also offers cruise packages in North America, Europe and the Caribbean.

Air Canada Cargo provides direct cargo services to over 150 Canadian, U.S. transborder and international destinations and has sales representation in over 50 countries. Air Canada Cargo is Canada's largest provider of air cargo services as measured by cargo capacity. Air cargo services are provided on domestic and U.S. transborder flights and on international flights on routes between Canada and major markets in Europe, Asia, South America and Australia.

4. STRATEGY

Air Canada has been pursuing a strategy of profitable growth and sustainability to create value for shareholders and to lower the overall risk profile of the company. The airline continues to focus its activities on improving its revenue performance while increasing its productivity and improving its cost structure with the objective of increasing operating earnings and cash flow. Key components of this strategy are to leverage Air Canada's strengths internationally, reduce costs and generate incremental revenues; profitably provide "best in class" customer services and products, with particular focus on the business traveller, and to transform Air Canada's corporate culture with an emphasis on leadership, accountability and entrepreneurship. Air Canada's goal is to enhance its position as one of the world's leading international carriers.

Leveraging the International Network

In 2010, in anticipation of growing demand for international passenger travel, Air Canada focused on progressively expanding its services in selected international markets while moderating growth in the domestic market. In 2010, capacity in the international markets (including U.S. transborder) increased 10.0%. In 2011, when compared to 2010, capacity growth of 6.6% in international markets (including U.S. transborder) reflected the full year impact of this initiative.

In 2012, Air Canada's focus is to continue leveraging its international network while maintaining a disciplined approach to growth. Air Canada believes it is well positioned to increase its international market by leveraging the following competitive advantages:

- Its widely-recognized brand and its strong position in the market for transatlantic and transpacific travel to and from Canada and the Canada-South America market;
- Its extensive global network, which is enhanced by Air Canada's membership in Star Alliance and by its participation in a transatlantic revenue sharing joint venture;
- Its young fleet, with an average age of 11.6 years at December 31, 2011 (average age of widebody aircraft of 12.3 years);
- Its Aeroplan program, which was voted "Program of the Year in the Americas" at the 2011 Frequent Travelers Awards;
- Its competitive products and services, including lie-flat beds in the Executive First cabin, concierge services and Maple Leaf lounges; and
- Its geographically well-positioned hubs (Toronto, Montreal and Vancouver), which provide natural advantages to serve customers travelling to or from the U.S. to Asia and Europe.

Through its world-class hub at Toronto Pearson International Airport ("Toronto Pearson") and strong international gateways at Montreal and Vancouver, Air Canada intends to grow global connecting traffic via Canada.

With its proximity to densely populated markets and superior facilities, Toronto Pearson provides a clear advantage, on which Air Canada intends to capitalize. Air Canada is working closely with the Greater Toronto Airport Authority ("GTAA") to continue to transform Toronto Pearson into a leading North American airport for international connections. With the consolidation of Air Canada's and most of its Star Alliance partners' operations in one terminal, Toronto Pearson's in-transit facilities now allow passengers to move seamlessly between Canada and U.S. Customs and Immigration.

Air Canada plans to continue to leverage its competitive advantages to capture sixth freedom traffic from the U.S. (meaning U.S. originating traffic carried through points in Canada to other international destinations), particularly from the Eastern U.S. where consumers are already in the habit of connecting to international flights. With its 54% share of passenger traffic at Toronto Pearson, Air Canada has the critical mass needed to attract a large share of traffic between the U.S. and Europe, Asia and Africa. Air Canada currently flies to 50 U.S. destinations from Toronto Pearson, including San Diego, Portland (Oregon), Cincinnati, Memphis, Portland (Maine), Syracuse (New York) and New Orleans, which were all added in 2010.

Air Canada believes that the significant increase in passenger flow that is now travelling from the United States and choosing to connect through the airline's hub airports in Canada to onward international flights is evidence that Air Canada's efforts are yielding results. While all hubs are experiencing connection growth, Toronto Pearson has experienced the highest increase in international connecting traffic with an increase of 110% since 2009.

Air Canada has been intensifying its focus on markets with high growth economies, such as Asia and South America, and has increased its capacity in those markets. Air Canada's decision to add capacity to the China market was also taken in light of Canada being granted Approved Destination Status from China in 2010, a designation that makes it easier for Chinese nationals to visit Canada. China and South America are both important strategic markets for Air Canada and the development of its franchise in those markets continues to be an important element of the airline's business strategy.

The further development of commercial alliances with major international carriers also continues to be an important aspect of Air Canada's business strategy. Through its membership in Star Alliance, which allows the airline to offer its customers a choice of 1,290 airports in 189 countries, Air Canada is expanding its global reach. Air Canada is also strengthening its market presence in North and Central America, Europe, the Middle East, Africa and India through its participation in a transatlantic revenue sharing joint venture with United Airlines and Deutsche Lufthansa AG, referred to as A++. By coordinating pricing, scheduling and sales, Air Canada is better able to serve customers by offering more travel options, while reducing travel times.

Leveraging New Opportunities for Revenue Growth and Cost Transformation

A competitive cost structure is a key element for long-term profitability and sustainability. A key element of Air Canada's business strategy is to pursue sustainable reductions in its cost structure without compromising customer experience and to leverage opportunities for revenue growth.

Pursuing its goal to develop a competitive cost structure, in mid-2009, Air Canada launched a company-wide cost transformation program, referred to as the CTP, with a goal of generating annualized revenue gains and cost savings of $530 million by the end of 2011. Through the renegotiation of various contracts, operating process improvements and productivity gains, Air Canada achieved its overall CTP target of $530 million, on a run-rate basis, by the end of the third quarter of 2011.

The airline continues to seek cost reduction and revenue generating initiatives beyond those achieved through the CTP through its Business Transformation team and other avenues. These initiatives include the use of technology and the streamlining of processes to reduce costs and increase customer satisfaction, and the leveraging of cross branch synergies to find new revenue sources and eliminate waste.

A key structural change in aviation over the past decade has been the proliferation of low-cost carriers. The low-cost model has overwhelmingly been the preferred mode of airline start-ups over the last decade, and their spread around the world, into both the short-haul and long-haul markets has caused a fundamental shift in the competitive dynamic of the industry.

Air Canada views its participation in the low-cost segment of the leisure market as important to the airline. Air Canada is currently evaluating various models that would allow its participation in this market segment. The airline's commercial strategy would focus on: 1) maintaining the appeal of Air Canada's mainline operations for passengers who require a large choice of frequencies and other full service amenities 2) stimulating demand with lower fares and 3) preventing the erosion of passengers on leisure routes through a low-cost carrier venture.

Air Canada also expects to achieve further cost savings starting in 2014 when it is scheduled to begin introducing Boeing 787 aircraft into its fleet. The Boeing 787 aircraft would allow the airline to reduce operating expenses through fuel and maintenance savings, in addition to gaining greater workforce efficiency. These new aircraft will also provide the airline with the ability to serve new markets that it cannot currently serve in an efficient manner. Air Canada is evaluating which and how many of its existing Boeing 767-300 aircraft, which would be more expensive to operate, will be removed from service on lease expiry as the Boeing 787 aircraft are delivered.

Engaging with Customers with a Focus on Premium Passengers and Premium Products

Increasing customer satisfaction levels and growing the airline's premium customer base remain key elements of Air Canada's business strategy. Air Canada's goal is to continuously meet and exceed customer expectations by delivering consistently friendly, professional and "best in class" service.

In 2011, Air Canada was successful in promoting its premium cabin, as evidenced by an 8.3% increase in premium cabin revenues when compared to 2010.

Air Canada was also recognized with the following awards, reflecting both the skill and professionalism of its employees and the quality of its product offerings:

- "Best In-Flight Services in North America" and "Best North American Airline for International Travel" in Business Traveler's "Best in Business Travel" award program, for a fourth consecutive year;
- "Best Airline in North America" in the annual The Global Traveler Reader Survey Awards, based on the responses of more than 25,000 readers of Global Traveler Magazine, for a third consecutive year;
- "Best Flight Experience to Canada from Anywhere in the World" by readers of Executive Travel Magazine in their annual "Leading Edge Awards" readership survey of frequent international travelers, for a fourth consecutive year; and
- "Best International Airline in North America" in a worldwide survey of more than 17 million air travelers conducted by independent research firm, Skytrax, for their 2011 World Airline Awards, for a second consecutive year.

The 2011 Ipsos Reid Business Travel Study also reflected encouraging results with 73% of Canadian business travellers choosing Air Canada as the preferred airline. This was the third consecutive year of improved results, which also registered increases in customer satisfaction and in Air Canada's ranking as the airline used most often.

In 2012, the airline will continue to focus on better managing its premium class cabin to maximize revenues, and seeking new opportunities to increase premium revenues. Air Canada will also look to broaden its access to corporate customers by focusing on small to medium size enterprises. Air Canada believes it maintains a revenue premium that more than offsets the higher costs associated with service to premium passengers.

Enhancing the Corporate Culture and Developing a Strong Employee Brand

Another cornerstone of Air Canada's business strategy and objectives is to transform its corporate culture to one that embraces leadership, accountability and entrepreneurship. Air Canada believes that a healthy, dynamic corporate culture can provide many benefits, including a competitive edge through innovation and customer service, a shared purpose, team cohesiveness, and high employee morale and performance, all of which can have an important impact on a company's long-term performance.

Air Canada experienced difficult labour negotiations in 2011, which diverted focus from this strategic component. Nevertheless, the manner in which employees overcame challenges arising from the labour context was remarkable and a true demonstration that culture change is taking shape at Air Canada. There were countless instances where employees took ownership to resolve customer concerns and where empowered employees acted as true leaders, promoting the Air Canada brand and delivering great customer service despite adversity. Air Canada continues to be awarded many industry honours, proof that employees continue to participate in the airline's transformation and recognize that maintaining high levels of customer satisfaction is fundamental to the airline's success. The emphasis on cost containment is also reinforcing the value placed on a more entrepreneurial culture at Air Canada, one in which all employees are encouraged to act as owners and ambassadors of the airline.

5. OVERVIEW

Air Canada's results of operations for 2011 compared to 2010 are as follows:

- Operating income of $179 million decreased $53 million from 2010 while EBITDAR of $1,242 million declined $144 million, both before a favourable adjustment of $46 million to a provision for cargo investigations in 2010. On a capacity increase of 4.7%, Air Canada experienced strong revenue growth in the year, driven by increased fares and fuel surcharges, however the revenue growth was more than offset by an increase in total operating expenses, the result of significantly higher jet fuel prices year-over-year.
- Operating revenues increased $826 million or 8% from 2010, on passenger revenue growth of 8.3%. The growth in system passenger revenues in 2011 was due to a 4.5% increase in system passenger traffic and a 3.3% improvement in system yield. In 2011, the impact of a stronger Canadian dollar on foreign currency denominated passenger revenues reduced system passenger revenues by $64 million while the impact of the Japan earthquake and its aftermath is believed to have reduced passenger revenues by $28 million. Overall capacity was 4.7% higher than in 2010, reflecting ASM growth in all markets. This system capacity growth was slightly above the 4.0% to 4.5% full year 2011 ASM capacity increase projected in Air Canada's news release dated November 4, 2011 due to fewer weather-related flight cancellations than previously forecasted. System RASM increased 3.2% year-over-year on the yield growth.
- Operating expenses increased $879 million or 8% from 2010, of which $723 million was due to higher fuel expense year-over-year. Excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, CASM decreased 2.9% from 2010. CASM, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, was favourably impacted by the following: a stronger Canadian dollar on foreign currency denominated expenses which reduced operating expenses by $60 million; the 4.7% capacity growth; an increase in both aircraft utilization and stage length of 2.7%; a decrease in depreciation, amortization and impairment expense; a decrease in wages and salaries; and the benefits of the airline's cost transformation program. Partially offsetting these decreases was an increase in employee benefits expense.
- A key element of Air Canada's business strategy is to consistently improve unit revenue and cost productivity. To this end, in early 2009, Air Canada launched a major company-wide cost transformation program (the "CTP") with the objective of achieving annualized revenue improvements and cost savings of $530 million by the end of 2011. As at September 30, 2011, Air Canada had surpassed this CTP target. Air Canada views continuous cost transformation and improvement as one of its most important priorities, and a critical objective going forward to support ongoing unit cost improvements.
- A net loss of $249 million or $0.92 per diluted share was a deterioration of $225 million from the net loss of $24 million or $0.12 per diluted share recorded in 2010. The net loss in 2011 included foreign exchange losses of $54 million while the net loss in 2010 included foreign exchange gains of $184 million, an interest expense charge of $54 million related to the repayment of the term credit facility, an impairment charge on aircraft of $49 million, and the net favourable adjustment to the provision for cargo investigations of $46 million.
- Free cash of $366 million decreased $380 million from 2010, largely due to a decline in net cash from operations of $210 million, higher pension payments of $129 million, and a reduction in cash provided by working capital of $79 million.
- At December 31, 2011, adjusted net debt of $4,576 million decreased $298 million from December 31, 2010. Debt repayments of $608 million in 2011 were funded from positive free cash flow of $366 million and the proceeds from new debt borrowings of $232 million. The favourable impact of foreign exchange on aircraft rent also lowered capitalized operating lease obligations by $126 million in 2011. Cash, cash equivalents and short-term investments totalled $2,099 million as at December 31, 2011, representing 18% of twelve-month trailing operating revenues.

6. RESULTS OF OPERATIONS – FULL YEAR 2011 VERSUS FULL YEAR 2010

The following table and discussion compares the results of Air Canada for the full year of 2011 versus the full year of 2010.

	Full Year		Change	
(Canadian dollars in millions, except per share figures)	2011	2010	$	%
Operating revenues				
Passenger	$ 10,208	$ 9,427	$ 781	8
Cargo	481	466	15	3
Other	923	893	30	3
	11,612	**10,786**	**826**	**8**
Operating expenses				
Aircraft fuel	3,375	2,652	723	27
Wages, salaries, and benefits	1,991	1,913	78	4
Airport and navigation fees	1,007	961	46	5
Capacity purchase agreements	1,003	971	32	3
Depreciation, amortization and impairment	728	801	(73)	(9)
Aircraft maintenance	681	654	27	4
Sales and distribution costs	612	581	31	5
Food, beverages and supplies	278	279	(1)	–
Communications and information technology	193	195	(2)	(1)
Aircraft rent	335	353	(18)	(5)
Other	1,230	1,194	36	3
	11,433	**10,554**	**879**	**8**
Operating income before exceptional item	**179**	**232**	**(53)**	
Provision adjustment for cargo investigations, net[1]	**–**	**46**	**(46)**	
Operating income	**179**	**278**	**(99)**	
Non-operating income (expense)				
Foreign exchange gain (loss)	(54)	184	(238)	
Interest income	36	19	17	
Interest expense	(320)	(397)	77	
Net financing expense relating to employee benefit liabilities	(16)	(75)	59	
Loss on financial instruments recorded at fair value	(63)	(3)	(60)	
Other	(12)	(31)	19	
	(429)	**(303)**	**(126)**	
Loss before income taxes	**(250)**	**(25)**	**(225)**	
Recovery of income taxes	1	1	–	
Loss for the period	**$ (249)**	**$ (24)**	**$ (225)**	
EBITDAR before the provision adjustment for cargo investigations, net[1] [2]	**$ 1,242**	**$ 1,386**	**$ (144)**	
EBITDAR[2]	**$ 1,242**	**$ 1,432**	**$ (190)**	
Loss per share – Diluted	**$ (0.92)**	**$ (0.12)**	**$ (0.80)**	

(1) *In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.*

(2) *See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).*

System passenger revenues increased 8.3% from 2010

Compared to 2010, system passenger revenues increased $781 million or 8.3% to $10,208 million in 2011 due to traffic and yield growth.

The table below provides passenger revenue by geographic region for the full year of 2011 and the full year of 2010.

Passenger Revenue	Full Year 2011 $ Million	Full Year 2010 $ Million	$ Change	% Change
Canada	4,015	3,790	225	5.9
U.S. transborder	2,064	1,797	267	14.8
Atlantic	2,033	1,962	71	3.6
Pacific	1,177	1,087	90	8.3
Other	919	791	128	16.1
System	**10,208**	**9,427**	**781**	**8.3**

The table below provides year-over-year percentage changes in passenger revenues and other operating statistics for the full year of 2011 versus 2010.

Full Year 2011 Versus Full Year 2010	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	5.9	0.3	0.9	0.4	4.7	5.3
U.S. transborder	14.8	6.7	9.8	2.2	4.3	7.3
Atlantic	3.6	5.9	3.8	(1.7)	(0.5)	(2.5)
Pacific	8.3	7.2	5.6	(1.3)	2.3	0.8
Other	16.1	7.1	7.3	0.2	8.1	8.4
System	**8.3**	**4.7**	**4.5**	**(0.1)**	**3.3**	**3.2**

Air Canada increased its overall capacity by 4.7% in 2011. Consistent with a key Air Canada strategy of expanding international operations, international capacity (including the U.S. transborder market) increased 6.6% from 2010. Components of the year-over-year change in full year system passenger revenues included:

- The system traffic increase which reflected growth in all markets. The traffic increase was slightly below the capacity growth, resulting in a minimally lower passenger load factor.
- The system yield increase which reflected growth in all markets, with the exception of the Atlantic. The yield increase was mainly due to increased fares and fuel surcharges to partly offset higher fuel prices. Gains in premium cabin traffic also contributed to the yield improvement.
- The system yield improvement which was achieved in spite of a $64 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated passenger revenues.

The system RASM increase was due to the yield improvement.

Refer to section 7 of this MD&A for year-over-year percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the fourth quarter 2011 and each of the previous four quarters.

Domestic passenger revenues increased 5.9% from 2010

Domestic passenger revenues of $4,015 million in 2011 increased $225 million or 5.9% from 2010 due to yield and traffic growth. The capacity growth in 2011 was mainly due to Air Canada's new service from Toronto Island's Billy Bishop Airport to Montreal Trudeau Airport.

Components of the year-over-year change in domestic passenger revenues included:

- The traffic increase which reflected growth on all major domestic services. The traffic increase was slightly above the capacity growth, resulting in a slightly higher passenger load factor.

- The yield increase which reflected growth on all major domestic services. The yield improvement was mainly due to fuel-related fare increases to partly offset higher fuel prices. The yield improvement was achieved in spite of a $12 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated domestic passenger revenues.

The RASM growth was mainly due to the yield improvement.

U.S. transborder passenger revenues increased 14.8% from 2010

U.S. transborder passenger revenues of $2,064 million in 2011 increased $267 million or 14.8% from 2010 due to traffic and yield growth. The capacity growth in 2011 mainly reflected an increase in frequencies on routes to California, Florida and Las Vegas, as well as the addition of the airline's new service to New Orleans. Components of the year-over-year change in U.S. transborder passenger revenues included:

- The traffic increase which reflected growth on all major U.S. transborder services and was in part due to sixth freedom traffic flows from the U.S. (meaning U.S. originating traffic carried through points in Canada to other international destinations) in support of Air Canada's international expansion initiatives.

- The yield improvement which was due to fuel-related fare increases to offset higher fuel prices. A gain in premium cabin traffic was also a contributing factor. Yield improvements were recorded on all major U.S. transborder services with the exception of routes to Hawaii where a more competitive pricing environment had a negative impact on yields. The yield improvement was achieved in spite of a $31 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated U.S. transborder passenger revenues.

The RASM improvement was due to the higher yield and passenger load factor.

Atlantic passenger revenues increased 3.6% from 2010

Atlantic passenger revenues of $2,033 million in 2011 increased $71 million or 3.6% from 2010 due to traffic growth. The capacity increase in 2011 was mainly due to additional frequencies on summer seasonal routes, including Montreal and Toronto to Athens, Toronto to Barcelona and Madrid, and Toronto to Dublin. In addition, Air Canada operated an additional Montreal to London Heathrow flight, as well as additional frequencies from Toronto to Copenhagen. Air Canada also operated larger aircraft on flights from Toronto to Munich and Zurich and on its Toronto – Montreal to Brussels service. Components of the year-over-year change in Atlantic passenger revenues included:

- The traffic increase which reflected growth on all major Atlantic services, with the exception of routes to the United Kingdom. The U.K. market continued to be challenged by the weak economic environment and additional competitive pricing actions, impacting both local traffic and connecting markets over Air Canada's London gateway. The traffic increase was below the capacity growth, resulting in a lower passenger load factor.

- The yield decline which was mainly due to the impact of increased competition and competitive pricing activities and the continuing weak economic conditions in Europe. Despite this, premium cabin traffic experienced gains when compared to 2010. The yield decline was also due to a $13 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated Atlantic passenger revenues.

The RASM decrease was due to the lower passenger load factor and the decline in yield.

Pacific passenger revenues increased 8.3% from 2010

Pacific passenger revenues of $1,177 million in 2011 increased $90 million or 8.3% from 2010 due to traffic and yield growth. The capacity growth in 2011 mainly reflected a capacity increase on routes to China partly offset by a capacity decrease on routes to Japan. Air Canada estimates that the impact of the Japan earthquake and is aftermath reduced passenger revenues by $28 million in 2011. Components of the year-over-year change in Pacific passenger revenues included:

- The traffic increase which reflected growth on routes to China and Korea and, to a lesser extent, Hong Kong. The traffic increase was below the capacity growth, resulting in a lower passenger load factor.

- The yield improvement which was in part due to yield improvements in the economy cabin on routes to Japan and Korea, as well as to fuel surcharges to offset higher fuel prices. A gain in premium cabin traffic was also a factor in the yield improvement. The yield improvement was achieved in spite of a $5 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated Pacific passenger revenues.

The RASM improvement was due to the yield growth in the economy cabin, combined with overall traffic gains in the premium cabin.

Other passenger revenues increased 16.1% from 2010

Other passenger revenues (comprised of Australia, Caribbean, Mexico and Central and South America) of $919 million in 2011 increased $128 million or 16.1% from 2010, mainly due to yield and traffic growth. In 2011, the capacity growth was largely due to capacity increases on routes to Mexico, Chile and Argentina and, to a lesser extent, on routes to the Caribbean. Components of the year-over-year increase in Other passenger revenues included:

- The overall traffic increase which reflected growth on all major services. The overall traffic increase slightly exceeded the capacity growth, resulting in a minimally higher passenger load factor.

- The overall yield improvement which reflected growth on all major services. The overall yield improvement was due to increased fares and fuel surcharges to partly offset higher fuel prices. Routes to Australia and South America recorded significant yield improvements year-over-year, on stronger passenger demand and increased network flows. A gain in premium cabin traffic was also a factor in the yield improvement. The year-over-year yield improvement was achieved in spite of a $2 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated Other passenger revenues.

The overall RASM improvement was mainly due to the yield growth.

Cargo revenues increased 3.3% from 2010

In the full year of 2011, cargo revenues amounted to $481 million, a $15 million or 3.3% increase from 2010 due to a yield improvement.

The table below provides cargo revenue by geographic region for the full year of 2011 and the full year of 2010.

Cargo Revenue	Full Year 2011 $ Million	Full Year 2010 $ Million	$ Change	% Change
Canada	66	69	(3)	(4.4)
U.S. transborder	17	17	–	0.3
Atlantic	194	164	30	18.2
Pacific	146	164	(18)	(11.1)
Other	58	52	6	12.3
System	**481**	**466**	**15**	**3.3**

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the full year of 2011 versus the full year of 2010.

Full Year 2011 Versus Full Year 2010	Cargo Revenue % Change	Capacity (ETMs) % Change	Rev / ETM % Change	Traffic (RTMs) % Change	Yield / RTM % Change
Canada	(4.4)	(7.1)	2.9	(10.2)	5.3
U.S. transborder	0.3	13.6	(11.7)	(0.2)	0.5
Atlantic	18.2	5.7	11.8	2.1	15.8
Pacific	(11.1)	7.2	(17.1)	(6.4)	(5.0)
Other	12.3	3.1	9.0	3.9	8.0
System	**3.3**	**4.6**	**(1.3)**	**(1.7)**	**5.0**

Components of the year-over-year change in cargo revenues in the full year included:

- The growth in cargo yield which was due to increased fuel surcharges year-over-year. Partially offsetting this increase was the unfavourable impact of a stronger Canadian dollar on foreign currency denominated revenues (mainly U.S. dollars), which reduced cargo revenues by $3 million in 2011.

- The overall decline in cargo traffic which was largely due to a continuing weak economic environment in Asia, in part due to the Japan earthquake and its aftermath.

Refer to section 7 of this MD&A for year-over-year percentage changes in cargo revenues, capacity, revenue per ETM, traffic and yield by quarter for the fourth quarter 2011 and each of the previous four quarters.

Other revenues increased 3% from 2010

Other revenues consist primarily of revenues from the sale of the ground portion of vacation packages, ground handling services, and other airline-related services, as well as revenues related to the lease or sublease of aircraft to third parties.

Other revenues of $923 million in 2011 increased $30 million or 3% from 2010. The growth in other revenues was due to a $33 million increase in third party ground package revenues at Air Canada Vacations, which was mainly due to higher passenger volumes, and by an increase in cancellation and change fees year-over-year. Partly offsetting these increases were a decrease in aircraft sublease revenues due to fewer aircraft being subleased to third parties compared to 2010, and the unfavourable impact of a stronger Canadian dollar on U.S. currency denominated aircraft lease and sublease revenues.

CASM increased 3.5% from 2010. Excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, CASM decreased 2.9% from 2010

The following table compares Air Canada's CASM for the full year of 2011 to Air Canada's CASM for the corresponding period in 2010.

	Full Year		Change	
(cents per ASM)	**2011**	**2010**	**cents**	**%**
Wages and salaries	2.31	2.39	(0.08)	(3.3)
Benefits	0.69	0.62	0.07	11.3
Aircraft fuel	5.08	4.18	0.90	21.5
Airport and navigation fees	1.52	1.51	0.01	0.7
Capacity purchase agreements	1.51	1.53	(0.02)	(1.3)
Ownership (DAR)[1]	1.60	1.82	(0.22)	(12.1)
Aircraft maintenance	1.03	1.03	–	–
Sales and distribution costs	0.92	0.92	–	–
Food, beverages and supplies	0.42	0.44	(0.02)	(4.5)
Communications and information technology	0.29	0.31	(0.02)	(6.5)
Other	1.83	1.87	(0.04)	(2.1)
Total operating expense	**17.20**	**16.62**	**0.58**	**3.5**
Remove:				
Cost of fuel expense and cost of ground packages at Air Canada Vacations	(5.54)	(4.61)	(0.93)	20.2
Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations[2]	**11.66**	**12.01**	**(0.35)**	**(2.9)**

(1) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expenses.

(2) Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

The main factors contributing to the year-over-year change in CASM, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, in the full year included:

- The favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), which reduced operating expenses by $60 million;
- The 4.7% capacity growth, which resulted in the airline's fixed costs being allocated over a greater number of ASMs;
- An increase in both aircraft utilization and average stage length of 2.7%;
- A decrease in depreciation, amortization and impairment expense;
- A decrease in wages and salaries largely reflecting reduced expenses related to incentive compensation programs partly offset by higher average salaries; and
- The impact of CTP initiatives which reduced various operating expense categories, including: wages and salaries, capacity purchase costs, food, beverage and supplies, communications and information technology and other operating expenses.

These above-noted decreases were partly offset by an increase in employee benefits expense.

Excluding fuel expense, CASM decreased 2.6% from 2010. The 2.6% decrease in CASM, excluding fuel expense, was in line with the 2.0% to 3.0% decrease projected in Air Canada's news release dated November 4, 2011.

Operating expenses increased 8% from 2010

Air Canada recorded operating expenses of $11,433 million, an increase of $879 million or 8% from the operating expenses of $10,554 million recorded in 2010. The more significant variances are discussed below.

Fuel expense increased 27% from 2010

Fuel expense amounted to $3,375 million in 2011, an increase of $723 million or 27% from 2010. Factors contributing to the year-over-year change in fuel expense included:

- A higher base fuel price, which accounted for an increase of $973 million; and
- A higher volume of fuel consumed, which was driven by the additional capacity year-over-year, and which accounted for an increase of $93 million.

The above-noted increases were partly offset by the following:

- Fuel hedging losses reclassified from AOCL of $183 million in 2010 versus no fuel hedging losses recorded in fuel expense in 2011, resulting in a favourable variance of $183 million year-over-year; and
- The favourable impact of a stronger Canadian dollar versus the U.S. dollar which accounted for a decrease of $160 million.

The table below provides Air Canada's fuel cost per litre, excluding and including hedging, for the periods indicated.

	Full Year		Change	
(Canadian dollars in millions, except where indicated)	**2011**	**2010**	**$**	**%**
Aircraft fuel expense – GAAP[1]	$ 3,349	$ 2,638	$ 711	27
Remove: Fuel hedging losses reclassified from AOCL into fuel expense	–	(183)	183	100
Add: Net cash payments on fuel derivatives[2]	4	60	(56)	(93)
Economic cost of fuel – Non-GAAP[3]	**$ 3,353**	**$ 2,515**	**$ 838**	**33**
Fuel consumption (thousands of litres)	3,937,102	3,790,911	146,191	4
Fuel costs per litre (cents) – GAAP	85.1	69.6	15.5	22
Fuel costs per litre (cents) – excluding fuel hedging losses	85.1	64.8	20.3	31
Economic fuel costs per litre (cents) – Non-GAAP	85.2	66.4	18.8	28

(1) Excludes fuel expense related to third party carriers, other than Jazz, operating under capacity purchase agreements.

(2) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives. Excludes early terminated hedging contracts of $5 million in the second quarter of 2010 covering 2010 consumption.

(3) The economic cost of fuel is a non-GAAP measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada uses this measure to calculate its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives. It excludes non-cash accounting gains and losses from fuel derivative instruments.

Wages, salaries and benefits expense amounted to $1,991 million in 2011, an increase of $78 million or 4% from 2010

Wages and salaries expense amounted to $1,533 million in 2011, an increase of $12 million or 1% from 2010, mainly due to higher average salaries and an increase in the average number of FTE employees year-over-year. On capacity growth of 4.7%, the average number of FTE employees increased 2.1% year-over-year, resulting in a productivity improvement of 2.5%, as measured by ASMs per FTE employee. Partly offsetting these increases was a decrease in expenses related to incentive compensation programs, including those linked to Air Canada's operational performance.

Employee benefits expense amounted to $458 million in 2011, an increase of $66 million or 17% from 2010. The increase in employee benefits expense was mainly due to higher pension and post-employment expenses resulting from changes in actuarial assumptions year-over-year. The $66 million increase in employee benefits expense was slightly above the increase of $60 million projected in Air Canada's news release dated November 4, 2011.

Airport and navigation fees increased 5% from 2010

Airport and navigation fees amounted to $1,007 million in 2011, an increase of $46 million or 5% from 2010. This increase was mainly due to a 2.5% increase in aircraft departures, the impact of changes in schedule and aircraft types operated to certain destinations and to an increase in terminal user fees, effective April 1, 2011, at London Heathrow Airport. Costs associated with Air Canada's new services operated by Sky Regional between Billy Bishop Toronto City Airport and Montreal Trudeau Airport were also contributing factors to this increase.

Capacity purchase costs increased 3% from 2010

Capacity purchase costs amounted to $1,003 million in 2011 compared to $971 million in 2010, an increase of $32 million or 3%. This increase was mainly due to higher Jazz CPA rates, increased flying by Jazz, and costs associated with Air Canada's new services operated by Sky Regional between Billy Bishop Toronto City Airport and Montreal Trudeau Airport. Partly offsetting these increases was the favourable impact of foreign exchange on U.S. currency denominated Jazz CPA charges paid by Air Canada, which accounted for a decrease of $13 million in capacity purchase costs in 2011. In addition, in 2010, Air Canada recorded a charge of $7 million related to Jazz covered aircraft returns while no such charge was recorded in 2011.

Ownership costs decreased 8% from 2010

Ownership costs, which are comprised of depreciation, amortization and impairment, and aircraft rent expenses, of $1,063 million in 2011 decreased $91 million or 8% from the same period in 2010. This decrease was largely due to Air Canada having recorded an impairment charge of $49 million relating to Airbus A340-300 and Boeing 767-200 aircraft in 2010 while no such charge was recorded in 2011. Other contributing factors included the favourable impact of a stronger Canadian dollar versus the U.S. dollar, which reduced aircraft rent expense by $18 million, the impact of lower rates associated with leased Airbus A320 aircraft, as well as decreases in software amortization costs and depreciation expense on rotable aircraft parts. Costs associated with the airline's new services between Billy Bishop Toronto City Airport and Montreal Trudeau Airport partly offset these decreases. The $73 million decrease in depreciation, amortization and impairment expense was essentially in line with the decrease of $75 million projected in Air Canada's news release dated November 4, 2011.

Aircraft maintenance expense increased 4% from 2010

In 2011, aircraft maintenance expense of $681 million increased $27 million or 4% from 2010, of which $20 million was due to changes in cost and discount rate assumptions for provisions related to end of lease maintenance return conditions. A higher volume of engine maintenance events and an increase in maintenance cost obligations related to aircraft lease terminations were also contributing factors to the increase in aircraft maintenance expense versus 2010. Partly offsetting these increases were a decrease in components maintenance activity and the favourable impact of a stronger Canadian dollar on U.S. currency denominated maintenance expenses. The 4% increase in aircraft maintenance expense was in line with the increase of 4.0% to 5.0% projected in Air Canada's news release dated November 4, 2011.

Sales and distribution costs increased 5% from 2010

In 2011, sales and distribution costs of $612 million increased $31 million or 5% from 2010. Factors contributing to the year-over-year change in sales and distribution costs in the full year included:

- The passenger revenue growth of 8.3%;
- An increase in credit card fees which was due to higher passenger sales and an increase in the percentage of sales made on credit cards; and
- An increase in sales and distribution costs at Air Canada Vacations which was due to a change in commission structure and higher passenger sales.

Food, beverages and supplies expense decreased $1 million from 2010

In 2011, food, beverages and supplies expense of $278 million decreased $1 million from 2010. The impact of growth in passenger traffic, including in the premium class cabin, was offset by the favourable impact of cost reduction initiatives, most of which are related to contract and process improvements.

Other operating expenses increased 3% from 2010

Other operating expenses amounted to $1,230 million in 2011, an increase of $36 million or 3% from 2010.

The following table provides a breakdown of the more significant items included in other expenses:

	Full Year		Change	
(Canadian dollars in millions)	**2011**	**2010**	**$**	**%**
Air Canada Vacations' land costs	$ 307	$ 272	$ 35	13
Terminal handling	193	185	8	4
Building rent and maintenance	127	126	1	1
Crew cycle	115	117	(2)	(2)
Miscellaneous fees and services	108	110	(2)	(1)
Remaining other expenses	380	384	(4)	(1)
	$ 1,230	**$ 1,194**	**$ 36**	**3**

Factors contributing to the year-over-year change in Other expenses in the full year included:

- The 4.7% growth in capacity;
- An increase of $35 million or 13% in expenses related to ground packages at Air Canada Vacations which was due to increased passenger volumes;
- An increase of $8 million or 4% in terminal handling expenses which was largely due to a 2.5% increase in system frequencies and to costs associated with Air Canada's new service between Billy Bishop Toronto City Airport and Montreal Trudeau Airport; and
- The favourable impact of CTP initiatives which reduced various other operating expenses.

Non-operating expense amounted to $429 million in 2011 compared to non-operating expense of $303 million in 2010

The following table provides a breakdown of non-operating expenses for the periods indicated:

	Full Year		Change
(Canadian dollars in millions)	**2011**	**2010**	**$**
Foreign exchange gain (loss)	$ (54)	$ 184	$ (238)
Interest income	36	19	17
Interest expense	(320)	(397)	77
Net financing expense relating to employee benefit liabilities	(16)	(75)	59
Loss on financial instruments recorded at fair value	(63)	(3)	(60)
Other	(12)	(31)	19
	$ (429)	**$ (303)**	**$ (126)**

Factors contributing to the year-over-year increase in non-operating expense in the full year included:

- Losses on foreign exchange (mainly related to U.S. currency denominated long-term debt) which amounted to $54 million in 2011 compared to gains of $184 million in 2010. The losses in 2011 were mainly attributable to a weaker Canadian dollar at December 31, 2011 compared to December 31, 2010. The December 31, 2011 closing exchange rate was US$1 = C$1.017 while the December 31, 2010 closing exchange rate was US$1 = C$0.9946.
- An increase in interest income of $17 million which was mainly due to higher returns on investments.

- A decrease in interest expense of $77 million which was mainly due to Air Canada having recorded a charge of $54 million related to the repayment of its secured term credit facility in 2010 while no such charge was recorded in 2011, as well as higher debt repayments year-over-year. The impact of net debt repayments made in 2011, the impact of lower interest rates, and the favourable impact of a stronger Canadian dollar on U.S. currency denominated interest expense when compared to 2010 were also contributing factors in the decrease in interest expense year-over-year.
- A decrease in net financing expense relating to employee benefit liabilities of $59 million which was due to a decline in the discount rate used to measure the expense.
- Losses related to fair value adjustments on derivative instruments which amounted to $63 million in 2011 versus losses of $3 million in 2010. Refer to section 12 of this MD&A for additional information.

7. RESULTS OF OPERATIONS – FOURTH QUARTER 2011 VERSUS FOURTH QUARTER 2010

The following table and discussion compares the results of Air Canada for the fourth quarter of 2011 versus the fourth quarter of 2010.

	Fourth Quarter		Change	
(Canadian dollars in millions, except per share figures)	2011	2010	$	%
Operating revenues				
Passenger	$ 2,374	$ 2,296	$ 78	3
Cargo	125	124	1	1
Other	200	196	4	2
	2,699	**2,616**	**83**	**3**
Operating expenses				
Aircraft fuel	808	640	168	26
Wages, salaries, and benefits	501	487	14	3
Airport and navigation fees	237	229	8	3
Capacity purchase agreements	251	241	10	4
Depreciation, amortization and impairment	174	227	(53)	(23)
Aircraft maintenance	212	164	48	29
Sales and distribution costs	140	146	(6)	(4)
Food, beverages and supplies	53	54	(1)	(2)
Communications and information technology	48	50	(2)	(4)
Aircraft rent	86	86	–	–
Other	287	277	10	4
	2,797	**2,601**	**196**	**8**
Operating income (loss) before exceptional item	**(98)**	**15**	**(113)**	
Provision adjustment for cargo investigations, net[1]	**–**	**46**	**(46)**	
Operating income (loss)	**(98)**	**61**	**(159)**	
Non-operating income (expense)				
Foreign exchange gain	114	136	(22)	
Interest income	10	9	1	
Interest expense	(76)	(86)	10	
Net financing expense relating to employee benefit liabilities	(4)	(18)	14	
Gain (loss) on financial instruments recorded at fair value	(5)	8	(13)	
Other	(1)	(21)	20	
	38	**28**	**10**	
Income (loss) before income taxes	**(60)**	**89**	**(149)**	
Recovery of (provision for) income taxes	–	–	–	
Net income (loss) for the period	**$ (60)**	**$ 89**	**$ (149)**	
EBITDAR before the provision adjustment for cargo investigations, net[1] [2]	**$ 162**	**$ 328**	**$ (166)**	
EBITDAR[2]	**$ 162**	**$ 374**	**$ (212)**	
Net income (loss) per share – Diluted	**$ (0.22)**	**$ 0.27**	**$ (0.49)**	

(1) *In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.*

(2) *See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).*

System passenger revenues increased 3.4% from the fourth quarter of 2010

System passenger revenues of $2,374 million in the fourth quarter of 2011 increased $78 million or 3.4% from 2010 fourth quarter passenger revenues of $2,296 million. Fourth quarter 2010 passenger revenues included a favourable annual adjustment of $40 million related to the airline's transatlantic joint venture with United Airlines and Deutsche Lufthansa AG, which was finalized in December 2010 but with effect as of January 1, 2010, and to other interline agreements. For comparative purposes, the tables and the discussion below excludes the impact of the $40 million favourable adjustment recorded in the fourth quarter of 2010, which related to activities attributable to the first three quarters of 2010.

System passenger revenues of $2,374 million in the fourth quarter of 2011 increased $118 million or 5.2% from the adjusted fourth quarter passenger revenues of $2,256 million in 2010, due to traffic and yield growth. Premium cabin revenues increased $23 million or 4.5% from the fourth quarter of 2010 due to a traffic increase of 8.2% as yield declined 2.2%.

The table below provides passenger revenue by geographic region for the fourth quarter of 2011 and the fourth quarter of 2010.

Passenger Revenue	Fourth Quarter 2011 $ Million	Fourth Quarter 2010 $ Million	$ Change	% Change
Canada	981	950	31	3.2
U.S. transborder	500	448	52	11.6
Atlantic	400	404	(4)	(1.0)
Pacific	279	261	18	6.9
Other	214	193	21	11.1
System	**2,374**	**2,256**	**118**	**5.2**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the fourth quarter of 2011 versus the fourth quarter of 2010.

Fourth Quarter 2011 Versus Fourth Quarter 2010	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	3.2	2.1	2.1	–	0.4	0.4
U.S. transborder	11.6	3.2	5.3	1.4	5.4	7.4
Atlantic	(1.0)	2.2	1.2	(0.8)	(3.1)	(4.0)
Pacific	6.9	1.4	1.6	0.1	4.7	4.9
Other	11.1	4.6	4.9	0.2	5.7	5.9
System	**5.2**	**2.5**	**2.6**	**0.1**	**1.9**	**2.0**

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q4'10	Q1'11	Q2'11	Q3'11	Q4'11
Passenger Revenues	11.2	10.3	11.7	7.9	5.2
Capacity (ASMs)	7.8	7.7	6.4	2.6	2.5
Traffic (RPMs)	8.0	5.7	6.1	3.8	2.6
Passenger Load Factor (pp Change)	0.2	(1.5)	(0.2)	1.1	0.1
Yield	2.8	4.2	5.2	3.8	1.9
RASM	3.0	2.2	4.9	5.1	2.0

In the fourth quarter of 2011, Air Canada's overall capacity was 2.5% higher than the fourth quarter of 2010, with capacity growth reflected in all markets. The system capacity growth was in line with the 1.5% to 2.5% fourth quarter 2011 ASM capacity increase projected in Air Canada's news release dated November 4, 2011.

Components of the year-over-year change in fourth quarter system passenger revenues included:

- The system traffic increase which reflected growth in all markets. The traffic increase was slightly above the capacity growth, resulting in a minimally higher passenger load factor.
- The system yield growth which reflected growth in all markets, with the exception of the Atlantic. The overall yield improvement was due to increased fares and fuel surcharges to partly offset higher fuel costs.

The adjusted system RASM improvement was mainly due to the higher yield.

Domestic passenger revenues increased 3.2% from the fourth quarter of 2010

Domestic passenger revenues of $981 million in the fourth quarter of 2011 increased $31 million or 3.2% from the fourth quarter of 2010 due to traffic growth and, to a lesser extent, a yield improvement.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q4'10	Q1'11	Q2'11	Q3'11	Q4'11
Passenger Revenues	7.5	8.4	7.9	4.7	3.2
Capacity (ASMs)	0.2	(0.9)	(0.2)	0.3	2.1
Traffic (RPMs)	2.0	(0.5)	(0.6)	2.1	2.1
Passenger Load Factor (pp Change)	1.4	0.4	(0.3)	1.5	–
Yield	5.3	8.7	8.4	2.4	0.4
RASM	7.1	9.2	8.0	4.3	0.4

On May 1, 2011, Sky Regional, on behalf of Air Canada, began operating 15 daily flights from Toronto Island's Billy Bishop Airport to Montreal's Pierre Elliott Trudeau International Airport ("Montreal Trudeau Airport"). The domestic capacity growth in the fourth quarter of 2011 was mainly due to this new service and to an increase in frequencies on Air Canada's Toronto-Vancouver service. Components of the year-over-year change in fourth quarter domestic passenger revenues included:

- The traffic increase which reflected growth on all major domestic services. The traffic gains were in line with the capacity growth, resulting in a passenger load factor unchanged from the fourth quarter of 2010.
- The yield improvement which was due to fuel-related fare increases to partly offset higher fuel prices.

The RASM improvement reflected the higher yield as passenger load factor was unchanged from the fourth quarter of 2010.

U.S. transborder passenger revenues increased 11.6% from the fourth quarter of 2010

U.S. transborder passenger revenues of $500 million in the fourth quarter of 2011 increased $52 million or 11.6% from the fourth quarter of 2010 due to yield and traffic growth.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

U.S. Transborder	Year-over-Year by Quarter (% Change)				
	Q4'10	Q1'11	Q2'11	Q3'11	Q4'11
Passenger Revenues	10.7	14.5	20.2	13.2	11.6
Capacity (ASMs)	11.7	10.8	7.8	4.7	3.2
Traffic (RPMs)	12.0	11.5	12.9	9.3	5.3
Passenger Load Factor (pp Change)	0.2	0.4	3.5	3.4	1.4
Yield	(1.3)	2.5	6.4	3.4	5.4
RASM	(1.0)	3.1	11.4	8.0	7.4

In the fourth quarter of 2011, the growth in capacity was largely due to an increase in frequencies on routes to California, Florida, Las Vegas and Hawaii.

Components of the year-over-year change in fourth quarter U.S. transborder passenger revenues included:

- The traffic increase which reflected growth on all major U.S. transborder services and was in part due to sixth freedom traffic flows from the U.S. (meaning U.S. originating traffic carried through points in Canada to other international destinations) in support of Air Canada's international expansion initiatives. The traffic gains exceeded the capacity growth, resulting in a higher passenger load factor.
- The yield improvement which reflected growth on all major U.S. transborder services. The yield improvement was due to fuel-related fare increases to offset higher fuel prices.

The RASM improvement was due to the higher yield and passenger load factor.

Atlantic passenger revenues decreased 1.0% from the fourth quarter of 2010

For comparative purposes, the table and the discussion below regarding the Atlantic market excludes the impact of the $40 million favourable adjustment recorded in the fourth quarter of 2010, which related to activities attributable to the first three quarters of 2010.

On an adjusted basis, Atlantic passenger revenues of $400 million in the fourth quarter of 2011 decreased $4 million or 1.0% from the fourth quarter of 2010 due to a yield decline.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q4'10	Q1'11	Q2'11	Q3'11	Q4'11
Passenger Revenues	7.5	0.8	11.6	8.2	(1.0)
Capacity (ASMs)	5.5	6.2	12.3	3.6	2.2
Traffic (RPMs)	2.5	(0.8)	8.4	4.1	1.2
Passenger Load Factor (pp Change)	(2.2)	(5.0)	(3.0)	0.5	(0.8)
Yield	4.7	1.3	2.7	3.8	(3.1)
RASM	1.7	(5.4)	(0.8)	4.3	(4.0)

In the fourth quarter of 2011, the growth in capacity year-over-year was mainly due to extended operations on summer seasonal routes, including Greece, Spain, Italy and St. John's, Newfoundland to London. Additional frequencies to Brussels and, the use of larger aircraft on routes to Germany also contributed to the capacity growth.

Components of the year-over-year change in fourth quarter Atlantic passenger revenues included:

- The traffic increase which reflected growth on all major Atlantic services, with the exception of routes to the United Kingdom. Traffic on routes to the U.K. continued to be challenged by the weak economic environment in the U.K. and additional competitive pricing actions, impacting both local traffic and connecting markets over Air Canada's London gateway. The traffic gains did not meet the capacity growth, resulting in a lower passenger load factor.

- The adjusted yield decline which was due in part to the impact of increased competitive activities and continued weak economic conditions in Europe, especially in some of our core markets; UK, France, and Germany. Approximately 30% of our Atlantic revenues are generated from point of sale Europe.

The adjusted RASM decline was due to the lower yield and passenger load factor.

Pacific passenger revenues increased 6.9% from the fourth quarter of 2010

Pacific passenger revenues of $279 million in the fourth quarter of 2011 increased $18 million or 6.9% from the fourth quarter of 2010, mainly due to yield and traffic growth.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q4'10	Q1'11	Q2'11	Q3'11	Q4'11
Passenger Revenues	31.7	17.0	6.4	5.8	6.9
Capacity (ASMs)	23.0	21.5	7.2	2.0	1.4
Traffic (RPMs)	22.9	16.0	5.9	1.5	1.6
Passenger Load Factor (pp Change)	(0.1)	(4.0)	(1.1)	(0.5)	0.1
Yield	7.2	0.7	0.4	4.2	4.7
RASM	7.0	(3.9)	(0.8)	3.6	4.9

In the fourth quarter of 2011, the increase in Pacific capacity mainly reflected a capacity increase on routes to Korea.

Components of the year-over-year change in fourth quarter Pacific passenger revenues included:

- The traffic increase which reflected growth on routes to China and Korea. The traffic growth was slightly higher than the capacity growth, resulting in a higher passenger load factor.

- The yield increase which reflected growth on all major Pacific services. The yield growth was due to fare improvements, gains in premium cabin traffic, and to increased fuel surcharges to partly offset higher fuel prices.

The RASM improvement was mainly due to stronger yields on routes to China.

Other passenger revenues increased 11.1% from the fourth quarter of 2010

Other passenger revenues (comprised of routes to Australia, the Caribbean, Mexico, Central and South America) of $214 million in the fourth quarter of 2011 increased $21 million or 11.1% from the fourth quarter of 2010 due to yield and traffic growth.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q4'10	Q1'11	Q2'11	Q3'11	Q4'11
Passenger Revenues	15.4	16.4	20.7	16.9	11.1
Capacity (ASMs)	7.2	9.1	8.6	5.3	4.6
Traffic (RPMs)	9.4	7.7	10.9	5.8	4.9
Passenger Load Factor (pp Change)	1.6	(1.1)	1.7	0.4	0.2
Yield	5.4	8.1	9.0	10.4	5.7
RASM	7.5	6.7	11.4	11.0	5.9

In the fourth quarter of 2011, the capacity growth was largely due to capacity increases on routes to South America. Components of the year-over-year change in fourth quarter Other passenger revenues included:

- The overall traffic increase which reflected growth on all major services. The overall traffic increase slightly exceeded the capacity growth, resulting in a higher passenger load factor.
- The overall yield improvement which was due to increased fares and fuel surcharges to partly offset higher fuel prices. A gain in premium cabin traffic was also a factor in the yield improvement. Routes to Australia and South America recorded significant yield improvements year-over-year, on stronger passenger demand and increased network flows.

The overall RASM improvement was mainly due to the yield growth.

Cargo revenues increased 1.2% from the fourth quarter of 2010

Cargo revenues of $125 million in the fourth quarter of 2011 increased $1 million or 1.2% from the fourth quarter of 2010 due to yield growth.

The table below provides cargo revenue by geographic region for the fourth quarter of 2011 and the fourth quarter of 2010.

Cargo Revenue	Fourth Quarter 2011 $ Million	Fourth Quarter 2010 $ Million	$ Change	% Change
Canada	16	17	(1)	(2.4)
U.S. transborder	5	5	–	(2.5)
Atlantic	47	45	2	5.1
Pacific	40	42	(2)	(6.0)
Other	17	15	2	13.6
System	**125**	**124**	**1**	**1.2**

The table below provides year-over-year percentage changes in system cargo revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q4'10	Q1'11	Q2'11	Q3'11	Q4'11
Cargo Revenues	13.0	12.0	3.8	(1.7)	1.2
Capacity (ETMs)	7.7	7.4	7.0	1.9	2.5
Revenue per ETM	3.9	3.3	(3.1)	(3.5)	(1.3)
Traffic (RTMs)	10.0	5.8	(2.4)	(7.7)	(0.4)
Yield per RTM	1.6	4.9	6.3	6.5	1.6

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the fourth quarter of 2011 versus the fourth quarter of 2010.

Fourth Quarter 2011 Versus Fourth Quarter 2010	Cargo Revenue % Change	Capacity (ETMs) % Change	Rev / ETM % Change	Traffic (RTMs) % Change	Yield / RTM % Change
Canada	(2.4)	3.5	(5.7)	1.6	(4.0)
U.S. transborder	(2.5)	6.0	(8.0)	(7.4)	5.4
Atlantic	5.1	2.0	3.1	(6.6)	12.6
Pacific	(6.0)	1.8	(7.7)	2.7	(8.5)
Other	13.6	3.2	10.1	11.1	2.3
System	**1.2**	**2.5**	**(1.3)**	**(0.4)**	**1.6**

Components of the year-over-year change in fourth quarter cargo revenues included:

- The yield improvement which was mainly due to higher fuel surcharges year-over-year.
- The traffic decline which was mainly due to the adverse impact of increased industry capacity on Atlantic services. Following three quarters of year-over-year declines resulting from the earthquake in Japan and its aftermath, the Pacific reflected a recovery in cargo traffic, where pricing actions were taken to stimulate demand.

Other revenues increased 2% from the fourth quarter of 2010

Other revenues of $200 million in the fourth quarter of 2011 increased $4 million or 2% from the fourth quarter of 2010. The growth in other revenues was due to a $6 million increase in third party ground package revenues at Air Canada Vacations. This increase in third party revenues at Air Canada Vacations was due to a higher selling price of ground packages and, to a lesser extent, an increase in passenger volumes.

CASM increased 4.9% from the fourth quarter of 2010. Excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, CASM decreased 1.5% from the fourth quarter of 2010

The following table compares Air Canada's CASM for the fourth quarter of 2011 to Air Canada's CASM for the corresponding period in 2010.

	Fourth Quarter		Change	
(cents per ASM)	**2011**	**2010**	**cents**	**%**
Wages and salaries	2.57	2.69	(0.12)	(4.5)
Benefits	0.71	0.58	0.13	22.4
Aircraft fuel	5.29	4.29	1.00	23.3
Airport and navigation fees	1.55	1.54	0.01	0.6
Capacity purchase agreements	1.65	1.62	0.03	1.9
Ownership (DAR)[1]	1.70	2.10	(0.40)	(19.0)
Aircraft maintenance	1.39	1.10	0.29	26.4
Sales and distribution costs	0.92	0.98	(0.06)	(6.1)
Food, beverages and supplies	0.35	0.37	(0.02)	(5.4)
Communications and information technology	0.31	0.34	(0.03)	(8.8)
Other	1.85	1.83	0.02	1.1
Total operating expense	**18.29**	**17.44**	**0.85**	**4.9**
Remove:				
Cost of fuel expense and cost of ground packages at Air Canada Vacations	(5.66)	(4.62)	(1.04)	22.5
Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations[2]	**12.63**	**12.82**	**(0.19)**	**(1.5)**

(1) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expenses.

(2) Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

The main factors contributing to the year-over-year change in fourth quarter CASM, excluding fuel and the cost of ground packages at Air Canada Vacations, included:

- A decrease in depreciation, amortization and impairment expense;
- A decrease in wages and salaries largely reflecting reduced expenses related to incentive compensation programs partly offset by higher average salaries;
- The 2.5% capacity growth, which resulted in Air Canada's fixed costs being allocated over a greater number of ASMs; and
- An increase in average stage length of 0.8%.

These above-noted decreases were partly offset by an increase in aircraft maintenance expense and an increase in employee benefits expense.

Excluding fuel expense, CASM decreased 1.1% from the fourth quarter of 2010. The 1.1% decrease in CASM, excluding fuel expense, was better than the 0.5% to 1.0% increase projected in Air Canada's news release dated November 4, 2011. The better than expected performance was mainly due to lower than forecasted food, beverages and supplies expense and depreciation, amortization and impairment expense.

Operating expenses increased 8% from the fourth quarter of 2010

Air Canada recorded operating expenses of $2,797 million, an increase of $196 million or 8% from the operating expenses of $2,601 million recorded in the fourth quarter of 2010. The more significant variances are discussed below.

Fuel expense increased 26% from the fourth quarter of 2010

Fuel expense of $808 million in the fourth quarter of 2011, increased $168 million or 26% from the fourth quarter of 2010, mainly due to higher base fuel prices which accounted for an increase of $200 million year-over year. Fuel hedging losses of $31 million were reclassified from Accumulated Other Comprehensive Loss ("AOCL") to fuel expense in the fourth quarter of 2010 while no fuel hedging losses were recorded in fuel expense in the fourth quarter of 2011, resulting in a favourable variance of $31 million year-over-year.

The table below provides Air Canada's fuel cost per litre, excluding and including discontinued hedge accounting reclassifications, for the periods indicated.

		Fourth Quarter		Change	
(Canadian dollars in millions, except where indicated)		2011	2010	$	%
Aircraft fuel expense – GAAP[1]		$ 801	$ 636	$ 165	26
Remove:	Fuel hedging losses reclassified from AOCL into fuel expense	–	(31)	31	100
Add:	Net cash payments on fuel derivatives[2]	8	7	1	14
Economic cost of fuel – Non-GAAP[3]		**$ 809**	**$ 612**	**$ 197**	**32**
Fuel consumption (thousands of litres)		912,423	905,519	6,904	1
Fuel costs per litre (cents) – GAAP		87.7	70.2	17.5	25
Fuel costs per litre (cents) – excluding fuel hedging losses		87.7	66.8	20.9	31
Economic fuel costs per litre (cents) – Non-GAAP		88.6	67.5	21.1	31

(1) Excludes fuel expense related to third party carriers, other than Jazz, operating under capacity purchase agreements.

(2) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives.

(3) The economic cost of fuel is a non-GAAP measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada uses this measure to calculate its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives. It excludes non-cash accounting gains and losses from fuel derivative instruments.

Wages, salaries and benefits expense amounted to $501 million in the fourth quarter of 2011, an increase of $14 million or 3% from the fourth quarter of 2010

Wages and salaries expense amounted to $392 million in the fourth quarter of 2011, a decline of $9 million or 2% from the fourth quarter of 2010. A decrease in expenses related to incentive compensation programs was partly offset by the impact of higher average salaries year-over-year and an increase in the average number of full-time equivalent ("FTE") employees from the fourth quarter of 2010. On capacity growth of 2.5%, the average number of FTE employees, increased 1.5% year-over-year, resulting in a productivity improvement of 1.0%, as measured by ASMs per FTE employee.

Employee benefits expense amounted to $109 million in the fourth quarter of 2011, an increase of $23 million or 27% from the fourth quarter of 2010, in large part due to an increase in pension and post-employment benefits expenses resulting from changes in actuarial assumptions year-over-year. An increase of $5 million related to an updated valuation of workers' compensation liabilities was also a factor in the increase in employee benefits expense.

Airport and navigation fees increased 3% from the fourth quarter of 2010

Airport and navigation fees amounted to $237 million in the fourth quarter of 2011, an increase of $8 million or 3% from the fourth quarter of 2010. This increase was mainly due to a growth of 1.3% in aircraft departures, the impact of changes in schedule and aircraft types operated to certain destinations, as well as an increase in terminal user fees, effective April 1, 2011, at London Heathrow Airport. Costs associated with Air Canada's new services operated by Sky Regional between Billy Bishop Toronto City Airport and Montreal Trudeau Airport also contributed to the increase.

Capacity purchase costs increased 4% from the fourth quarter of 2010

Capacity purchase costs amounted to $251 million in the fourth quarter of 2011 compared to $241 million in the fourth quarter of 2010, an increase of $10 million or 4%. This increase was mainly due to higher Jazz CPA rates and costs associated with Air Canada's new services operated by Sky Regional between Billy Bishop Toronto City Airport and Montreal Trudeau Airport.

Ownership costs decreased 17% from the fourth quarter of 2010

Ownership costs, which are comprised of depreciation, amortization and impairment, and aircraft rent expenses, of $260 million in the fourth quarter of 2011 declined $53 million or 17% from the fourth quarter of 2010. This decrease was due to Air Canada having recorded an impairment charge of $49 million relating to Airbus A340-300 and Boeing 767-200 aircraft in the fourth quarter of 2010 while no such charge was recorded in the fourth quarter of 2011.

Aircraft maintenance expense increased 29% from the fourth quarter of 2010

In the fourth quarter of 2011, aircraft maintenance expense of $212 million increased $48 million or 29% from the fourth quarter of 2010. In the fourth quarter of 2011, Air Canada recorded an unfavourable adjustment of $20 million to its end of lease maintenance return provision, resulting from changes in cost and discount rate assumptions. A higher volume of engine maintenance events, which was largely related to Air Canada's narrowbody fleet, and an increase in maintenance cost obligations related to aircraft lease terminations were also contributing factors to the increase.

Sales and distribution costs decreased 4% from the fourth quarter of 2010

In the fourth quarter of 2011, sales and distribution costs of $140 million decreased $6 million or 4% from the fourth quarter of 2010 on passenger revenue growth of 5.2%. Sales and distribution costs are comprised of commissions and incentives paid to passenger and cargo distributors, credit card and GDS transaction fees, as well as sales and distribution costs related to Air Canada Vacations. Factors contributing to the year-over-year change in fourth quarter sales and distribution costs included:

- A decrease in GDS transaction fees, which was in part due to higher volume credits accrued in the fourth quarter of 2011 compared to the fourth quarter of 2010, as well as the impact of contract improvements; and
- A decrease in interline commissions which was due to contract improvements.

The above-noted decreases were partly offset by the following:

- The passenger revenue growth of 5.2%; and
- An increase in credit card fees which was due to higher passenger sales and an increase in the percentage of sales made on credit cards.

Food, beverages and supplies expense decreased 2% from the fourth quarter of 2010

In the fourth quarter of 2011, food, beverages and supplies expense of $53 million decreased $1 million or 2% from the fourth quarter of 2010. The impact of a 2.6% growth in passenger traffic was more than offset by the favourable impact of CTP initiatives, most of which are related to contract and process improvements.

Other operating expenses increased 4% from the fourth quarter of 2010

Other operating expenses amounted to $287 million in the fourth quarter of 2011, an increase of $10 million or 4% from the fourth quarter of 2010.

The following table provides a breakdown of the more significant items included in other expenses:

	Fourth Quarter		Change	
(Canadian dollars in millions)	**2011**	**2010**	**$**	**%**
Air Canada Vacations' land costs	$ 57	$ 49	$ 8	16
Terminal handling	43	44	(1)	(2)
Building rent and maintenance	29	31	(2)	(7)
Crew cycle	30	28	2	6
Miscellaneous fees and services	32	33	(1)	(2)
Remaining other expenses	96	92	4	4
	$ 287	**$ 277**	**$ 10**	**4**

Factors contributing to the year-over-year change in fourth quarter Other expenses included:

- The 2.5% growth in capacity; and
- An increase of $8 million or 16% in expenses related to ground packages at Air Canada Vacations which was due to a higher cost of ground packages and, to a lesser extent, an increase in passenger volumes.

Non-operating income amounted to $38 million in the fourth quarter of 2011 compared to non-operating income of $28 million in the fourth quarter of 2010

The following table provides a breakdown of non-operating income for the periods indicated:

	Fourth Quarter		Change
(Canadian dollars in millions)	**2011**	2010	$
Foreign exchange gain (loss)	$ 114	$ 136	$ (22)
Interest income	10	9	1
Interest expense	(76)	(86)	10
Net financing expense relating to employee benefit liabilities	(4)	(18)	14
Loss on financial instruments recorded at fair value	(5)	8	(13)
Other	(1)	(21)	20
	$ 38	**$ 28**	**$ 10**

Factors contributing to the year-over-year change in fourth quarter non-operating income included:

- Gains on foreign exchange (mainly related to U.S. currency denominated long-term debt) which amounted to $114 million in the fourth quarter of 2011 compared to gains of $136 million in the fourth quarter of 2010. The gains in the fourth quarter of 2011 were mainly attributable to a stronger Canadian dollar at December 31, 2011 when compared to September 30, 2011. The December 31, 2011 closing exchange rate was US$1 = C$1.017 while the September 30, 2011 closing exchange rate was US$1 = C$1.0482.
- A decrease in interest expense of $10 million in the fourth quarter of 2011 which was largely due to the impact of net debt repayments made in 2011 and the impact of lower interest rates when compared to the fourth quarter of 2010.
- A decrease in net financing expense relating to employee benefit liabilities of $14 million which was due to a decline in the discount rate used to measure the expense.
- Losses related to fair value adjustments on derivative instruments which amounted to $5 million in the fourth quarter of 2011 versus gains of $8 million in the fourth quarter of 2010. Refer to section 12 of this MD&A for additional information.

8. FLEET

The following table provides Air Canada's operating fleet as at December 31, 2011 (excluding aircraft which are leased or subleased to third parties and excluding aircraft operated by Jazz under the Jazz CPA and by other regional airlines operating flights on behalf of Air Canada under commercial agreements with Air Canada).

	Total Seats	Number of Operating Aircraft(1)	Average Age	Owned(1)	Finance Lease(2)	Owned – Special Purpose Entities(2)	Operating Lease
Widebody Aircraft							
Boeing 777-300	349	12	3.8	3	1	–	8
Boeing 777-200	270	6	4.1	4	–	–	2
Boeing 767-300	191-213	30	17.7	5	8	2	15
Airbus A330-300	265	8	11.2	–	–	8	–
Narrowbody Aircraft							
Airbus A321	174	10	9.8	–	–	5	5
Airbus A320	146	41	18.7	–	–	–	41
Airbus A319	120	38	13.8	8	10	14	6
EMBRAER 190	93	45	4.8	45	–	–	–
EMBRAER 175	73	15	6.3	15	–	–	–
Total		**205**	**11.6**	**80**	**19**	**29**	**77**

(1) Excludes aircraft that have been removed from service.

(2) Owned aircraft, aircraft under finance leases, and other aircraft under lease from special purpose entities that are consolidated by Air Canada and are carried on Air Canada's statement of financial position. Owned aircraft include aircraft financed under conditional sales agreements.

The following table provides the number of aircraft in Air Canada's operating fleet as at December 31, 2011 and 2010, as well as planned changes to its operating fleet (excluding aircraft which are leased or subleased to third parties and excluding aircraft operated by Jazz under the Jazz CPA and by other regional airlines operating flights on behalf of Air Canada under commercial agreements with Air Canada).

	Actual (As at December 31, 2011)			Planned (As at December 31, 2011)			
	December 31, 2010	2011 Fleet Changes	December 31, 2011	2012 Fleet Changes	December 31, 2012	2013 Fleet Changes	December 31, 2013
Boeing 777-300	12	–	12	–	12	–	12
Boeing 777-200	6	–	6	–	6	–	6
Boeing 767-300	30	–	30	–	30	–	30
Airbus A330-300	8	–	8	–	8	–	8
Airbus A321	10	–	10	–	10	–	10
Airbus A320	41	–	41	–	41	–	41
Airbus A319	38	–	38	–	38	–	38
EMBRAER 190	45	–	45	–	45	–	45
EMBRAER 175	15	–	15	–	15	–	15
Total	**205**	–	**205**	–	**205**	–	**205**
Average age (years)	**10.7**		**11.6**		**12.6**		**13.6**

The following table provides, as at December 31, 2011, the number of aircraft operated by Jazz under the Jazz CPA and by other airlines operating flights under the Air Canada Express banner on behalf of Air Canada pursuant to commercial agreements with Air Canada.

	As at December 31, 2011			
	Jazz	Sky Regional	Other	Total
CRJ-100	17	–	–	**17**
CRJ-200	25	–	–	**25**
CRJ-705	16	–	–	**16**
Dash 8-100	34	–	–	**34**
Dash 8-300	26	–	–	**26**
Dash 8-400	8	5	–	**13**
Beech 1900	–	–	16	**16**
Total	**126**	**5**	**16**	**147**

At December 31, 2011, the 126 total aircraft operated by Jazz under the Jazz CPA included one Dash 8-400 aircraft which operated earlier than planned. In January 2012, the number of aircraft operated by Jazz under the CPA reverted to a total 125 aircraft. During 2012, seven Dash 8-400 aircraft, owned by Jazz, will be introduced into the Jazz CPA fleet and eight Bombardier CRJ-100 aircraft, owned by Air Canada, will be removed from the Jazz CPA fleet. The Jazz covered fleet is expected to remain at 125 aircraft throughout 2012.

On May 1, 2011, Sky Regional, on behalf of Air Canada and pursuant to a capacity purchase agreement between the parties, commenced service between Toronto Island's Billy Bishop Airport and Montreal's Trudeau Airport.

Air Canada leases or subleases 83 aircraft to third parties, which have final maturities ranging from 2012 to 2024. Air Canada aircraft, which are leased or subleased to third parties, are not shown in Air Canada's operating fleet table. These leased or subleased aircraft include six Airbus A340-300s, two Airbus A340-500s, 18 Bombardier CRJ-100 aircraft, 25 Bombardier CRJ-200 aircraft and 15 Bombardier CRJ-705 aircraft. All of the CRJ aircraft are leased or subleased to Jazz. In addition, seven Dash 8-100 aircraft are leased to Jazz, five Dash 8-400 aircraft are subleased to Sky Regional and five Beech aircraft are subleased to other Tier III carriers. In 2011, Air Canada exercised purchase rights for two Boeing 777 aircraft with scheduled deliveries in mid-2013. Air Canada is currently reviewing operating alternatives which may include subleasing, and as a result, these two aircraft have not been included in the fleet tables above.

9. FINANCIAL AND CAPITAL MANAGEMENT

9.1. Liquidity

Air Canada manages its liquidity needs through a variety of strategies, which include seeking to achieve positive cash from operations, sourcing committed financing for new and existing aircraft and through other financing activities.

At December 31, 2011, cash, cash equivalents and short-term investments amounted to $2,099 million, or 18% of 2011 operating revenues (2010 – $2,192 million, or 20% of 2010 operating revenues), exceeding Air Canada's minimum target liquidity level of 15% of 12-month trailing operating revenues.

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations (including pension funding obligations), covenants in credit card and other agreements. Refer to sections 9.6, 9.7 and 9.8 for schedules of Air Canada's capital commitments, contractual and pension funding obligations. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. Air Canada's principal objective in managing liquidity risk is to maintain a minimum unrestricted cash balance in excess of a target liquidity level of 15% of annual operating revenues.

9.2. Financial Position

The following table provides a condensed statement of financial position of Air Canada as at December 31, 2011 and as at December 31, 2010.

(Canadian dollars in millions)	December 31, 2011	December 31, 2010	Change $
Assets			
Cash, cash equivalents and short-term investments	$ 2,099	$ 2,192	$ (93)
Other current assets	1,228	1,155	73
Current assets	3,327	3,347	(20)
Property and equipment	5,088	5,629	(541)
Intangible assets	312	317	(5)
Goodwill	311	311	–
Deposits and other assets	595	549	46
Total assets	**$ 9,633**	**$ 10,153**	**$ (520)**
Liabilities			
Current liabilities	$ 3,153	$ 3,124	$ 29
Long-term debt and finance leases	3,906	4,028	(122)
Pension and other benefit liabilities	5,563	3,328	2,235
Maintenance provisions	548	493	55
Other long-term liabilities	469	468	1
Total liabilities	**13,639**	**11,441**	**2,198**
Total equity	**(4,006)**	**(1,288)**	**(2,718)**
Total liabilities and equity	**$ 9,633**	**$ 10,153**	**$ (520)**

Movements in current assets and current liabilities are described in section 9.4 of this MD&A. Long-term debt and finance leases are discussed in section 9.3 of this MD&A.

Property and equipment amounted to $5,088 million at December 31, 2011, a reduction of $541 million from December 31, 2010. The reduction was mainly due to the impact of depreciation expense of $688 million in 2011. Additions to property and equipment amounted to $160 million in 2011, including progress payments on future aircraft deliveries and facilities of $77 million, flight equipment including capitalized maintenance events of $64 million, and ground and other equipment of $14 million.

Pension and other benefit liabilities increased $2,235 million in 2011, mainly due to a decrease in interest rates used to determine the pension obligations. Total pension funding payments in 2011 amounted to $385 million. Refer to section 9.8 for additional information on Air Canada's pension funding obligations.

9.3. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at December 31, 2011 and as at December 31, 2010.

(Canadian dollars in millions)	December 31, 2011	December 31, 2010	Change $
Total long-term debt and finance leases	$ 3,906	$ 4,028	$ (122)
Current portion of long-term debt and finance leases	424	567	(143)
Total long-term debt and finance leases, including current portion	4,330	4,595	(265)
Less cash, cash equivalents and short-term investments	(2,099)	(2,192)	93
Net debt	**$ 2,231**	**$ 2,403**	**$ (172)**
Capitalized operating leases[1]	2,345	2,471	(126)
Adjusted net debt	**$ 4,576**	**$ 4,874**	**$ (298)**

(1) Adjusted net debt is a non-GAAP financial measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.0. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent was $335 million in 2011 and $353 million in 2010.

Total debt and finance leases, including current portion, amounted to $4,330 million at December 31, 2011, a decrease of $265 million from December 31, 2010. The reduction in long-term debt and finance leases from December 31, 2010 was mainly due to debt repayments of $608 million, including balloon maturities related so special purpose aircraft leasing entities totalling $221 million, as further described below. This decrease was partly offset by the unfavourable impact of a weaker Canadian dollar at December 31, 2011 compared to December 31, 2010 on Air Canada's foreign currency denominated debt (mainly U.S. dollars), which accounted for an increase of $92 million, and by proceeds from borrowings of $232 million.

In the fourth quarter of 2011, long-term debt and finance lease obligations decreased $149 million. The decrease in long-term debt and finance lease obligations was due to foreign exchange gains of $120 million and scheduled debt repayments of $124 million partly offset by new borrowings of $107 million.

In 2011, Air Canada received net financing proceeds of $125 million (U.S. $128 million), after financing fees of $2 million, through draws on a secured term loan facility (the "Facility"). The draws on the Facility were utilized to refinance amounts related to eight Airbus A319 aircraft and four Boeing 767-300ER aircraft with refinanced terms of seven and four years, respectively. The Facility will also be available in 2012 to refinance up to US$42 million of the amount related to four Airbus A319 aircraft.

In 2011, Air Canada entered into a revolving loan facility consisting of a Canadian dollar denominated revolving facility in the amount of $50 million and a U.S. dollar denominated revolving facility in the amount of $100 million. The agreement expires on January 31, 2015. An amount of $22 million was drawn under the facility in the fourth quarter of 2011.

In the fourth quarter of 2011, proceeds of $85 million were raised through the issuance of a bond by a Fuel Facility Corporation that is part of the consolidated accounts of Air Canada. The financing will be used to fund capital expenditures by the Fuel Facility Corporation over the next several years.

9.4. Working Capital

The following table provides information on Air Canada's working capital balances at December 31, 2011 and at December 31, 2010.

(Canadian dollars in millions)	December 31, 2011	December 31, 2010	Change $
Cash and short-term investments	$ 2,099	$ 2,192	$ (93)
Accounts receivable	712	641	71
Other current assets	516	514	2
Accounts payable and accrued liabilities	(1,175)	(1,182)	7
Advance ticket sales	(1,554)	(1,375)	(179)
Current portion of long-term debt and finance leases	(424)	(567)	143
Net working capital	**$ 174**	**$ 223**	**$ (49)**

The net positive working capital of $174 million at December 31, 2011 represented a decrease of $49 million from December 31, 2010. Positive net cash from operating activities of $588 million was partially offset by cash flows required to retire certain balloon maturities on debt, as described in section 9.3 of this MD&A, the impact of capital expenditures of $220 million, and the excess of employee benefit funding over expense of $153 million in 2011.

9.5. Consolidated Cash Flow Movements

The following table provides the cash flow movements for Air Canada for the periods indicated:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2011**	**2010**	**Change $**	**2011**	**2010**	**Change $**
Net cash from operating activities, before the under noted items	$ 3	$ 143	$ (140)	$ 588	$ 798	$ (210)
Net cash used for fuel hedge settlements, premiums and collateral deposits	(11)	(16)	5	(3)	(37)	34
Excess of employee benefit funding over expense	(57)	(9)	(48)	(153)	(24)	(129)
Change in maintenance provisions	52	15	37	94	57	37
Changes in non-cash working capital balances	–	25	(25)	60	139	(79)
Cash flows from (used for) operating activities	(13)	158	(171)	586	933	(347)
Additions to property, equipment and intangible assets	(56)	(36)	(20)	(220)	(187)	(33)
Free cash flow[1]	**(69)**	**122**	**(191)**	**366**	**746**	**(380)**
Proceeds from sale of assets	2	1	1	6	29	(23)
Proceeds from sale and leaseback transactions	–	–	–	–	20	(20)
Reduction to Aveos letter of credit	–	–	–	–	23	(23)
Short-term investments	(46)	(440)	394	(149)	(810)	661
Other	4	(6)	10	(37)	(40)	3
Cash flows used for investing activities (excluding additions to property, equipment and intangible assets)	**(40)**	**(445)**	**405**	**(180)**	**(778)**	**598**
Proceeds from borrowings	107	–	107	232	1,175	(943)
Shares issued	–	2	(2)	–	2	(2)
Reduction of long-term debt and finance lease obligations	(124)	(100)	(24)	(608)	(1,159)	551
Distributions related to aircraft special purpose leasing entities	–	–	–	(52)	(11)	(41)
Cash flows from (used for) financing activities	**(17)**	**(98)**	**81**	**(428)**	**7**	**(435)**
Net increase (decrease) in cash and cash equivalents	(126)	(421)	295	(242)	(25)	(217)
Net increase (decrease) in short-term investments	46	440	(394)	149	810	(661)
Net increase (decrease) in cash, cash equivalents and short-term investments	**$ (80)**	**$ 19**	**$ (99)**	**$ (93)**	**$ 785**	**$ (878)**

(1) Free cash flow is a non-GAAP financial measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada considers free cash flow to be an indicator of the financial strength and performance of its business because it shows how much cash is available, including repaying debt, meeting ongoing financial obligations and reinvesting in Air Canada.

Negative free cash flow amounted to $69 million in the fourth quarter of 2011 compared to positive free cash flow of $122 million in the fourth quarter of 2010, a year-over-year decrease of $191 million. This decrease in free cash flow from the fourth quarter of 2010 was largely due to a decline in net cash from operations, consistent with the decline in fourth quarter EBITDAR, the impact of higher pension payments, and an increase in capital expenditures of $20 million.

When compared to 2010, free cash flow of $366 million declined $380 million. This decrease in free cash flow from December 31, 2010 was largely due to a decline in net cash from operations, a reduction in cash provided by working capital and an increase in past service pension funding obligations. Starting in 2011, Air Canada resumed making past service contributions to its domestic registered plans pursuant to the terms of the Air Canada 2009 Pension Regulations, whereas no such contributions were required or made in 2010. Refer to section 9.8 of this MD&A for additional information.

9.6. Capital Expenditures and Related Financing Arrangements

Boeing

As at December 31, 2011, Air Canada had outstanding purchase commitments with The Boeing Company ("Boeing") for the acquisition of 37 Boeing 787 aircraft and two Boeing 777 aircraft following the exercise of its purchase rights as described below. Air Canada also has purchase rights for 16 Boeing 777 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing), purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery position), and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's current pricing). In 2011, Air Canada exercised purchase rights for two Boeing 777 aircraft with scheduled deliveries in mid-2013. Air Canada is currently reviewing operating alternatives for these two aircraft and, as a result, these two aircraft have not been included in the fleet table in section 9.8 of this MD&A, however, they have been included in the table below.

The first seven deliveries of its Boeing 787 aircraft are currently scheduled for delivery in 2014 and the remaining 30 between 2015 and 2019.

Air Canada has financing commitments from Boeing and the engine manufacturer covering 31 of the 37 Boeing 787 firm aircraft orders. The financing terms for 28 out of the 31 covered aircraft are for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments. For the remaining three out of the 31 covered aircraft, the financing under the commitment covers up to 90% of the capital expenditure and the term to maturity is 15 years, with principal payments made on a mortgage style basis resulting in equal instalment payments of principal and interest over the term to maturity.

Capital Commitments

The estimated aggregate cost of the future firm Boeing 787 aircraft deliveries and other capital purchase commitments as at December 31, 2011 approximates $4,976 million (of which $3,110 million is subject to committed financing, subject to the fulfillment of certain terms and conditions). Other capital purchase commitments relate principally to building and leasehold improvement projects.

The table below provides Air Canada's current projected, planned and committed capital expenditures for 2012, for the next four years and after 2016.

(Canadian dollars in millions)	2012	2013	2014	2015	2016	Thereafter	Total
Projected committed expenditures	$ 155	$ 318	$ 755	$ 575	$ 1,017	$ 2,156	**$ 4,976**
Projected planned but uncommitted expenditures	122	120	120	120	120	not available	not available
Total projected expenditures[1] [2]	277	438	875	695	1,137	not available	not available
Projected financing on committed expenditures	–	–	(604)	(460)	(813)	(1,233)	**(3,110)**
Total projected expenditures, net of financing	**$ 277**	**$ 438**	**$ 271**	**$ 235**	**$ 324**	not available	not available

(1) U.S. dollar amounts are converted using the December 31, 2011 closing exchange rate of US$1 = C$1.017. Final aircraft delivery prices include estimated escalation and, where applicable, interest on deferred delivery payments.

(2) The table above excludes certain maintenance events that are capitalized under IFRS amounting to $60 million in 2012. Future capitalized maintenance amounts for 2013 and beyond are not yet determinable.

9.7. Contractual Obligations

The table below provides updated information on Air Canada's long-term debt and finance lease obligations, including interest and principal repayment obligations as at December 31, 2011. The table also includes the impact of the loan facility as described in section 9.3 of this MD&A, assuming the full commitment will be drawn upon, including the balance available in 2012 of US$42 million related to the refinancing of the last four Airbus A319 aircraft under this facility.

(Canadian dollars in millions)	2012	2013	2014	2015	2016	Thereafter	Total
Principal							
Long-term debt obligations	$ 367	$ 535	$ 261	$ 1,261	$ 455	$ 1,090	**$ 3,969**
Finance lease obligations	57	61	57	52	25	174	**426**
	424	596	318	1,313	480	1,264	**4,395**
Interest							
Long-term debt obligations	231	226	193	142	51	108	**951**
Finance lease obligations	41	34	28	22	18	65	**208**
	272	260	221	164	69	173	**1,159**
Total long-term debt, finance leases and interest repayment obligations[1-5]	**$ 696**	**$ 856**	**$ 539**	**$ 1,477**	**$ 549**	**$ 1,437**	**$ 5,554**
Net impact of loan facility	(34)	9	9	9	9	5	**7**
Total long-term debt and finance lease obligations, including net impact of loan facility	**$ 662**	**$ 865**	**$ 548**	**$ 1,486**	**$ 558**	**$ 1,442**	**$ 5,561**
Operating lease obligations	**$ 395**	**$ 362**	**$ 296**	**$ 247**	**$ 205**	**$ 612**	**$ 2,117**
Committed capital expenditures	**$ 155**	**$ 318**	**$ 755**	**$ 575**	**$ 1,017**	**$ 2,156**	**$ 4,976**
Total obligations, including net impact of loan facility	**$ 1,212**	**$ 1,545**	**$ 1,599**	**$ 2,308**	**$ 1,780**	**$ 4,210**	**$ 12,654**

(1) The interest repayment obligations relate to long-term debt, debt consolidated under special purpose entities and finance leases.

(2) The operating lease obligations above mainly relate to U.S. dollar aircraft operating leases.

(3) The committed capital expenditures above mainly relate to U.S. dollar aircraft-related expenditures. These expenditures also include purchases relating to system development costs, facilities and leasehold improvements.

(4) Total contractual obligations exclude commitments for goods and services required in the ordinary course of business. Also excluded are other long-term liabilities mainly due to reasons of uncertainty of timing of cash flows and items that are non-cash in nature.

(5) The table above excludes the future minimum non-cancellable commitment under the Jazz CPA of $760 million in 2012, the future minimum non-cancellable commitment under capacity purchase agreements with other regional carriers of $57 million in 2012 and the minimum annual commitment to purchase Aeroplan® Miles from Aeroplan of $222 million for 2012. Future commitments for 2013 and beyond are not yet determinable.

Covenants in Credit Card Agreements

Air Canada has various agreements with companies that process customer credit card transactions. Approximately 85% of the Air Canada's sales are processed using credit cards, with remaining sales processed through cash based transactions. Air Canada receives payment for a credit card sale generally in advance of when the passenger transportation is provided.

Air Canada's principal credit card processing agreements for card processing services requirements in North America have an expiry date of May 2012. Air Canada is in the process of negotiating longer-term arrangements. Air Canada's obligation to provide a deposit to the credit card processor under these agreements, as well as the amount of such deposit, are determined pursuant to a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for Air Canada and the unrestricted cash of Air Canada. Air Canada also has agreements with this processor for the provision of certain credit card processing services requirements for markets other than North America and for its cargo operations worldwide and such agreements contain deposit obligations similar to the obligations set forth above.

9.8. Pension Funding Obligations

Air Canada maintains several pension plans, including defined benefit and defined contribution pension plans and plans providing other retirement and post-employment benefits to its employees. Based on actuarial valuations completed in the third quarter of 2011, the aggregate solvency deficit in its domestic registered pension plans as at January 1, 2011 was $2,167 million. The valuations as of January 1, 2012 will be completed in the first half of 2012 but, as described in the paragraph below, valuations will not increase pension past service cost funding obligations required prior to 2014. Solvency deficit obligations for 2014 would be determined based on actuarial valuations completed in mid-2014.

In July 2009, the Government of Canada adopted the Air Canada 2009 Pension Regulations. The Air Canada 2009 Pension Regulations relieved Air Canada from making any past service contributions (i.e. special payments to amortize the plan solvency deficits) to its ten domestic defined benefit registered pension plans in respect of the period beginning April 1, 2009, and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution is the lesser of (i) $150 million, $175 million, and $225 million in 2011, 2012, and 2013, respectively, on an accrued basis, and (ii) the maximum past service contribution permitted under the Canadian Income Tax Act. Current service contributions continue to be made in the normal course while the Air Canada 2009 Pension Regulations are in effect.

After consideration of the effect of the Air Canada 2009 Pension Regulations, as outlined above, total employer pension funding contributions in 2011 amounted to $385 million.

(Canadian dollars in millions)	2011	2010
Past service cost for registered pension plans	$ 138	$ –
Current service cost for registered pension plans	171	169
Other pension arrangements[1]	76	74
Total contributions	**$ 385**	**$ 243**

(1) Includes retirement compensation arrangements, supplemental plans and international plans.

Funding obligations are generally dependent on a number of factors, including the assumptions used in the most recently filed actuarial valuation reports for current service (including the applicable discount rate used or assumed in the actuarial valuation), the plan demographics at the valuation date, the existing plan provisions, existing pension legislation and changes in economic conditions (mainly the return on fund assets and changes in interest rates). Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition to changes in plan demographics and experience, actuarial assumptions and methods may be changed from one valuation to the next, including due to changes in plan experience, financial markets, future expectations, changes in legislation and other factors. Until 2013, Air Canada's past service pension funding obligations are also limited by the Air Canada 2009 Pension Plan Funding Regulations.

Air Canada's projected pension funding obligations, on a cash basis, for 2012 and for the next year, are provided in the table below. As of 2014, the Air Canada 2009 Pension Regulations will cease to have effect and Air Canada's pension funding obligations may vary significantly based on a wide variety of factors, including those identified above.

(Canadian dollars in millions)	2012	2013
Past service domestic registered plans	$ 173	$ 221
Current service domestic registered plans	168	173
Other pension arrangements[1]	85	82
Projected pension funding obligations	**$ 426**	**$ 476**

(1) Includes retirement compensation arrangements, supplemental plans and international plans.

Amendments to the Defined Benefit Pension Plans

In 2011, Air Canada reached an agreement with the Canadian Auto Workers union ("CAW") Local 2002, which represents approximately 4,000 call centre and airport check-in and gate agents employed by Air Canada and the Canadian Union of Public Employees ("CUPE"), the union representing the airline's 6,800 flight attendants. The agreements include amendments to the defined benefit pension plans of CAW and CUPE members, which are subject to regulatory approval and will be accounted for at the time this approval has been received. In addition, a hybrid pension regime consisting of defined contribution and defined benefit components applies to new employees represented by the CAW and CUPE, hired after the date of ratification of the new agreements. The expense and obligations relating to the hybrid pension plan as at December 31, 2011 are negligible.

Pension and Benefits Agreement with Aveos

Air Canada and Aveos are parties to a Pension and Benefits Agreement covering the transfer of certain pension and benefit assets and obligations to Aveos. On July 14, 2011 (the "Certification Date"), certain unionized employees of Air Canada elected to become employees of Aveos. Under the terms of the Pension and Benefits Agreement and subject to regulatory approval where required, the assets and obligations under the pension, other post-retirement and post-employment benefits plans pertaining to the transferred unionized employees will be transferred to Aveos.

The terms of the Pension and Benefits Agreement relating to transferred unionized employees provide for the determination of solvency liabilities and pension assets as at July 14, 2011, in respect of unionized employees transferred to Aveos employed in the airframe function and, as at October 16, 2007 in respect of unionized employees transferred to Aveos employed in all other functions.

Air Canada will compensate Aveos for the present value of the accounting liability in respect of other post-retirement and post-employment liabilities as at July 14, 2011. These compensation amounts will be paid by Air Canada through quarterly payments to Aveos over a period not exceeding five years after the transfer. Airframe employees represent approximately half of the approximate 2,200 transferred employees.

Until the Certification Date, the current service pension cost and the current service and interest costs for other employee benefits, in respect of employees assigned to Aveos, were expensed by Air Canada with a full recovery recorded as an amount charged to Aveos. From the Certification Date, transferred employees accrue employee benefits in the Aveos defined benefit plans. Air Canada's financial statements do not reflect the determination of the solvency liabilities to be transferred to Aveos, the determination of amount of assets to be transferred to Aveos and the resulting compensation amount to be paid by Air Canada to Aveos, as these amounts are not yet determined. Based on the January 1, 2011 actuarial valuation, these compensation amounts are not expected to be material.

9.9. Share Information

The issued and outstanding shares of Air Canada, along with shares potentially issuable, are, as of the dates indicated below, as follows:

	Number of Shares at	
	January 31, 2012	January 31, 2011
Issued and outstanding shares		
Class A variable voting shares	42,271,105	48,424,211
Class B voting shares	235,134,838	230,548,173
Total issued and outstanding shares	**277,405,943**	**278,972,384**
Class A variable voting and Class B voting shares potentially issuable		
Warrants	89,430,300	89,430,300
Shares held in trust	1,502,542	–
Stock options	6,581,242	3,460,027
Performance share units	–	2,500
Total shares potentially issuable	**97,514,084**	**92,892,827**
Total outstanding and potentially issuable shares	**374,920,027**	**371,865,211**

Issuer Bid

In December 2011, Air Canada announced that it received approval from the Toronto Stock Exchange ("TSX") to implement a normal course issuer bid to purchase, for cancellation, up to 24,737,753 Class A Variable Voting Shares and/or Class B Voting Shares (the "Shares"), representing, at that time, 10% of the total public float of the Shares.

The repurchase program, which commenced on December 12, 2011 and will end no later than December 11, 2012, will be conducted through the facilities of the TSX, or alternative trading systems, if eligible, and will conform to their regulations.

In 2011, Air Canada purchased and cancelled 239,524 shares under its normal issuer bid for cash at an average cost of $1.08 per share.

Shareholder Rights Plan

In 2011, the shareholders of Air Canada ratified a shareholder rights plan agreement (the "Plan") designed to foster fair treatment of all shareholders in connection with any take-over bid for Air Canada.

The Plan is scheduled to expire at the close of business on the date immediately following the date of Air Canada's annual meeting of shareholders to be held in 2014, unless terminated earlier in accordance with the terms of the Plan.

10. QUARTERLY FINANCIAL DATA

The following tables summarize quarterly financial results and major operating statistics for Air Canada for the last eight quarters.

(Canadian dollars in millions, except where indicated)	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Operating revenues	$ 2,519	$ 2,625	$ 3,026	$ 2,616	$ 2,753	$ 2,918	$ 3,242	$ 2,699
Aircraft fuel	619	660	733	640	742	882	943	808
Ownership (DAR)(1)	286	281	274	313	273	265	265	260
Other operating expenses	1,750	1,637	1,713	1,648	1,804	1,698	1,764	1,729
Operating expenses	2,655	2,578	2,720	2,601	2,819	2,845	2,972	2,797
Operating income (loss) before exceptional item	(136)	47	306	15	(66)	73	270	(98)
Provision adjustment for cargo investigations, net(2)	–	–	–	46	–	–	–	–
Operating income (loss)	(136)	47	306	61	(66)	73	270	(98)
Total non-operating income (expense)	23	(365)	11	28	47	(120)	(394)	38
Recovery of (provision for) income taxes	1	–	–	–	–	1	–	–
Net income (loss)	$ (112)	$ (318)	$ 317	$ 89	$ (19)	$ (46)	$ (124)	$ (60)

(1) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expense.

(2) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

(Canadian dollars in millions, except where indicated)	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Revenue passenger miles (millions)	11,692	12,896	15,531	11,756	12,355	13,677	16,126	12,065
Available seat miles (millions)	14,727	15,523	18,328	14,918	15,859	16,512	18,799	15,290
Passenger load factor (%)	79.4	83.1	84.7	78.8	77.9	82.8	85.8	78.9
RASM (cents)(1)	14.2	14.8	14.8	15.1	14.5	15.6	15.5	15.4
CASM (cents)	18.0	16.6	14.8	17.4	17.8	17.2	15.8	18.3
CASM, excluding fuel expense (cents)	13.8	12.3	10.8	13.2	13.1	11.9	10.8	13.0
CASM, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations (cents)(2)	12.9	12.0	10.6	12.8	12.2	11.5	10.6	12.6
Economic fuel price per litre (cents)(3)	66.2	66.8	64.6	67.5	78.2	87.9	85.8	88.6
EBITDAR before the provision adjustment for cargo investigations, net(4)(5)	$ 150	$ 328	$ 580	$ 328	$ 207	$ 338	$ 535	$ 162
EBITDAR(4)(5)	$ 150	$ 328	$ 580	$ 374	$ 207	$ 338	$ 535	$ 162
Net income (loss) per share								
– Basic	$ (0.41)	$ (1.14)	$ 1.13	$ 0.31	$ (0.07)	$ (0.17)	$ (0.45)	$ (0.22)
– Diluted	$ (0.41)	$ (1.14)	$ 1.10	$ 0.27	$ (0.07)	$ (0.17)	$ (0.45)	$ (0.22)

(1) System RASM excludes the impact of a $40 million favourable adjustment recorded in the fourth quarter of 2010.

(2) Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, is a non-GAAP financial measure. Refer to section 20 of this MD&A for additional information.

(3) Includes fuel handling and is net of fuel hedging results.

(4) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

(5) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before a provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).

11. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for Air Canada for the years 2009 through to 2011. The information for 2009 is reported on a Canadian GAAP basis (prior to the adoption of IFRS), while the information for 2010 and 2011 is reported on an IFRS basis. Accordingly, the financial information for 2009 is not directly comparable to subsequent periods.

(Canadian dollars in millions, except where indicated)	2011 IFRS	2010 IFRS	2009 GAAP
Operating revenues	$ 11,612	$ 10,786	$ 9,739
Operating expenses	11,433	10,554	10,055
Operating income (loss) before exceptional item	**179**	**232**	**(316)**
Provision for cargo investigations, net[1]	–	46	–
Operating income (loss)	**179**	**278**	**(316)**
Total non-operating income (expense), non-controlling interest, and income taxes	(429)	(303)	292
Net loss	**$ (249)**	**$ (24)**	**$ (24)**
EBITDAR before a provision adjustment for cargo investigations, net[1] [2]	**$ 1,242**	**$ 1,386**	**$ 679**
EBITDAR[2]	**$ 1,242**	**$ 1,432**	**$ 679**
Net loss per share – Basic	**$ (0.92)**	**$ (0.12)**	**$ (0.18)**
Net loss per share – Diluted	**$ (0.92)**	**$ (0.12)**	**$ (0.18)**
Cash, cash equivalents and short-term investments	**$ 2,099**	**$ 2,192**	**$ 1,407**
Total assets	**$ 9,633**	**$ 10,153**	**$ 10,406**
Total long-term liabilities[3]	**$ 10,910**	**$ 8,884**	**$ 6,140**
Total liabilities	**$ 13,639**	**$ 11,441**	**$ 8,759**

(1) *In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.*

(2) *See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before a provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).*

(3) *Total long-term liabilities include long-term debt (including current portion) and capital leases, pension and other benefit liabilities, maintenance provisions and other long-term liabilities.*

12. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Summary of "Gain (Loss) on Financial Instruments Recorded at Fair Value"

The following is a summary of "gain (loss) on financial instruments recorded at fair value" included in non-operating expense on Air Canada's consolidated statement of operations for the periods indicated:

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	**2011**	**2010**	**2011**	**2010**
Fuel derivatives	$ 1	$ 11	$ (26)	$ (11)
Interest rate swaps	(1)	(3)	(22)	7
Share forward contracts	(3)	1	(10)	4
Other	(2)	(1)	(5)	(3)
Gain (loss) on financial instruments recorded at fair value	**$ (5)**	**$ 8**	**$ (63)**	**$ (3)**

Risk Management

Under its risk management policy, Air Canada manages its interest rate risk, foreign exchange risk, share based compensation risk and market risk through the use of various interest rates, foreign exchange, fuel and other derivative financial instruments. Air Canada uses derivative financial instruments only for risk management purposes, not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

As noted below, Air Canada engages in derivative hedging in an effort to mitigate various risks. The derivative fair values represent the amount of the consideration that could be exchanged in an arm's length transaction between willing parties who are under no compulsion to act. Fair value of these derivatives is determined using active markets, where available. When no such market is available, valuation techniques are applied such as discounted cash flow analysis. Where practical, the valuation technique incorporates all factors that would be considered in setting a price, including Air Canada's own credit risk and the credit risk of the counterparty.

Interest Rate Risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Air Canada enters into both fixed and floating rate debt and leases certain assets where the rental amount fluctuates based on changes in short term interest rates. Air Canada manages interest rate risk on a portfolio basis and seeks financing terms in individual arrangements that are most advantageous taking into account all relevant factors, including credit margin, term and basis. The risk management objective is to minimize the potential for changes in interest rates to cause adverse changes in cash flows to Air Canada. The temporary investment portfolio, which earns a floating rate of return, is an economic hedge for a portion of the floating rate debt.

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in Air Canada's capital structure and is based upon a long term objective of 60% fixed and 40% floating but allows the flexibility to 75% fixed in the short term to adjust to prevailing market conditions. The ratio at December 31, 2011, was 69% fixed and 31% floating, including the effects of interest rate swap positions (69% and 31%, respectively, as at December 31, 2010).

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2011:

- Certain payments based upon aircraft rental amounts for the delivery of 15 Dash 8-400 aircraft to Jazz to be operated under the Jazz CPA are based on medium-term US interest rates at the time of delivery. To hedge against the exposure to increases in interest rates until the expected delivery date, Air Canada entered into forward start interest rate swaps with an aggregate notional value of US$234 million. The swaps have contractual terms of maturity that coincide with the term of the rental agreements. However, the derivatives will be settled on each expected delivery date of the aircraft with maturities ranging to July 2012. The aggregate notional value outstanding at December 31, 2011 was US$109 million for future delivery of seven Dash 8-400 aircraft. These derivatives have not been designated as hedges for accounting purposes. The fair value of these contracts as at December 31, 2011 was $13 million in favour of the counterparties, with a loss of $28 million recorded in gain on financial instruments at fair value on Air Canada's consolidated statement of operations.

- As at December 31, 2011, Air Canada had two interest rate swap agreements in place with terms to July 2022 and January 2024 relating to two Boeing 767 aircraft financing agreements with an aggregate notional value of $74 million (US$73 million) (2010 – $80 million (US$80 million)). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2011 was $15 million in favour of Air Canada (2010 – $13 million in favour of Air Canada). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2011, a gain of $6 million was recorded in gain on financial instruments recorded at fair value on Air Canada's consolidated statement of operations (2010 – $6 million gain).

Interest income includes $32 million (2010 – $15 million) related to cash and cash equivalents and short-term investments, which are classified as held for trading. Interest expense reflected on Air Canada's consolidated statement of operations relates to financial liabilities recorded at amortized cost.

Foreign Exchange Risk

Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Air Canada's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

Air Canada's cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in U.S. dollars. This unbalanced mix results in an annual U.S. dollar shortfall from operations. In order to mitigate this imbalance, Air Canada has adopted the practice of converting excess revenues from offshore currencies into U.S. dollars. In 2011, this conversion generated coverage of approximately 20% of the imbalance. The remaining 80% was covered through the use of a variety of foreign exchange derivatives, including spot transactions and U.S. dollar investments, which had maturity dates corresponding to the forecasted shortfall dates. The level of foreign exchange derivatives expiring at any one point in time is dependent upon a number of factors, which include the amount of foreign revenue conversion available, U.S. dollar net cash flows, as well as the amount attributed to aircraft and debt payments.

The following are the current derivatives employed in foreign exchange risk management activities and the adjustments recorded in 2011:

- As at December 31, 2011, Air Canada had outstanding foreign currency options and swap agreements to purchase U.S. dollars against Canadian dollars on $1,008 million (US$991 million) which mature in 2012 (2010 – $223 million (US$224 million) which matured in 2011). Air Canada did not have any agreements outstanding at December 31, 2011 to buy Euro dollars against Canadian dollars (2011 – Euro dollars against Canadian dollars on $15 million (EUR 11 million)). The fair value of these foreign currency contracts as at December 31, 2011 was $5 million in favour of Air Canada (2010 – $3 million in favour of the counterparties). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2011, a gain of $26 million was recorded in foreign exchange gain (loss) on Air Canada's consolidated statement of operations (2010 – $2 million gain).

Fuel Price Risk

Fuel price risk is the risk that future cash flows relating to jet fuel purchases will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries. Air Canada uses derivative contracts on jet fuel and other crude oil-based commodities, heating oil and crude oil. Heating oil and crude oil derivatives are used due to the relative limited liquidity of jet fuel derivative instruments on a medium to long-term horizon since jet fuel is not traded on an organized futures exchange. Air Canada's policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. Air Canada performs regular reviews and, if necessary, adjusts the strategy in light of market conditions. Air Canada does not purchase or hold any derivative financial instrument for speculative purposes.

In 2011:

- Air Canada recorded a loss of $26 million in gain (loss) on financial instruments recorded at fair value on Air Canada's consolidated statement of operations (2010 – $11 million loss).
- Air Canada purchased crude-oil call options and collars covering a portion of 2011 and 2012 fuel exposure. The cash premium related to these contracts was $35 million.
- Fuel derivative contracts cash settled with a net fair value of $31 million in favour of Air Canada ($27 million in favour of the counterparties in 2010).

As of December 31, 2011, approximately 23% of Air Canada's anticipated purchases of jet fuel for 2012 are hedged at an average West Texas Intermediate ("WTI") equivalent weighted average capped price of US$114 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over 2012 are crude-oil based contracts, comprised of call options and call spreads. The fair value of the fuel derivatives portfolio at December 31, 2011 was $11 million in favour of Air Canada ($33 million in favour of Air Canada in 2010) and is recorded in prepaid and other current assets on Air Canada's consolidated statement of financial position.

The following table outlines the notional volumes per barrel along with the WTI weighted average floor and capped price for each year currently hedged by type of derivative instruments as at December 31, 2011.

Derivative Instruments	Term	Volume (bbls)	WTI Equivalent Weighted Average Floor Price (US$/bbl)	WTI Equivalent Weighted Average Capped Price (US$/bbl)
Call options	2012	5,279,106	not applicable	$115
Call spreads	2012	360,000	not applicable	$107

Air Canada is expected to generate fuel hedging gains if oil prices increase above the average capped price.

Air Canada discontinued applying hedge accounting in the third quarter of 2009. Amounts that were deferred to Accumulated Other Comprehensive Loss ("AOCL") for derivatives previously designated under hedge accounting were taken into fuel expense in the period when the previously forecasted hedge transaction occurred. In 2010, $183 million was reclassified from AOCL to aircraft fuel expense, leaving no amounts remaining in AOCL.

The following information summarizes the impact of fuel derivatives on Air Canada's consolidated statement of operations and consolidated statement of comprehensive income.

		Fourth Quarter		Full Year	
(Canadian dollars in millions)		**2011**	2010	**2011**	2010
Consolidated Statement of Operations					
Operating expenses					
Aircraft fuel	Realized effective loss on fuel derivatives previously designated under hedge accounting	not applicable	$ (31)	not applicable	$ (183)
Non-operating income (expense)					
Gain (loss) on financial instruments recorded at fair value					
	Fair market value gain (loss) – economic hedges	$ 1	$ 11	$ (26)	$ (11)
Consolidated Other Comprehensive Income					
	Reclassification of net realized loss on fuel derivatives previously designated under hedge accounting to aircraft fuel expense	not applicable	$ 31	not applicable	$ 183
	Tax on reclassification	not applicable	$ 1	not applicable	$ 1

13. CRITICAL ACCOUNTING ESTIMATES

Critical accounting estimates are those that are most important to the portrayal of Air Canada's financial condition and results of operations. They require management's most difficult, subjective or complex judgments, often because of the need to make estimates about the effect of matters that are inherently uncertain. Actual results could differ from those estimates under different assumptions or conditions.

Air Canada has identified the following areas that contain critical accounting estimates utilized in the preparation of its consolidated financial statements.

Passenger Revenues

Air Canada performs regular evaluations on the advance ticket sales liability, which may result in adjustments being recognized as passenger revenue. Due to the complex pricing structures; the complex nature of interline and other commercial agreements used throughout the industry; historical experience over a period of many years; and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual amounts that are different from those estimates.

Employee Future Benefits

The cost and related liabilities of Air Canada's pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions, including discount rates, expected rates of return on assets, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty.

Air Canada maintains several defined benefit plans providing pension, other retirement and post-employment benefits to its employees. Management makes a number of assumptions in the calculation of both the accrued benefit obligation as well as the pension costs.

	December 31, 2011	December 31, 2010
Weighted average assumptions used to determine the accrued benefit liability		
Discount rate	5.20%	5.50%
Rate of compensation increase	2.50%	2.50%
Weighted average assumptions used to determine the accrued benefit cost		
Discount rate	5.50%	6.40%
Expected long-term rate	6.90%	7.00%
Rate of compensation increase	2.50%	2.50%

Discount Rate

The discount rate used to determine the pension obligation was determined by reference to market interest rates on corporate bonds rated "AA" or better with cash flows that approximately match the timing and amount of expected benefit payments. An increase or decrease in the discount rate of 0.25% results in a decrease or increase of $473 million to the pension obligation, respectively. A sensitivity analysis on pension expense assuming a change in the discount rate on plan obligations is provided below.

Expected Return on Assets Assumption

Air Canada's expected long-term rate of return on assets assumption is selected based on the facts and circumstances that existed as of the measurement date and the specific portfolio mix of plan assets. Air Canada's management, in conjunction with its actuaries, reviews anticipated future long-term performance of individual asset categories and considers the asset allocation strategy adopted by Air Canada, including the longer duration in its bond portfolio in comparison to other pension plans. These factors are used to determine the average rate of expected return on the funds invested to provide for the pension plan benefits. The determination of the long-term rate considers recent fund performance and historical returns, to the extent that the past is indicative of the expected long-term, prospective rate. There can be no assurance that any of the plans will earn the expected rate of return. A sensitivity analysis on pension expense assuming a change in the expected return on plan assets is provided below.

Composition of Pension Plan Assets

Domestic Registered Plans

The composition of the domestic registered plan assets and the target allocation as follows:

	2011	2010	Target allocation[1]
Non-matched assets (mainly equities)	53.0%	54.0%	54.4%
Matched assets (mainly Canadian bonds)	47.0%	46.0%	45.6%
Total	**100.0%**	**100.0%**	**100.0%**

(1) Weighted average of the Master Trust Fund target allocation (99% of Domestic Registered Plan assets) and the Bond Trust Fund target allocation. The Bond Trust Fund serves the purpose of altering the asset mix of some of the participating plans. These plans exhibit characteristics that differ from the majority of the participating plans, which are solely invested in the Master Trust.

For the domestic registered plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Funds as amended during 2011. The investment return objective of the Fund is to achieve a total annualized rate of return that exceeds by a minimum of 1.0% before investment fees on average over the long term (i.e.10 years) the total annualized return that could have been earned by passively managing the Liability Benchmark. The Liability Benchmark, which is referenced to widely used Canadian fixed income performance benchmarks (DEX), is composed of a mix of the DEX Universe Provincial Bond Index, DEX Long Term Provincial Bond Index and DEX Real Return Bond Index that closely matches the characteristics of the pension liabilities.

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

- Non-matched assets are mainly equities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 25% to 39% of the total market value of the Master Trust Fund. Limitations are placed on the overall allocation to any individual security at both cost and market value. Investments in non-publicly traded securities and in non-traditional asset classes are allowed up to 10% of the total market value of the Master Trust Fund.
- Matched assets are mainly Canadian bonds, oriented toward long term investment grade securities rated "BBB" or higher. With the exception of Government of Canada securities or a province thereof, in which the plan may invest the entire fixed income allocation, these investments are required to be diversified among individual securities and sectors.

Derivatives are permitted provided that they are used for hedging a particular risk (including interest rate risk related to pension liabilities) or to create exposures to given markets and currencies and that counterparties have a minimum credit rating of "A". As of December 31, 2011, a 15% derivative exposure to matched assets is in place to hedge interest rate risk related to pension liabilities.

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

The trusts for the supplemental plans are invested 50% in indexed equity investments, in accordance with their investment policies, with the remaining 50% held by the Canada Revenue Agency as a refundable tax, in accordance with tax legislation.

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

Sensitivity Analysis

Sensitivity analysis on 2011 employee benefits expense and on net financing expense relating to employee benefit liabilities, based on different actuarial assumptions with respect to discount rate and expected return on plan assets, is as follows:

	0.25 Percentage Point	
(Canadian dollars in millions)	**Decrease**	**Increase**
Discount rate on obligation assumption		
Employee benefits expense	$ 15	$ (15)
Net financing expense relating to employee benefit liabilities	(10)	8
	$ 5	**$ (7)**
Long-term rate of return on plan assets assumption		
Net financing expense relating to employee benefit liabilities	28	(28)
	$ 28	**$ (28)**

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 7.50% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2011 (2010 – 8.25%). The rate is assumed to decrease gradually to 5% by 2015. A one percentage point increase in assumed health care trend rates would have increased the current service and interest costs by $5 million and the obligation by $57 million. A one percentage point decrease in assumed health care trend rates would have decreased the current service and interest costs by $4 million and the obligation by $55 million.

Impairment Considerations of Long-Lived Assets

Long-lived assets include property and equipment, definite lived intangible assets, indefinite lived intangible assets and goodwill. Assets that have an indefinite useful life, including goodwill, are tested annually for impairment or when events or circumstances indicate that the carrying value may not be recoverable. Assets that are subject to depreciation or amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment test is performed by comparing the carrying amount of the asset or cash generating unit to their recoverable amount. Recoverable amount is calculated as the higher of an asset’s or cash-generating unit’s fair value less costs to sell and its value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units or CGUs). Management has determined that the appropriate level for assessing impairments in accordance with IFRS is at the North American and international fleet levels for aircraft and related assets supporting the operating fleet. Parked aircraft not used in operations and aircraft leased or subleased to third parties are assessed for impairment at the individual asset level. Value in use is calculated based upon a discounted cash flow analysis, which requires management to make a number of significant assumptions including assumptions relating to future operating plans, discount rates and future growth rates. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount.

Depreciation and Amortization Period for Long-Lived Assets

Air Canada makes estimates about the expected useful lives of long-lived assets and the expected residual values of the assets based on the estimated current fair value of the assets, Air Canada’s fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $17 million to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

Maintenance Provisions

The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. For the purposes of sensitivity of these estimates, a 2% increase in the aggregate cost for return conditions, holding all other factors constant, results in a cumulative balance sheet adjustment increasing the provision by $12 million at December 31, 2011 and an increase to maintenance expense in 2012 of approximately $1 million. If the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $13 million at December 31, 2011. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

14. ACCOUNTING POLICIES

14.1. Future Accounting Standards

The following is an overview of accounting standard changes that Air Canada will be required to adopt in future years. Except as otherwise noted below for IFRS 9, IAS 32 and amendments to IFRS 7, the standards are effective for Air Canada's annual periods beginning on or after January 1, 2013, with earlier application permitted. Air Canada does not expect to adopt any of these standards before their effective dates. Air Canada continues to evaluate the impact of these standards on its consolidated statement of operations and financial position.

IFRS 9 – Financial Instruments

IFRS 9 introduces new requirements for the classification and measurement of financial assets. IFRS 9 requires all recognized financial assets that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement to be subsequently measured at amortized cost or fair value. Specifically, financial assets that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of subsequent accounting periods. All other financial assets including equity investments are measured at their fair values at the end of subsequent accounting periods.

Requirements for financial liabilities were added in October 2010 and they largely carried forward existing requirements in IAS 39, Financial Instruments – Recognition and Measurement, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss would generally be recorded in other comprehensive income.

IFRS 9 is effective for annual periods beginning on or after January 1, 2015.

IFRS 10 – Consolidation

IFRS 10 requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12 Consolidation – Special Purpose Entities and parts of IAS 27 Consolidated and Separate Financial Statements.

IFRS 11 – Joint Arrangements

IFRS 11 requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, Interests in Joint Ventures, and SIC-13, Jointly Controlled Entities – Non-monetary Contributions by Venturers.

IFRS 12 – Disclosure of Interests in Other Entities

IFRS 12 establishes disclosure requirements for interests in other entities, such as joint arrangements, associates, special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities.

IFRS 13 – Fair Value Measurement

Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements. IFRS 13 is a more comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement.

Amendments to IAS 19 – Employee Benefits

The amendments to IAS 19 make significant changes to the recognition and measurement of defined benefit pension expense and termination benefits, and to enhance the disclosures for all employee benefits. Actuarial gains and losses are renamed "remeasurements" and will be recognized immediately in other comprehensive income ("OCI"). Remeasurements recognized in OCI will not be recycled through profit or loss in subsequent periods. The amendments also accelerate the recognition of past service costs whereby they are recognized in the period of a plan amendment. The annual expense for a funded benefit plan will be computed based on the application of the discount rate to the net defined benefit asset or liability. The amendments to IAS 19 will also impact the presentation of pension expense as benefit cost will be split between (i) the cost of benefits accrued in the current period (service cost) and benefit changes (past-service cost, settlements and curtailments); and (ii) finance expense or income.

A number of other amendments have been made to recognition, measurement and classification, including those re-defining short-term and other long-term benefits guidance on the treatment of taxes related to benefit plans, guidance on risk/cost sharing factors and expanded disclosures.

Air Canada's current accounting policy for employee benefits for the presentation of pension expense and the immediate recognition of actuarial gains and losses in OCI is consistent with the requirements in the new standard, however, additional disclosures and the computation of annual expense based on the application of the discount rate to the net defined benefit asset or liability will be required in relation to the revised standard.

Amendments to IAS 1 – Financial Statement Presentation

The amendments to IAS 1 require entities to separate items presented in OCI into two groups based on whether or not they may be recycled to profit or loss in the future. Items that will not be recycled, such as remeasurements resulting from the amendments to IAS 19, will be presented separately from items that may be recycled in the future, such as deferred gains and losses on cash flow hedges. Entities that choose to present OCI items before tax will be required to show the amount of tax related to the two groups separately.

Amendments to Other Standards

In addition, there have been amendments to existing standards, including IFRS 7 Financial Instruments: Disclosure, IAS 27, Separate Financial Statements, IAS 28, Investments in Associates and Joint Ventures, and IAS 32, Financial Instruments: Presentation. IFRS 7 amendments require disclosure about the effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. IAS 27 addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements. IAS 28 has been amended to include joint ventures in its scope and to address the changes in IFRS 10 – 13. IAS 32 addresses inconsistencies when applying the offsetting requirements, and is effective for annual periods beginning on or after January 1, 2014.

Carbon Emissions Accounting Policy

The European Union passed legislation for an Emissions Trading System which will include carbon emissions from aviation commencing in January 2012, including for flights operated between Canada and countries within the European Union. The legislation will require aircraft operators to monitor and report on fuel use and emissions data.

Air Canada will adopt the terms of the Emissions Trading Scheme ("ETS") commencing in January 2012. Effective January 1, 2012 Air Canada intends to adopt a cost of settlement accounting model whereby emission allowances granted by the European Union are recorded as an intangible asset and are measured at fair value at the date of initial recognition with an offset to deferred income as a government grant. Purchased emission allowances will be recorded at cost and also recognized as an intangible asset. The intangible assets will subsequently be measured using the cost model of IAS 38, Intangible Assets and will be de-recognized at the end of each emission compliance period as an offset to the Corporation's provision for emission obligations. The intangible assets will be subject to Air Canada's impairment of long-lived assets accounting policy.

The government grant, measured based on the fair value of emission allowances at the date of initial recognition, will be amortized as an offset to other operating expenses over the emission compliance period based on volume of emissions generated during the period compared to the expected volume of emissions during the emission compliance period.

A provision to deliver emissions allowances will be recognized, with an offset to other operating expense, as carbon emissions are made using a weighted average cost model per unit of emission expected to be incurred for the emission compliance period as a whole. This provision will be presented net of emission allowances on Air Canada's consolidated statement of financial position.

Based on current trading prices of European Union CO2 allowances (EUAs), Air Canada expects to incur operating costs of no more than $4 million in 2012. This amount is subject to change based on the change in the market price of EUAs. Based on current operating plans, no specific European Union ETS surcharges will be implemented, rather a fuel surcharge strategy will be employed.

15. OFF-BALANCE SHEET ARRANGEMENTS

The following is a summary of Air Canada's more significant off-balance sheet arrangements.

Guarantees

Performance Obligations Relating to Aircraft Leasing Agreements

With respect to 23 Air Canada aircraft leases, the difference between the reduced rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement under the Companies' Creditors Arrangement Act ("CCAA") on September 30, 2004, and amounts which would have been due under the original lease contracts will be forgiven at the expiry date of the leases if no material default has occurred by such date. In the event of a material default, which does not include any cross defaults to other unrelated agreements (including agreements with the counterparties of these aircraft leases), this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements, and any additional liability would be recorded only at the time management believes the amount is likely to be incurred.

Guarantees in Fuel Facilities Arrangements

Air Canada participates in fuel facility arrangements operated through Fuel Facility Corporations, along with other airlines that contract for fuel services at various major airports in Canada. The Fuel Facility Corporations operate on a cost recovery basis. The purpose of the Fuel Facility Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the Land Rights under the land lease. The aggregate debt of the five Fuel Facility Corporations in Canada that have not been consolidated by Air Canada under SIC Interpretation 12 – Consolidation of Special Purpose Entities is approximately $187 million as at December 31, 2011 (2010 – $171 million), which is Air Canada's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. Air Canada views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification Agreements

In the ordinary course of Air Canada's business, Air Canada enters into a variety of agreements, some of which may provide for indemnifications to counterparties that may require Air Canada to pay for costs and/or losses incurred by such counterparties. Air Canada cannot reasonably estimate the potential amount, if any, it could be required to pay under such indemnifications. Such amount would also depend on the outcome of future events and conditions, which cannot be predicted. While certain agreements specify a maximum potential exposure, certain others do not specify a maximum amount or a limited period. Historically, Air Canada has not made any significant payments under these indemnifications.

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

In aircraft financing or leasing agreements, Air Canada typically indemnifies the financing parties, trustees acting on their behalf and other related parties and/or lessors against liabilities that arise from the manufacture, design, ownership, financing, use, operation and maintenance of the aircraft and for tort liability, whether or not these liabilities arise out of or relate to the negligence of these indemnified parties, except for their gross negligence or wilful misconduct. In addition, in aircraft financing or leasing transactions, including those structured as leveraged leases, Air Canada typically provides indemnities in respect of various tax consequences including in relation to the leased or financed aircraft, the use, possession, operation, maintenance, leasing, subleasing, repair, insurance, delivery, import, export of such aircraft, the lease or finance arrangements entered in connection therewith, changes of law and certain income, commodity and withholding tax consequences.

When Air Canada, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, Air Canada has from time to time agreed to indemnify the service provider against certain liabilities that arise from third party claims, which may relate to the services performed by the service provider.

Under its general by-laws and pursuant to contractual agreements between Air Canada and each of its officers and directors, Air Canada has indemnification obligations to its directors and officers. Pursuant to such obligations, Air Canada indemnifies these individuals, to the extent permitted by law, against any and all claims or losses (including amounts paid in settlement of claims) incurred as a result of their service to Air Canada.

The maximum amount payable under the foregoing indemnities cannot be reasonably estimated. Air Canada expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities described above.

16. RELATED PARTY TRANSACTIONS

At December 31, 2011, Air Canada had no transactions with related parties as defined in the CICA Handbook – Part 1, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

17. SENSITIVITY OF RESULTS

Air Canada's financial results are subject to many different internal and external factors which can have a significant impact on operating results. The following table describes, on an indicative basis, the financial impact that changes in certain assumptions would generally have had on Air Canada's operating results. These guidelines were derived from 2011 levels of activity and make use of management estimates. The impacts are not additive, do not reflect the interdependent relationship of the elements and actual results may vary significantly due to a wide range of factors many of which are beyond the control of Air Canada.

(Canadian dollars in millions, except where indicated) Key Variable		2011 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Operating Income Impact
Revenue Measures				
Passenger yield (cents)	System	18.7	1% increase in yield	$ 96
	Canada	25.0		$ 38
Traffic (RPMs) (millions)	System	54,223	1% increase in traffic	$ 91
	Canada	15,971		$ 36
Passenger load factor (%)	System	81.6	1 percentage point increase	$ 111
RASM (cents)	System	15.3	1% increase in RASM	$ 93
Cost Measures				
Fuel – WTI price (US$/barrel)(1)		94	US$1/barrel increase to WTI	$ (24)
Fuel – jet fuel price (CAD cents/litre)(1)		85	1% increase	$ (33)
Cost per ASM (cents)		17.2	1% increase in CASM	$ (114)
Currency Exchange				
C$ to US$		C$1 = US$1.00	1 cent increase in exchange rate (i.e., $1.01 to $1.00 per US dollar)	$ 31

(1) Excludes the impact of fuel surcharges and fuel hedging. Refer to section 12 of this MD&A for information on Air Canada's fuel derivative instruments.

(Canadian dollars in millions, except where indicated) Key Variable	2011 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Pre-Tax Income Impact(1)
Currency Exchange			
C$ to US$	C$1 = US$1.00	1 cent increase in exchange rate (i.e., $1.01 to $1.00 per US dollar)	$ 65

(1) Excludes the impact of foreign exchange, forward contracts and currency swaps.

18. RISK FACTORS

The risks described herein may not be the only risks faced by Air Canada. Other risks of which Air Canada is not aware or which Air Canada currently deems to be immaterial may surface and have a material adverse impact on Air Canada, its business, results from operations and financial condition.

RISKS RELATING TO AIR CANADA

Operating Results

Prior to emergence, on September 30, 2004, from its restructuring under the Companies Creditors Arrangement Act, as amended ("CCAA"), Air Canada had sustained significant losses and Air Canada may sustain significant losses in the future. Since emergence from CCAA to December 31, 2011, Air Canada has accumulated a Deficit of $4,085 million in Shareholders' Equity. A variety of factors, including economic conditions and other factors described in this Risk Factors section, may result in Air Canada incurring significant losses. Despite ongoing strategic and business initiatives, including efforts at securing cost reductions and revenue improvements, Air Canada may not be able to successfully achieve positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to decrease costs, improve yield or offset or mitigate risks facing Air Canada, including those relating to economic conditions, labour issues, liquidity, pension funding, competition, and volatility in fuel costs and other expenses.

Leverage

Air Canada has, and is expected to continue to have and incur, a significant amount of indebtedness, including substantial fixed obligations under aircraft leases and other financings (including under the private offering of senior secured notes completed in 2010), and as a result of challenging economic or other conditions affecting Air Canada, Air Canada may incur greater levels of indebtedness than currently exist. The amount of indebtedness that Air Canada currently has and which it may incur in the future could have a material adverse effect on Air Canada, for example, by (i) limiting Air Canada's ability to obtain additional financing, (ii) requiring Air Canada to dedicate a substantial portion of its cash flow from operations to payments on its indebtedness and fixed cost obligations, thereby reducing the funds available for other purposes, (iii) making Air Canada more vulnerable to economic downturns, and (iv) limiting Air Canada's flexibility in planning for, or reacting to, competitive pressures or changes in its business environment.

The ability of Air Canada to make scheduled payments under its indebtedness will depend on, among other things, its future operating performance and its ability to refinance its indebtedness, if necessary. In addition, as Air Canada incurs indebtedness which bears interest at fluctuating interest rates, to the extent these interest rates increase, its interest expense will increase. There can be no assurance that Air Canada will be able to generate sufficient cash from its operations to pay its debts and lease obligations. Each of these factors is, to a large extent, subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond Air Canada's control.

Need for Additional Capital and Liquidity

Air Canada faces a number of challenges in its business, including in relation to economic conditions, pension plan funding, labour issues, volatile fuel prices, contractual covenants which could require Air Canada to deposit cash collateral with third parties, foreign exchange rates and increased competition from international, U.S. transborder and low-cost domestic carriers. Air Canada's liquidity levels may be adversely impacted by these as well as by other factors and risks identified in this MD&A. As part of Air Canada's efforts to meet such challenges and to support Air Canada's business strategy, significant liquidity and significant operating and capital expenditures are, and will in the future be, required. There can be no assurance that Air Canada will continue to be able to obtain on a timely basis sufficient funds on terms acceptable to Air Canada to provide adequate liquidity and to finance the operating and capital expenditures necessary to overcome challenges and support its business strategy if cash flows from operations and cash on hand are insufficient.

Failure to generate additional funds, whether from operations or additional debt or equity financings, could require Air Canada to delay or abandon some or all of its anticipated expenditures or to modify its business strategy and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Furthermore, competitors with greater liquidity or the ability to raise money more easily and on less onerous terms could create a competitive disadvantage for Air Canada.

Air Canada's credit ratings influence its ability to access capital markets and its liquidity. There can be no assurance that Air Canada's credit ratings will not be downgraded, which would add to Air Canada's borrowing and insurance costs, hamper its ability to attract capital, adversely impact its liquidity, and limit its ability to operate its business, all of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Economic and Geopolitical Conditions

Airline operating results are sensitive to economic and geopolitical conditions which can have a significant impact on Air Canada. For example, economic and geopolitical conditions may impact demand for air transportation in general or to or from certain destinations, and may also impact Air Canada's operating costs, pension plan contributions, fuel costs, and costs and availability of capital and supplies required by Air Canada. Especially in light of Air Canada's substantial fixed cost structure, any prolonged or significant impact arising from economic and geopolitical conditions, including weakness of the Canadian, U.S. or world economies could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. Air Canada is not able to predict with certainty market conditions and the fares that Air Canada may be able to charge. Customer expectations can change rapidly and the demand for lower fares may limit revenue opportunities. Travel, especially leisure travel, is a discretionary consumer expense. Demand for business and premium travel are also impacted by economic conditions. Depressed economic conditions in North America and other areas served by Air Canada, as well as geopolitical instability in various areas of the world, concerns about the environmental impacts of air travel and tendencies towards "green" travel initiatives where consumers reduce their travel activities, could have the effect of reducing demand for air travel in Canada and abroad and could materially adversely impact Air Canada's profitability.

Pension Plans

Canadian federal pension legislation requires that the funded status of registered pension plans be determined periodically, on both a going concern basis (essentially assuming indefinite plan continuation) and a solvency basis (essentially assuming immediate plan termination).

Pension plan solvency valuations are influenced primarily by long-term interest rates and by the investment return on plan assets, which in turn may be dependent on a variety of factors, including economic conditions. The interest rate used to calculate benefit obligations for solvency purposes is a prescribed rate derived from the interest rates on long-term Government of Canada bonds. Deteriorating economic conditions or prolonged period of low interest rates may result in significant increases in Air Canada's funding obligations, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Refer to section 9.8 of this MD&A for additional information relating to Air Canada's pension funding obligations. In particular, as of 2014, the Air Canada 2009 Pension Regulations will cease to have effect and Air Canada's pension funding obligations may vary significantly based on several factors, including regulatory developments, assumptions and methods used and changes in the economic conditions (mainly the return on fund assets and changes in interest rates). Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of Air Canada in 2011. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events, jet fuel refining costs and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. During the last five years, fuel prices increased and fluctuated near or at historically high levels. Should fuel prices fluctuate significantly or increase significantly above current levels, fuel costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. Based on 2011 volumes, management estimates that a US$1 per barrel movement in the average price of West Texas Intermediate ("WTI") crude oil would have resulted in an approximate $24 million change in 2011 fuel expense for Air Canada (excluding any impact of fuel surcharges, foreign exchange rates and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between WTI crude oil and jet fuel as well as foreign exchange rates remained constant.

Labour Costs and Labour Relations

Labour costs constituted another one of Air Canada's largest operating cost items in 2011. There can be no assurance that Air Canada will be able to maintain such costs at levels that do not negatively affect its business, results from operations and financial condition. There can be no assurance that future agreements with employees' unions or the outcome of arbitrations will be on terms consistent with Air Canada's expectations or comparable to agreements entered into by Air Canada's competitors. Any future agreements or outcome of negotiations or arbitrations including in relation to wages or other labour costs or work rules may result in increased labour costs or other charges, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Most of Air Canada's employees are unionized. The collective agreements representing the majority of the unionized workforce were renewed or extended in 2009 and expired in 2011. In 2011, collective agreements with the unions representing Air Canada's customer service employees at airports and call centres, as well as with the union representing its flight attendants were, respectively, concluded and imposed through arbitration during 2011. Also in 2011, Air Canada entered into a collective agreement with the union representing the airline's London-Heathrow based employees. Negotiations continue or are expected to soon commence with the remaining bargaining units of Canadian-based union represented employees. No strikes or lock-outs may lawfully occur during the term of the collective agreements, nor during the negotiations of their renewal until a number of pre-conditions, in respect of the unions for Canadian-based employees, prescribed by the Canada Labour Code, have been satisfied. There can be no assurance that collective agreements will be further renewed without labour conflict or action or that there will not otherwise be any labour conflict or action that could also lead to an interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada to conduct its operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Any labour disruption or work stoppage by any of the unionized work groups of Jazz or other parties with whom Air Canada conducts business could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, labour conflicts at Star Alliance partners could result in lower demand for connecting traffic with Air Canada and, ultimately, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Foreign Exchange

Air Canada's financial results are sensitive to the fluctuating value of the Canadian dollar. In particular, Air Canada has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the U.S./Canada dollar exchange rate. Management estimates that during 2011, a $0.01 strengthening of the Canadian dollar versus the U.S. dollar (i.e., $1.01 to $1.00 per U.S. dollar) would have had an estimated $31 million favourable impact on operating income and a $65 million favourable impact on pre-tax income. Conversely, a corresponding opposite change in the exchange rate would have had the corresponding opposite effect. Air Canada incurs significant expenses in U.S. dollars for items such as fuel, aircraft rental and maintenance charges, interest payments, debt servicing and computerized reservations system fees, while a substantial portion of its revenues are generated in Canadian dollars. A significant deterioration of the Canadian dollar relative to the U.S. dollar would increase the costs of Air Canada relative to its U.S. competitors and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, Air Canada may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

Competition

Air Canada operates within a highly competitive industry. Over the past few years, several carriers have entered or announced their intention to enter or expand into the domestic (including regional), the U.S. transborder and international markets in which Air Canada operates.

Canadian low-cost and other carriers have entered and/or expanded or announced their intention to compete in many of Air Canada's key domestic (including regional) markets and, along with some U.S. carriers have also entered and/or expanded their operations in the U.S. transborder and leisure-oriented markets. Carriers against which Air Canada competes, including U.S. carriers, may undergo (and some have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness and lower operating costs and may therefore be in a position to more effectively compete with Air Canada. Air Canada is also facing increasing competition in international markets as carriers increase their international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition. Expansion or new competition by low-cost or other carriers in any of the markets served by Air Canada may adversely affect Air Canada's business results from operations and financial condition.

Air Canada also encounters substantial price competition. The prevalence of low-cost carriers, along with the advent of Internet travel websites and other travel products distribution channels, has resulted in a substantial increase in discounted and promotional fares initiated by Air Canada's competitors. A decision to match competitors' fares to maintain passenger traffic results in reduced yields which, in turn, could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Furthermore, Air Canada's ability to reduce its fares in order to effectively compete with other carriers is dependent on Air Canada's ability to achieve acceptable operating margins and may also be limited by government policies to encourage competition. Likewise, competitors continue to pursue commissions/incentive actions and, in many cases, increase these payments. The decision to modify Air Canada's current programs in order to remain competitive and maintain passenger traffic could result in increased costs to Air Canada's business.

Furthermore, consolidation within the airline industry could result in increased competition as some airlines emerging from such consolidations and entering into integrated commercial cooperation arrangements, such as joint ventures, may be able to compete more effectively, which could have a material adverse effect on Air Canada.

Airline Industry Characterized by Low Gross Profit Margins and High Fixed Costs

The airline industry is characterized by low gross profit margins and high fixed costs. The costs of operating any particular flight do not vary significantly with the number of passengers carried and, therefore, a relatively small change in the number of passengers or in fare pricing or traffic mix would have a significant effect on Air Canada's operating and financial results. This condition has been exacerbated by aggressive pricing by low-cost carriers, which has had the effect of driving down fares in general. Accordingly, a shortfall from expected revenue levels could have a material adverse effect on Air Canada, its business, results from operations and financial condition. As a result of high fixed costs, should Air Canada be required to reduce its overall capacity or the number of flights operated, it may not be able to successfully reduce certain fixed costs in the short term and may be required to incur important termination or other restructuring costs, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Limitations Due to Restrictive Covenants

Some of the financing and other major agreements to which Air Canada is a party contain restrictive, financial (including in relation to asset valuations, liquidity, minimum EBITDAR, fixed charge coverage ratio and debt coverage ratios) and other covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which Air Canada may structure or operate its business, including by reducing Air Canada's liquidity, limiting Air Canada's ability to incur indebtedness, create liens, sell assets, pay dividends, make capital expenditures, and engage in acquisitions, mergers or restructurings or a change of control. Future financing and other major agreements may also be subject to similar covenants which limit Air Canada's operating and financial flexibility, which could materially and adversely affect Air Canada's ability to operate its business and its profitability.

A failure by Air Canada to comply with its contractual obligations (including restrictive, financial and other covenants), or to pay its indebtedness and fixed costs could result in a variety of material adverse consequences, including the acceleration of its indebtedness, the withholding of credit card proceeds by the credit card service providers and the exercise of remedies by its creditors, lessors or other co-contracting parties, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, Air Canada may not be able to repay the accelerated indebtedness or fulfill its obligations under certain contracts, make required aircraft lease payments or otherwise cover its fixed costs. Also, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of Air Canada which secure Air Canada's obligations.

Refer to section 9.7 of this MD&A for information on Air Canada's credit card processing agreements.

Airport User Fees and Air Navigation Fees

With the privatization of airports and air navigation authorities in Canada, new airport and air navigation authorities have significantly increased their fees. Though certain authorities have implemented some fee reductions, if authorities in Canada or elsewhere were to significantly increase their fees, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

Strategic, Business, Technology and Other Important Initiatives

In order to operate its business, achieve its goals and remain competitive, Air Canada continuously seeks to identify and devise, invest in, implement and pursue strategic, business, technology and other important initiatives, such as those relating to participation in the low-cost market, the aircraft fleet restructuring, business processes, information technology, revenue management, cost transformation, improving premium passenger revenues, expansion of flying capacity (including in respect of new routes), corporate culture transformation, initiatives seeking to ensure a consistently high quality customer service experience and others. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond Air Canada's control. Such factors include the performance of third parties, including suppliers, the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of these initiatives by Air Canada's customers, suppliers and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement these initiatives could adversely affect Air Canada's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

For instance, a key component of Air Canada's business plan is the acquisition of new and more efficient Boeing 787 aircraft. A delay or failure in the completion of Air Canada's fleet restructuring, including further delays by the manufacturers in the delivery of the widebody aircraft, or an inability to remove, as planned, certain aircraft from the fleet in coordination with the planned entry into service of new aircraft, could adversely affect the implementation of Air Canada's business plan which may, in turn, have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Dependence on Technology

Air Canada relies heavily on technology, including computer and telecommunications equipment and software and Internet-based systems, to operate its business, increase its revenues and reduce its costs. These systems include those relating to Air Canada's telecommunications, websites, computerized airline reservations and airport customer services and flight operations.

These technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of third party suppliers' acts or omissions, natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, unauthorized or fraudulent users, and other operational and security issues. While Air Canada continues to invest in initiatives, including security initiatives and disaster recovery plans, these measures may not be adequate or implemented properly. Any such technology systems failure, interruption or misuse could materially and adversely affect Air Canada's operations and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key Supplies and Suppliers

Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services in a timely manner, including those available at airports or from airport authorities or otherwise required for Air Canada's operations such as fuel, aircraft and related parts and aircraft maintenance services (including maintenance services obtained from Aveos). In certain cases, Air Canada may only be able to access goods and services from a limited number of suppliers and transition to new suppliers may take significant amounts of time and require significant resources. A failure, refusal or inability of a supplier may arise as a result of a wide range of causes, many of which are beyond Air Canada's control. In addition, there can be no assurance as to the continued viability of any of Air Canada's suppliers. Any failure or inability of Air Canada to successfully source goods and services, including by reason of a failure, refusal or inability of a supplier, or to source goods and services on terms and pricing and within the timeframes acceptable to Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Aeroplan®

Through its commercial agreement with Aeroplan, Air Canada is able to offer its customers who are Aeroplan members the opportunity to earn Aeroplan Miles. Based on customer surveys, management believes that rewarding customers with Aeroplan Miles is a significant factor in customers' decision to travel with Air Canada and contributes to building customer loyalty. The failure by Aeroplan to adequately fulfill its obligations towards Air Canada under the Aeroplan Commercial Participation and Services Agreement and in connection with the Aeroplan program, or other unexpected interruptions of Aeroplan services which are beyond Air Canada's control, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Jazz

Under the Jazz CPA, Jazz provides Air Canada's customers service in lower density markets and higher density markets at off-peak times throughout Canada and to and from certain destinations in the United States and also provides valuable traffic feed to Air Canada's mainline routes. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees which are determined based upon certain costs incurred by Jazz. Air Canada also reimburses Jazz, without mark-up, for certain pass-through costs incurred directly by Jazz, such as fuel, navigation, landing and terminal fees and certain other costs. Significant increases in such pass-through costs, the failure by Jazz to adequately fulfill its obligations under the Jazz CPA, or other unexpected interruptions or cessation of Jazz's services which are beyond Air Canada's control could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires that Air Canada make certain minimum payments to Jazz regardless of the amount of flying done on its behalf by Jazz.

Star Alliance™

The strategic and commercial arrangements with Star Alliance members provide Air Canada with important benefits, including codesharing, efficient connections and transfers, reciprocal participation in frequent flyer programs and use of airport lounges from the other members. Should a key member leave Star Alliance or otherwise fail to meet its obligations thereunder, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

Interruptions or Disruptions in Service

Air Canada's business is significantly dependent upon its ability to operate without interruption at a number of hub airports, including Toronto Pearson International Airport. Delays or disruptions in service, including those due to security or other incidents, weather conditions, labour conflicts with airport workers, baggage handlers, air traffic controllers and other workers not employed by Air Canada or other causes beyond the control of Air Canada could have a material adverse impact on Air Canada, its business, results from operations and financial condition.

Interruptions and disruptions in service may be caused by, and the demand and cost of air travel may be adversely impacted by, environmental conditions and factors in addition to those relating to the weather. Environmental conditions and factors, such as those arising from volcanic eruptions or other natural phenomena, as well as those arising from man-made sources, could cause interruptions and disruptions in service, increase Air Canada's costs or adversely impact demand for air travel, any of which could have a material adverse impact on Air Canada, its business, results from operations and financial condition.

Current Legal Proceedings

Investigations by Competition Authorities Relating to Cargo

The European Commission, the United States Department of Justice and the Competition Bureau in Canada have investigated or are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities have sought or requested information from Air Canada as part of their investigations. Air Canada has been cooperating with these investigations, which are likely to lead, or have led, to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions. Air Canada is also named as a defendant, and may otherwise become implicated, in a number of class action lawsuits and other proceedings that have been filed before the United States District Court in Canada and Europe in connection with these allegations. In the United States, the investigation by the U.S. Department of Justice has concluded with no proceedings having been instituted against Air Canada.

On November 9, 2010, Air Canada announced that the European Commissions issued a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21,037,500 Euros (approximately $29.4 million at an exchange rate of $1.3970) was imposed on Air Canada. Air Canada is appealing this decision and has filed an application for appeal before the European General Court. In the first quarter of 2011, Air Canada paid the fine, as required, pending the outcome of its appeal.

As at December 31, 2011, Air Canada has a provision of $37 million relating to outstanding claims in this matter, which is recorded in accounts payable and accrued liabilities on Air Canada's consolidated statement of financial position. This provision is an estimate based upon the status of the investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. As stated above, Air Canada is

appealing the decision issued by the European Commission and, if and as appropriate, based on the outcome of any updates regarding this appeal as well as developments regarding proceedings and investigations in other jurisdictions, may record adjustments to the provision and/or its income in subsequent periods as required.

Billy Bishop Toronto City Airport

In February 2006, Jazz commenced proceedings before the Ontario Superior Court of Justice against Porter Airlines Inc. ("Porter") and other defendants (collectively the "Porter Defendants") after Jazz became aware that it would be excluded from operating flights from Billy Bishop Toronto City Airport. On October 26, 2007, the Porter Defendants counter-claimed against Jazz and Air Canada alleging various violations of competition law, including that Jazz and Air Canada's commercial relationship contravenes Canadian competition laws, and claiming $850 million in damages. On October 16, 2009, Jazz discontinued its suit in the Ontario Superior Court against Porter.

Concurrently with the Ontario Superior Court of Justice proceedings, Jazz commenced judicial review proceedings against the Toronto Port Authority ("TPA") before the Federal Court of Canada relating to Jazz's access to the Billy Bishop Toronto City Airport. The Porter Defendants were granted intervener and party status in these proceedings. In January 2008, Porter filed a defence and counterclaim against Jazz and Air Canada making allegations and seeking conclusions similar to those in the Ontario Superior Court counterclaim. In March 2010, Jazz discontinued its proceedings in the Federal Court of Canada against the TPA. On May 14, 2010, Porter filed a discontinuance of its counterclaim before the Federal Court of Canada.

The counterclaim filed by Porter in the Ontario Superior Court of Justice against Jazz and Air Canada was stayed pending the outcome of the mirror counterclaim in the Federal Court. This stay has now been lifted and the counterclaim has been reactivated. Management views Porter's counterclaim as being without merit.

In the first quarter of 2010, Air Canada filed legal proceedings with the Federal Court of Canada seeking to challenge the process announced by the TPA to allocate flight capacity or slots at the Billy Bishop Toronto City Airport. On July 21, 2010, the Federal Court of Canada dismissed Air Canada's challenge and Air Canada appealed this decision before the Federal Court of Appeal. On December 12, 2011, the Federal Court of Appeal dismissed Air Canada's appeal, adversely impacting Air Canada's ability to secure new slots at the Billy Bishop Toronto City Airport ("BBTCA") on a fair and equitable basis to effectively compete with Porter.

Pay Equity

The Canadian Union of Public Employees ("CUPE"), which represents Air Canada's flight attendants, filed a complaint before the Canadian Human Rights Commission where it alleges gender-based wage discrimination. CUPE claims the predominantly female flight attendant group should be paid the same as the predominantly male pilot and mechanics groups because their work is of equal value. The complaint, which dates from 1991, was not investigated on the merits because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act. On January 26, 2006, the Supreme Court of Canada ruled that they do work in the same "establishment" and sent the case back to the Canadian Human Rights Commission to proceed to assess the merits of CUPE's complaint. On March 16, 2007, the Canadian Human Rights Commission referred the complaint against Air Canada for investigation and an investigation proceeded and was concluded in 2011 with the determination that the complaint will not be referred to the Canadian Human Rights Tribunal for inquiry. CUPE has initiated proceedings before the Federal Court to challenge this determination, which Air Canada will seek to have upheld. Air Canada considers that any proceedings will show that it is complying with the equal pay provisions of the Canadian Human Rights Act, however, management has determined that it is not possible at this time to predict with any degree of certainty the final outcome of the proceedings.

Mandatory Retirement

Air Canada is engaged in a number of proceedings involving challenges to the mandatory retirement provisions of certain of its collective agreements, including the Air Canada–Air Canada Pilots Association ("ACPA") collective agreement which incorporate provisions of the pension plan terms and conditions applicable to pilots requiring them to retire at age 60. Air Canada has fully or partially resolved some of these complaints and is defending others. At this time, it is not possible to determine with any degree of certainty the extent of any financial liability that may arise from Air Canada being unsuccessful in its defence of these proceedings.

Future Legal Proceedings

Airlines are susceptible to various claims and litigation, including class action claims, in the course of operating their business or with respect to the interpretation of existing agreements. Any future claims or litigation could also have a material adverse effect on Air Canada, its business and results from operations.

Key Personnel

Air Canada is dependent on the experience and industry knowledge of its executive officers and other key employees to execute its business plan. If Air Canada were to experience a substantial turnover in its leadership or other key employees, Air Canada's business, results from operations and financial condition could be materially adversely affected. Additionally, Air Canada may be unable to attract and retain additional qualified key personnel as needed in the future.

RISKS RELATING TO THE AIRLINE INDUSTRY

Terrorist Attacks and Security Measures

The potential for terrorist attacks and terrorist activity causes uncertainty in the minds of the traveling public. The occurrence of a terrorist attack (or attempted attacks) (whether domestic or international and whether involving Air Canada or another carrier or no carrier at all) and increasingly restrictive security measures, such as those relating to the content of carry-on baggage, passenger identification document requirements, and passenger screening procedures could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in costs, including insurance, security or other costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Epidemic Diseases (Severe Acute Respiratory Syndrome (SARS), H1N1 Influenza or Other Epidemic Diseases)

The international outbreaks of Severe Acute Respiratory Syndrome (SARS) in 2003, and the resulting actions tabled by the World Health Organization (the "WHO"), including a travel advisory against non-essential travel to Toronto, Canada had a significant adverse effect on passenger demand for air travel in Air Canada's markets and resulted in a major negative impact on traffic on the entire network. An outbreak of influenza, SARS, H1N1 influenza virus or of another epidemic disease (whether domestic or international) or any WHO or similar travel advisories (whether relating to Canadian cities or regions or other cities, regions or countries) could have a material adverse effect on passenger demand for air travel. Any resulting reduction in traffic in the markets served by Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Casualty Losses

Due to the nature of its core operating business, Air Canada may be subject to liability claims arising out of accidents or disasters involving aircraft on which Air Canada's customers are traveling or involving aircraft of other carriers maintained or repaired by Air Canada, including claims for serious personal injury or death. There can be no assurance that Air Canada's insurance coverage will be sufficient to cover one or more large claims and any shortfall may be material. Additionally, any accident or disaster involving one of Air Canada's aircraft or an aircraft of another carrier receiving line maintenance services from Air Canada may significantly harm Air Canada's reputation for safety, which would have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Seasonal Nature of the Business, Other Factors and Prior Performance

Air Canada has historically experienced considerably greater demand for its services in the second and third quarters of the calendar year and significantly lower demand in the first and fourth quarters of the calendar year. This demand pattern is principally a result of the preference of a high number of leisure travelers to travel during the spring and summer months. Air Canada has substantial fixed costs that do not meaningfully fluctuate with passenger demand in the short term.

As described elsewhere, demand for and cost of air travel is also affected by factors such as geopolitical and economic conditions, war or the threat of war or terrorist attacks, fare levels and weather conditions. Due to these and other factors, operating results for an interim period are not necessarily indicative of operating results for an entire year, and operating results for an historical period are not necessarily indicative of operating results for a future period.

Regulatory Matters

The airline industry is subject to extensive Canadian and foreign government regulations relating to, among other things, security, safety, consumer rights, privacy, licensing, competition, environment (including noise levels and carbon emissions) and, in some measure, pricing. For example, new and proposed legislation have been considered or adopted concerning carbon emissions emanating from the aviation industry. Such legislative initiatives include, for example, market-based mechanisms called emissions trading systems, which are being proposed and implemented to reduce the amount of carbon emissions through the setting of emissions allowances and charging aircraft operators for a certain percentage of theses allowances. The implementation of additional regulations or decisions, including those relating to carbon emissions, and others, whether by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency or other domestic or foreign governmental entities, may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The European Union passed legislation for an Emissions Trading System, which will include carbon emissions from aviation commencing in January 2012, including for flights operated between Canada and countries within the European Union. The legislation requires aircraft operators to monitor and report on fuel use and emissions data. While this legislation is expected to result in increased costs relating to the purchase of emissions allowances, the net financial impact will, in part, depend upon how much of such cost, if any, will be recovered, including in the form of higher passenger fares and cargo rates. Refer to section 14.1 of this MD&A for additional information.

The availability of international routes to Canadian air carriers is regulated by agreements between Canada and foreign governments. Changes in Canadian or foreign government aviation policy could result in the alteration or termination of these agreements and could adversely affect Air Canada and its international operations.

Air Canada is subject to domestic and foreign laws regarding privacy of passenger and employee data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries in which Air Canada operates. The need to comply with these regulatory regimes is expected to result in additional operating costs and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

There can be no assurances that new laws, regulations or revisions to same, or decisions, will not be adopted or rendered, from time to time, and these could impose additional requirements or restrictions, which may adversely impact Air Canada's business, results from operations and financial condition.

Availability of Insurance Coverage and Increased Insurance Costs

The aviation insurance industry has been continually reevaluating the terrorism risks that it covers, and this activity may adversely affect some of Air Canada's existing insurance carriers or Air Canada's ability to obtain future insurance coverage. To the extent that Air Canada's existing insurance carriers are unable or unwilling to provide it with insurance coverage, and in the absence of measures by the Government of Canada to provide the required coverage, Air Canada's insurance costs may increase further and may result in Air Canada being in breach of regulatory requirements or contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Third Party War Risk Insurance

There is a risk that the Government of Canada may not continue to provide an indemnity for third party war risk liability coverage, which it currently provides to Air Canada and certain other carriers in Canada until December 31, 2013. In the event that the Government of Canada does not continue to provide such indemnity or amends such indemnity, Air Canada and other industry participants would have to turn to the commercial insurance market to seek such coverage. Air Canada estimates that such coverage would cost Air Canada approximately US$5 million per year. Alternative solutions, such as those envisioned by the International Civil Aviation Organization ("ICAO") and the International Air Transport Association ("IATA"), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their efforts in this area; however, the achievement of a global solution is not likely in the immediate or near future. The U.S. federal government has set up its own facility to provide war risk coverage to U.S. carriers, thus removing itself as a key component of any global plan.

19. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Disclosure controls and procedures within the Corporation have been designed to provide reasonable assurance that all relevant information is identified to its President and Chief Executive Officer ("CEO"), its Executive Vice President and Chief Financial Officer ("CFO") and its Disclosure Policy Committee to ensure appropriate and timely decisions are made regarding public disclosure.

Internal controls over financial reporting have been designed by management, under the supervision of, and with the participation of the Corporation's CEO and CFO, to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and its preparation of financial statements for external purposes in accordance with GAAP.

The Corporation will file certifications, signed by the Corporation's CEO and CFO, with the Canadian Securities Administrators ("CSA") upon filing of the Corporation's Annual Information Form. In those filings, the Corporation's CEO and CFO will certify, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of the Corporation's disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting. The Corporation's CEO and CFO also certify the appropriateness of the financial disclosures in the Corporation's interim filings with securities regulators. In those interim filings, the Corporation's CEO and CFO also certify the design of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting.

The Corporation's Audit, Finance and Risk Committee reviewed this MD&A and the audited consolidated financial statements, and the Corporation's Board of Directors approved these documents prior to their release.

Management's Report on Disclosure Controls and Procedures

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined under National Instrument 52-109) and concluded, as at December 31, 2011, that such disclosure controls and procedures were effective.

Management's Report on Internal Controls over Financial Reporting

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's internal controls over financial reporting (as defined under National Instrument 52-109). In making this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commissions ("COSO") in Internal Control – Integrated Framework. Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2011, the Corporation's internal controls over financial reporting were effective. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in Internal Controls over Financial Reporting

As a result of the transition from Canadian GAAP to IFRS effective January 1, 2011, there have been material changes in internal controls over financial reporting in the following process areas:

- Accounting policy selection (including controls over changes in accounting policies);
- Property and equipment;
- Provisions (lease return conditions);
- Impairment of long-lived assets;
- Employee benefits.

Management has considered the control risks of the transition to IFRS and has performed procedures to obtain reasonable assurance on the design and operation of internal controls over financial reporting that are new or significantly modified as a result of the transition.

20. NON-GAAP FINANCIAL MEASURES

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation, amortization and impairment, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. EBITDAR is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning, and therefore may not be comparable to similar measures presented by other public companies.

EBITDAR before a provision adjustment for cargo investigations and EBITDAR are reconciled to operating income (loss) as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2011**	**2010**	**Change $**	**2011**	**2010**	**Change $**
GAAP operating income (loss) before a provision adjustment for cargo investigations, net[1]	$ (98)	$ 15	$ (113)	$ 179	$ 232	$ (53)
Add back:						
Aircraft rent	86	86	–	335	353	(18)
Depreciation, amortization and impairment	174	227	(53)	728	801	(73)
EBITDAR before a provision adjustment for cargo investigations, net[1]	**$ 162**	**$ 328**	**$ (166)**	**$ 1,242**	**$ 1,386**	**$ (144)**
Add back:						
Provision adjustment for cargo investigations, net[1]	–	46	(46)	–	46	(46)
EBITDAR	**$ 162**	**$ 374**	**$ (212)**	**$ 1,242**	**$ 1,432**	**$ (190)**

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

Operating Expense, Excluding Fuel Expense and Excluding the Cost of Ground Packages at Air Canada Vacations

Air Canada uses operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, to assess the operating performance of its ongoing airline business as such expenses may distort the analysis of certain business trends and render comparative analyses to other airlines less meaningful. Fuel expense fluctuates widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs, the Canada/U.S. currency exchange rate, and excluding this expense from GAAP expense results, allows Air Canada to more effectively compare its operating performance. Air Canada incurs expenses related to ground packages at Air Canada Vacations, which some airlines generally do not incur, and excluding these expenses from GAAP results, allows its operating expense performance to be more comparable to those of other airlines. In addition, these costs do not generate ASMs and therefore excluding these costs from GAAP expense results, provides for a more meaningful comparison across periods when ground package costs are changing. Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and therefore may not be comparable to similar measures presented by other public companies.

Operating expense, excluding the cost of ground packages at Air Canada Vacations and fuel expense, is reconciled to operating expense as follows:

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2011	2010	Change $	2011	2010	Change $
GAAP operating expense	$ 2,797	$ 2,601	$ 196	$ 11,433	$ 10,554	$ 879
Remove:						
Cost of ground packages at Air Canada Vacations	(57)	(49)	(8)	(307)	(272)	(35)
Operating expense, excluding fuel expense	**$ 2,740**	**$ 2,552**	**$ 188**	**$ 11,126**	**$ 10,282**	**$ 844**
Remove:						
Aircraft fuel	(808)	(640)	(168)	(3,375)	(2,652)	(723)
Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations	**$ 1,932**	**$ 1,912**	**$ 20**	**$ 7,751**	**$ 7,630**	**$ 121**

Adjusted Net Income (Loss) Per Share – Diluted

Air Canada uses adjusted net income (loss) per share – diluted to assess the performance of its business without the effects of foreign exchange and exceptional items. Such measure is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and therefore may not be comparable to similar measures presented by other public companies.

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2011	2010	Change $	2011	2010	Change $
Net income (loss) for the period attributable to shareholders of Air Canada	$ (62)	$ 87	$ (149)	$ (255)	$ (33)	$ (222)
Remove:						
Foreign exchange (gain) loss	(114)	(136)	22	54	(184)	238
Provision adjustment for cargo provisions, net	–	(46)	46	–	(46)	46
Impairment charge on aircraft	–	49	(49)	–	49	(49)
Interest expense charge on repayment of term credit facility	–	–	–	–	54	(54)
Adjusted net loss	**$ (176)**	**$ (46)**	**$ (130)**	**$ (201)**	**$ (160)**	**$ (41)**
Adjusted weighted average number of outstanding shares used in computing diluted loss per share (in millions)	277	278	(1)	278	278	–
Adjusted net loss per share – diluted	**$ (0.64)**	**$ (0.17)**	**$ (0.47)**	**$ (0.72)**	**$ (0.58)**	**$ (0.14)**

21. GLOSSARY

Atlantic passenger and cargo revenues — Refers to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe.

Available Seat Miles or ASMs — A measure of passenger capacity calculated by multiplying the total number of seats available for passengers by the miles flown.

CASM — Operating expense per ASM.

EBITDAR — EBITDAR is earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent and is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation, amortization and impairment, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Refer to section 20 of this MD&A for additional information.

Effective Ton Miles or ETMs — Refers to the mathematical product of tonnage capacity times distance hauled.

Other passenger and cargo revenues — Refers to revenues from flights with origins and destinations principally in Central and South America, Australia, the Caribbean and Mexico.

Pacific passenger and cargo revenues — Refers to revenues from flights that cross the Pacific Ocean with origins and destinations principally in Asia.

Passenger Load Factor — A measure of passenger capacity utilization derived by expressing Revenue Passenger Miles as a percentage of Available Seat Miles.

Passenger Revenue per Available Seat Mile or RASM — Average passenger revenue per ASM.

Percentage point (pp) — A measure for the arithmetic difference of two percentages.

Revenue Passenger Miles or RPMs — A measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried.

Revenue Ton Miles or RTMs — Refers to the mathematical product of weight in tons of a shipment being transported by the number of miles that it is transported.

Yield — Average passenger revenue per RPM.

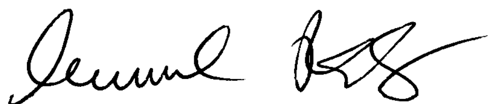
MANAGEMENT'S REPORT

The consolidated financial statements have been prepared by management. Management is responsible for the fair presentation of the consolidated financial statements in conformity with generally accepted accounting principles. Management is responsible for the selection of accounting policies and making significant accounting judgements and estimates. Management is also responsible for all other financial information included in the annual report and for ensuring that this information is consistent, where appropriate, with the information contained in the consolidated financial statements.

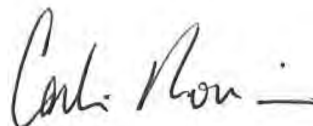
Management is responsible for establishing and maintaining adequate internal control over financial reporting which includes those policies and procedures that provide reasonable assurance over the safeguarding of assets and over the completeness, fairness and accuracy of the consolidated financial statements and other financial information.

The Audit, Finance and Risk Committee reviews the quality and integrity of the Corporation's financial reporting and recommends approval to the Board of Directors; oversees management's responsibilities as to the adequacy of the supporting systems of internal controls; provides oversight of the independence, qualifications and appointment of the external auditor; and, pre-approves audit and audit-related fees and expenses. The Board of Directors approves the Corporation's consolidated financial statements, management's discussion and analysis and annual report disclosures prior to their release. The Audit, Finance and Risk Committee meets with management, the internal auditors and external auditors at least four times each year to review and discuss financial reporting issues and disclosures, auditing and other matters.

The external auditors, PricewaterhouseCoopers LLP, conduct an independent audit of the consolidated financial statements in accordance with Canadian generally accepted auditing standards and express their opinion thereon. Those standards require that the audit is planned and performed to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The external auditors have unlimited access to the Audit, Finance and Risk Committee and meet with the Committee on a regular basis.



Michael Rousseau
Executive Vice President &
Chief Financial Officer



Calin Rovinescu
President &
Chief Executive Officer

February 8, 2012

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF AIR CANADA

We have audited the accompanying consolidated financial statements of Air Canada and its subsidiaries, which comprise the consolidated statement of financial position as at December 31, 2011, December 31, 2010 and January 1, 2010, and the consolidated statement of operations, statement of comprehensive income (loss), statement of changes in equity, and statement of cash flow for the years ended December 31, 2011 and December 31, 2010, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Air Canada and its subsidiaries as at December 31, 2011, December 31, 2010 and January 1, 2010, and its financial performance and its cash flow for the years ended December 31, 2011 and December 31, 2010 in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP[1]

Montreal, Quebec
February 8, 2012

[1] Chartered accountant auditor permit No. 18144

"PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(Canadian dollars in millions)		December 31, 2011	December 31, 2010	January 1, 2010
ASSETS				
Current				
Cash and cash equivalents	Note 3P	$ 848	$ 1,090	$ 1,115
Short-term investments	Note 3Q	1,251	1,102	292
Total cash, cash equivalents and short-term investments		2,099	2,192	1,407
Restricted cash	Note 3R	76	80	78
Accounts receivable		712	641	701
Aircraft fuel inventory		92	67	63
Spare parts and supplies inventory	Note 3S	93	88	64
Prepaid expenses and other current assets		255	279	338
Total current assets		3,327	3,347	2,651
Property and equipment	Note 5	5,088	5,629	6,287
Intangible assets	Note 6	312	317	329
Goodwill	Note 7	311	311	311
Deposits and other assets	Note 8	595	549	547
Total assets		**$ 9,633**	**$ 10,153**	**$ 10,125**
LIABILITIES				
Current				
Accounts payable and accrued liabilities		$ 1,175	$ 1,182	$ 1,246
Advance ticket sales		1,554	1,375	1,288
Current portion of long-term debt and finance leases	Note 9	424	567	468
Total current liabilities		3,153	3,124	3,002
Long-term debt and finance leases	Note 9	3,906	4,028	4,313
Pension and other benefit liabilities	Note 10	5,563	3,328	3,940
Maintenance provisions	Note 11	548	493	461
Other long-term liabilities	Note 12	469	468	429
Total liabilities		**$ 13,639**	**$ 11,441**	**$ 12,145**
EQUITY				
Shareholders' equity				
Share capital	Note 14	840	846	844
Contributed surplus		58	54	53
Deficit		(4,983)	(2,334)	(2,881)
Accumulated other comprehensive loss	Note 18	–	–	(184)
Total shareholders' equity		(4,085)	(1,434)	(2,168)
Non-controlling interests		79	146	148
Total equity		(4,006)	(1,288)	(2,020)
Total liabilities and equity		**$ 9,633**	**$ 10,153**	**$ 10,125**

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

On behalf of the Board of Directors:

Signed
David I. Richardson
Chairman

Signed
Michael M. Green
Chair of the Audit, Finance and Risk Committee

CONSOLIDATED STATEMENT OF OPERATIONS

For the year ended December 31 (Canadian dollars in millions except per share figures)		2011	2010
Operating revenues			
Passenger	Note 21	$ 10,208	$ 9,427
Cargo	Note 21	481	466
Other		923	893
Total revenues		**11,612**	**10,786**
Operating expenses			
Aircraft fuel		3,375	2,652
Wages, salaries and benefits		1,991	1,913
Airport and navigation fees		1,007	961
Capacity purchase agreements	Note 22	1,003	971
Depreciation, amortization and impairment		728	801
Aircraft maintenance		681	654
Sales and distribution costs		612	581
Food, beverages and supplies		278	279
Communications and information technology		193	195
Aircraft rent		335	353
Other		1,230	1,194
Total operating expenses		**11,433**	**10,554**
Operating income before exceptional item		**179**	**232**
Provision adjustment for cargo investigations, net	Note 19	–	46
Operating income		**179**	**278**
Non-operating income (expense)			
Foreign exchange gain (loss)		(54)	184
Interest income		36	19
Interest expense		(320)	(397)
Net financing expense relating to employee benefits	Note 10	(16)	(75)
Loss on financial instruments recorded at fair value	Note 18	(63)	(3)
Other		(12)	(31)
		(429)	(303)
Loss before income taxes		**(250)**	**(25)**
Recovery of income taxes	Note 13	1	1
Net loss		**$ (249)**	**$ (24)**
Net income (loss) attributable to:			
Shareholders of Air Canada		(255)	(33)
Non-controlling interests		6	9
		$ (249)	**$ (24)**
Net loss per share			
Basic and diluted	Note 16	$ (0.92)	$ (0.12)

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

For the year ended December 31 (Canadian dollars in millions)		2011	2010
Comprehensive income (loss)			
Net loss		$ (249)	$ (24)
Other comprehensive income, net of taxes:			
Net gain (loss) on employee benefit liabilities	Note 10	(2,394)	580
Reclassification of net realized losses on fuel derivatives to income	Note 18	–	184
		(2,394)	764
Total comprehensive income (loss)		**$ (2,643)**	**$ 740**
Comprehensive income (loss) attributable to:			
Shareholders of Air Canada		**$ (2,649)**	**$ 731**
Non-controlling interests		**6**	**9**
		$ (2,643)	**$ 740**

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Share capital	Contributed surplus	Deficit	Accumulated other comprehensive income (loss)	Total shareholders' equity	Non-controlling interests	Total equity
January 1, 2010	$ 844	$ 53	$ (2,881)	$ (184)	$ (2,168)	$ 148	$ (2,020)
Net income (loss)	–	–	(33)	–	(33)	9	(24)
Net gain on employee benefit liabilities	–	–	580	–	580	–	580
Other comprehensive income	–	–	–	184	184	–	184
Total comprehensive income	–	–	547	184	731	9	740
Share-based compensation	–	1	–	–	1	–	1
Ordinary shares issued	2	–	–	–	2	–	2
Distributions	–	–	–	–	–	(11)	(11)
December 31, 2010	$ 846	$ 54	$ (2,334)	$ –	$ (1,434)	$ 146	$ (1,288)
Net income (loss)	–	–	(255)	–	(255)	6	(249)
Net loss on employee benefit liabilities	–	–	(2,394)	–	(2,394)	–	(2,394)
Total comprehensive income	–	–	(2,649)	–	(2,649)	6	(2,643)
Share-based compensation	–	4	–	–	4	–	4
Shares purchased in trust for employee recognition award	(11)	–	–	–	(11)	–	(11)
Shares issued for employee recognition award	5	–	–	–	5	–	5
Distributions	–	–	–	–	–	(73)	(73)
December 31, 2011	$ 840	$ 58	$ (4,983)	$ –	$ (4,085)	$ 79	$ (4,006)

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

CONSOLIDATED STATEMENT OF CASH FLOW

For the year ended December 31 (Canadian dollars in millions)		2011	2010
Cash flows from (used for)			
Operating			
Net loss		$ (249)	$ (24)
Adjustments to reconcile to net cash from operations			
Depreciation, amortization and impairment		728	801
Foreign exchange (gain) loss		79	(212)
Deferred income taxes		–	3
Excess of employee benefit funding over expense		(153)	(24)
Fuel and other derivatives	Note 18	36	102
Fuel hedge collateral deposits, net	Note 18	–	43
Provision for cargo investigations, net	Note 19	(29)	(46)
Change in maintenance provisions		94	57
Changes in non-cash working capital balances		60	139
Other		20	94
		586	**933**
Financing			
Proceeds from borrowings	Note 9	232	1,175
Shares issued	Note 14	–	2
Reduction of long-term debt and finance lease obligations		(608)	(1,159)
Distributions related to aircraft special purpose leasing entities		(52)	(11)
		(428)	**7**
Investing			
Short-term investments		(149)	(810)
Additions to property, equipment and intangible assets		(220)	(187)
Proceeds from sale of assets	Note 5	6	29
Proceeds from sale-leaseback transactions	Note 5	–	20
Reduction to Aveos letter of credit	Note 20	–	23
Other		(37)	(40)
		(400)	**(965)**
Decrease in cash and cash equivalents		**(242)**	**(25)**
Cash and cash equivalents, beginning of year		1,090	1,115
Cash and cash equivalents, end of year		**$ 848**	**$ 1,090**

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

For the years ended December 31, 2011 and 2010
(Canadian dollars in millions – except per share amounts)

1. GENERAL INFORMATION

The accompanying audited consolidated financial statements (the “financial statements”) are of Air Canada. Air Canada is incorporated and domiciled in Canada. The address of its registered office is 7373 Côte-Vertu Boulevard West, Saint-Laurent, Quebec. The term “Corporation” refers to, as the context may require, Air Canada and/or one or more of its subsidiaries, including Touram Limited Partnership (“Air Canada Vacations”). These financial statements also include certain aircraft and engine leasing entities and fuel facility corporations, which are consolidated under SIC Interpretation 12 – Consolidation of Special Purpose Entities (Note 3B).

Air Canada is Canada's largest domestic, US transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-US transborder market as well as the international markets to and from Canada. Certain of the scheduled passenger services offered on domestic and Canada-US transborder routes are operated under the brand name “Air Canada Express” and operated by third parties such as Jazz Aviation LP (“Jazz”) through capacity purchase agreements. Air Canada also offers scheduled passenger services on domestic and Canada-US transborder routes through capacity purchase agreements on other regional carriers, including those operating aircraft of 18 seats or less, some of which are referred to as Tier III carriers. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star Alliance network. In addition, Air Canada provides certain passenger charter services under the brand name “AC Jetz”.

Air Canada offers air cargo services on domestic and US transborder routes using cargo capacity on aircraft operated by Air Canada and Jazz. Air Canada offers international cargo services on routes between Canada and major markets in Europe, Asia, South America and Australia using cargo capacity on Boeing 777 and other wide body aircraft operated by Air Canada.

Air Canada Vacations is one of Canada's leading tour operators. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, Central and South America, South Pacific and Asia) by developing, marketing and distributing vacation travel packages. Air Canada Vacations also offers cruise packages in North America, Europe and the Caribbean.

2. BASIS OF PREPARATION AND ADOPTION OF IFRS

The Corporation prepares its financial statements in accordance with Canadian generally accepted accounting principles ("GAAP") as defined in the Handbook of the Canadian Institute of Chartered Accountants – Part 1 ("CICA Handbook"). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board, and to require publicly accountable enterprises to apply IFRS effective for years beginning on or after January 1, 2011. Accordingly, these are the Corporation's first annual consolidated financial statements prepared in accordance with IFRS. In these financial statements, the term "Canadian GAAP" refers to GAAP in Canada before the adoption of IFRS and the term "GAAP" refers to generally accepted accounting principles in Canada after the adoption of IFRS.

These financial statements have been prepared in accordance with GAAP. Subject to certain transition elections and exceptions disclosed in Note 25, the Corporation has consistently applied the accounting policies used in the preparation of its opening IFRS statement of financial position at January 1, 2010 throughout all periods presented, as if these policies had always been in effect. Note 25 discloses the impact of the transition to IFRS on the Corporation's reported statement of financial position, statement of operations and cash flows, including the nature and effects of significant changes in accounting policies from those used in the Corporation's consolidated financial statements for the year ended December 31, 2010 prepared under Canadian GAAP.

These financial statements were approved by the Board of Directors of the Corporation for issue on February 9, 2012.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These financial statements are based on the accounting policies as described below. These policies have been consistently applied to all the periods presented, unless otherwise stated.

A) BASIS OF MEASUREMENT

These financial statements have been prepared under the historical cost convention, except for the revaluation of available-for-sale financial assets, cash, cash equivalents and short-term investments, restricted cash and derivative instruments which are measured at fair value.

B) PRINCIPLES OF CONSOLIDATION

These financial statements include the accounts of Air Canada and its subsidiaries. Subsidiaries are those entities (including special purpose entities) which Air Canada controls by having the power to govern the financial and operating policies of the entity. All inter-company balances and transactions are eliminated.

Non-controlling interests represent equity interests in subsidiaries owned by outside parties. The share of net assets of subsidiaries attributable to non-controlling interests is presented as a component of equity.

Special Purpose Entities

The Corporation has aircraft leasing transactions with a number of special purpose entities. Under SIC Interpretation 12 – Consolidation of Special Purpose Entities, the Corporation controls and consolidates leasing entities covering 35 aircraft (47 as at December 31, 2010 and January 1, 2010).

The Corporation participates in fuel facilities arrangements operated through fuel facility corporations (the "Fuel Facility Corporations"), along with other airlines to contract for fuel services at various major Canadian airports. The Fuel Facility Corporations are entities incorporated under federal or provincial statutes in order to acquire, finance and lease assets used in connection with the fuelling of aircraft and ground support equipment. The Fuel Facilities Corporations operate on a cost recovery basis. Under SIC Interpretation 12 – Consolidation of Special Purpose Entities, the Corporation controls and consolidates three of the Fuel Facility Corporations located in Canada (three as at December 31, 2010 and January 1, 2010).

C) PASSENGER AND CARGO REVENUES

Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is recognized on a straight-line basis over the period during which the travel pass is valid. The Corporation has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided. Passenger revenue also includes certain fees and surcharges and revenues from passenger-related services such as ticket changes, seat selection, and excess baggage which are recognized as the services are provided.

Airline passenger and cargo advance sales are deferred and included in Current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aeroplan Canada Inc. ("Aeroplan"), a corporation that provides loyalty program services to Air Canada and purchases seats from Air Canada pursuant to the Commercial Participation and Services Agreement between Aeroplan and Air Canada (the "CPSA").

D) CAPACITY PURCHASE AGREEMENTS

Air Canada has capacity purchase agreements with Jazz and certain other regional carriers, including those operating aircraft of 18 seats or less, some of which are referred to as Tier III carriers. Under these agreements, Air Canada markets, tickets and enters into other commercial arrangements relating to these flights and records the revenue it earns under Passenger revenue. Operating expenses under capacity purchase agreements include the capacity purchase fees, which, under the capacity purchase agreement between the Corporation and Jazz (the "Jazz CPA"), are based on variable and fixed rates ("CPA Rates") plus mark-up and pass-through costs. The CPA Rates are periodically set by the parties for rate periods of three years. The parties set the rates through negotiations based on Jazz's forecasted costs for the applicable rate period and an operating plan for the applicable rate period provided by Air Canada. Pass-through costs are non-marked-up costs charged to the Corporation and include fuel, airport and user fees and other costs. These expenses are recorded in the applicable category within Operating expenses.

E) AEROPLAN LOYALTY PROGRAM

Air Canada purchases Aeroplan Miles® from Aeroplan, an unrelated party. Air Canada is an Aeroplan partner providing certain of Air Canada's customers with Aeroplan Miles®, which can be redeemed by customers for air travel or other rewards acquired by Aeroplan.

Under the CPSA, Aeroplan purchases passenger tickets from Air Canada to meet its obligation for the redemption of Aeroplan Miles® for air travel. The proceeds from the sale of passenger tickets to Aeroplan are included in Advance ticket sales. Revenue related to these passenger tickets is recorded in passenger revenues when transportation is provided.

For Aeroplan Miles® earned by Air Canada customers, Air Canada purchases Aeroplan Miles® from Aeroplan in accordance with the terms of the CPSA. The cost of purchasing Aeroplan Miles® from Aeroplan is accounted for as a sales incentive and charged against passenger revenues when the points are issued, which occurs upon the qualifying air travel being provided to the customer.

F) OTHER REVENUES

Other revenue includes revenues from the sale of the ground portion of vacation packages, ground handling services and other airline related services. Vacation package revenue is recognized as services are provided over the period of the vacation. Other airline related service revenues are recognized as the products are sold to passengers or the services are provided.

Other revenue also includes revenue related to the lease or sublease of aircraft to third parties. Lease or sublease revenues are recognized on a straight line basis over the term of the lease or sublease. Rental revenue from operating leases and subleases amounted to $97 in 2011 (2010 – $101).

In certain subleases of aircraft to Jazz, for accounting purposes, the Corporation acts as an agent and accordingly reports the sublease revenues net against aircraft rent expense as the terms of the sublease match the terms of the Corporation's lease. The Corporation acts as lessee and sublessor in these matters.

G) EMPLOYEE BENEFITS

The cost of pensions, other post-retirement and post-employment benefits earned by employees is actuarially determined annually as at December 31. The cost is determined using the projected unit credit method and assumptions including market interest rates, management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and health care costs. The expected return on plan assets is based on market expectations at the beginning of the period for returns over the entire life of the related obligation.

Past service costs are recognized immediately in income unless the changes to the pension plan are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case these past service costs are amortized on a straight line basis over the vesting period. Gains and losses on curtailments or settlements are recognized in the period in which the curtailment or settlement occurs.

Net actuarial gains and losses are recognized immediately in other comprehensive income and deficit without subsequent reclassification to income. The current service cost and recognized element of any past service cost of employee benefits expense is recorded in Wages, salaries and benefits. The expected return on plan assets and interest arising on the benefit obligations are presented net in Net financing expense relating to employee benefits.

Certain of the Corporation's pension plans are subject to minimum funding requirements. The liability in respect of minimum funding requirements is determined using the projected minimum funding requirements, based on management's best estimates of the actuarially determined funded status of the plan, market discount rates and salary escalation estimates. The liability in respect of the minimum funding requirement and any subsequent remeasurement of that liability are recognized immediately in other comprehensive income and deficit without subsequent reclassification to income.

H) EMPLOYEE PROFIT SHARING PLANS

The Corporation has employee profit sharing plans. Payments are calculated based on full calendar year results and an expense recorded throughout the year as a charge to Wages, salaries and benefits based on the estimated annual payment under the plan. The Corporation also has an incentive program which is applicable to certain employees and is paid based on achieving monthly operational performance targets. Expenses under this program are recorded when the performance targets are achieved.

I) SHARE-BASED COMPENSATION PLANS

Certain employees of the Corporation participate in Air Canada's Long-Term Incentive Plan, which provides for the grant of stock options and performance share units ("PSUs"), as further described in Note 15. PSUs are notional share units which are exchangeable, on a one-to-one basis, as determined by the Board of Directors based on factors such as the remaining number of shares authorized for issuance under the Long-Term Incentive Plan as described in Note 15, for Air Canada shares, or the cash equivalent. The options and PSUs granted contain both time and performance based vesting features as those further described in Note 15.

The fair value of stock options with a graded vesting schedule is determined based on different expected lives for the options that vest each year, as it would be if the award were viewed as several separate awards, each with a different vesting date, and it is accounted for over the respective vesting period taking into consideration forfeiture estimates. For a stock option award attributable to an employee who is eligible to retire at the grant date, the fair value of the stock option award is expensed on the grant date. For a stock option award attributable to an employee who will become eligible to retire during the vesting period, the fair value of the stock option award is recognized over the period from the grant date to the date the employee becomes eligible to retire. The Corporation recognizes compensation expense and a corresponding adjustment to Contributed surplus equal to the fair value of the equity instruments granted using an option pricing model taking into consideration forfeiture estimates. Compensation expense is adjusted for subsequent changes in management's estimate of the number of options that are expected to vest.

Grants of PSUs are accounted for as cash settled instruments as described in Note 15. Accordingly, the Corporation recognizes compensation expense at fair value on a straight line basis over the applicable vesting period, taking into consideration forfeiture estimates. Compensation expense is adjusted for subsequent changes in the fair value of the PSU and management's current estimate of the number of PSUs that are expected to vest. The liability related to cash settled PSUs is recorded in Other long-term liabilities. Refer to Note 18 for a description of derivative instruments used by the Corporation to hedge the cash flow exposure to PSUs.

Air Canada also maintains an employee share purchase plan. Under this plan, contributions by the Corporation's employees are matched to a specific percentage by the Corporation. Employees must remain with the Corporation until March 31 of the subsequent year for vesting of the Corporation's contributions. These contributions are expensed in Wages, salaries, and benefits expense over the vesting period.

J) MAINTENANCE AND REPAIRS

Maintenance and repair costs for both leased and owned aircraft are charged to Aircraft maintenance as incurred, with the exception of maintenance and repair costs related to return conditions on aircraft under operating lease, which are accrued over the term of the lease, and major maintenance expenditures on owned and finance leased aircraft, which are capitalized as described below in Note 3T.

Maintenance and repair costs related to return conditions on aircraft leases are recorded over the term of the lease for the end of lease maintenance return condition obligations within the Corporation's operating leases, offset by a prepaid maintenance asset to the extent of any related power-by-the-hour maintenance service agreements or any recoveries under aircraft subleasing arrangements. The provision is recorded within Maintenance provisions using a discount rate taking into account the specific risks of the liability over the remaining term of the lease. Interest accretion on the provision is recorded in Other non-operating expense. For aircraft under operating leases which are subleased to third parties, the expense relating to the provision is presented net on the income statement of the amount recognized for any reimbursement of maintenance cost which is the contractual obligation of the sub-lessee. The reimbursement is recognized when it is virtually certain that reimbursement will be received when the Corporation settles the obligation. Any changes in the maintenance cost estimate, discount rates, timing of settlement or difference in the actual maintenance cost incurred and the amount of the provision is recorded in Aircraft maintenance in the period.

K) OTHER OPERATING EXPENSES

Included in Other operating expenses are expenses related to building rent and maintenance, airport terminal handling costs, professional fees and services, crew meals and hotels, advertising and promotion, insurance costs, ground costs for Air Canada Vacations packages, and other expenses. Other operating expenses are recognized as incurred.

L) FINANCIAL INSTRUMENTS

Under the Corporation's risk management policy, derivative financial instruments are used only for risk management purposes and not for generating trading profits.

Financial assets and financial liabilities, including derivatives, are recognized on the Consolidated Statement of Financial Position when the Corporation becomes a party to the contractual provisions of the financial instrument or derivative contract. All financial instruments are required to be measured at fair value on initial recognition. The Corporation's own credit risk and the credit risk of the counterparty are taken into consideration in determining the fair value of financial assets and financial liabilities, including derivative instruments. Measurement in subsequent periods is dependent upon the classification of the financial instrument. The Corporation classifies its financial assets as either fair value through profit or loss ("FVTPL"), loans and receivables, held to maturity or available-for-sale. The classification depends on the purpose for which the financial assets were acquired.

Management determines the classification of its financial assets at initial recognition. Financial assets at FVTPL are financial assets held for trading. A financial asset is classified in this category if acquired principally for the purpose of selling in the short term. Derivatives are also categorized as held for trading unless they are designated as hedges. Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Held-to-maturity financial assets are non-derivatives that have fixed and determinable payments and the entity has the ability and intent to hold the asset until maturity. Available-for-sale financial assets are non-derivatives that are either designated in this category or not classified in any of the other categories. For financial instruments classified as other than held-for-trading, transaction costs are added to the initial fair value of the related financial instrument. Financial assets and financial liabilities classified as held-for-trading are measured at FVTPL. Financial assets classified as held-to-maturity, loans and receivables, or other financial liabilities are measured at amortized cost using the effective interest rate method.

The Corporation assesses at the end of each reporting period whether there is objective evidence that a financial asset or a group of financial assets is impaired. For loans and receivables, the amount of the loss is measured as the difference between the asset's carrying value and the present value of estimated future cash flows. The carrying amount of the asset is reduced by the amount of the loss and the latter is recognized in the Consolidated Statement of Operations. In the case of equity investments classified as available-for-sale, a significant or prolonged decline in the fair value of the investment below its cost is evidence that the asset is impaired. If such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognized in the Consolidated Statement of Operations – is removed from equity and recognized in the Consolidated Statement of Operations. Impairment losses recognized on equity instruments are not reversed through the Consolidated Statement of Operations.

The Corporation enters into interest rate, foreign currency, fuel derivatives and share forward contracts to manage the associated risks. Derivative instruments are recorded on the Consolidated Statement of Financial Position at fair value, including those derivatives that are embedded in financial or non-financial contracts. Changes in the fair value of derivative instruments are recognized in Non-operating income (expense) with the exception of fuel derivatives designated as effective cash flow hedges, as further described below. These derivative contracts are included in the Consolidated Statement of Financial Position at fair value in Prepaid expenses and other current assets, Deposits and other assets, Accounts payable and accrued liabilities, or Other long-term liabilities based on the terms of the contractual agreements. All cash flows associated with purchasing and selling derivatives are classified as operating cash flows in the Consolidated Statement of Cash Flow.

The Corporation has implemented the following classifications:

- Cash and cash equivalents and Short-term investments are classified as held-for-trading and any period change in fair value is recorded through Interest income in the Consolidated Statement of Operations.
- Restricted cash is classified as held-for-trading and any period change in fair value is recorded through Interest income in the Consolidated Statement of Operations.
- Aircraft related and other deposits are classified as loans and receivables and are measured at amortized cost using the effective interest rate method. Interest income is recorded in the Consolidated Statement of Operations, as applicable.
- Accounts receivable are classified as loans and receivables and are measured at amortized cost using the effective interest rate method. Interest income is recorded in the Consolidated Statement of Operations, as applicable.

- Accounts payable, credit facilities, and bank loans are classified as other financial liabilities and are measured at amortized cost using the effective interest rate method. Interest expense is recorded in the Consolidated Statement of Operations, as applicable.

- Investments in equity instruments are recorded as available-for-sale financial assets within Deposits and other assets; available-for-sale financial assets are measured at fair value with gains or losses recorded in Other comprehensive income ("OCI").

Fuel Derivatives

After considering the costs and benefits specific to the application of cash flow hedge accounting, the Corporation no longer applies hedge accounting for fuel derivatives. The derivative instruments are recorded at fair value in each period with both realized and unrealized changes in fair value recognized immediately in earnings in non-operating income (expense). Amounts deferred to Accumulated OCI ("AOCI") for derivatives previously designated under hedge accounting were taken into fuel expense in the period in which the previously forecasted hedge transaction occurred. As at December 31, 2010, there is no remaining balance in AOCI related to fuel hedging contracts. Refer to Note 18 for the impact of fuel derivatives during the period.

M) FOREIGN CURRENCY TRANSLATION

The functional currency of Air Canada and its subsidiaries is the Canadian dollar. 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. Non-monetary assets and liabilities, revenues and expenses arising from transactions denominated in foreign currencies, are translated at the historical exchange rate or the average exchange rate during the period, as applicable. Adjustments to the Canadian dollar equivalent of foreign denominated monetary assets and liabilities due to the impact of exchange rate changes are recognized in Foreign exchange gain (loss).

N) INCOME TAXES

The tax expense for the period comprises current and deferred income tax. Tax is recognized in the Consolidated Statement of Operations, except to the extent that it relates to items recognized in OCI or directly in equity, in which case the tax is netted with such items.

The current income tax expense is calculated on the basis of the tax laws enacted or substantively enacted at the balance sheet date in the jurisdictions where the Corporation and its subsidiaries operate and generate taxable income. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulations are subject to interpretation. It establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred income tax is recognized, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax liabilities are not recognized if they arise from the initial recognition of goodwill; and deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets are recognized only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

O) EARNINGS PER SHARE

Basic earnings per share ("EPS") is calculated by dividing the net income (loss) for the period attributable to the shareholders of Air Canada by the weighted average number of ordinary shares outstanding during the period. Shares held in trust for employee share-based compensation awards are treated as treasury shares and excluded from basic shares outstanding in the calculation of basic EPS.

Diluted EPS is calculated by adjusting the weighted average number of ordinary shares outstanding for dilutive potential ordinary shares. The Corporation's potentially dilutive ordinary shares comprise stock options, equity-settled performance share units granted to employees, warrants, and any shares held in trust for employee share-based compensation awards. The

number of shares included with respect to time vesting options and warrants is computed using the treasury stock method unless they are anti-dilutive. Under this method, the proceeds from the exercise of such instruments are assumed to be used to purchase Class B Voting Shares at the average market price for the period and the difference between the number of shares and the number of shares assumed to be purchased are included in the calculation. The number of shares included with respect to performance-based employee share options and PSUs are treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time. If the specified conditions are met, then the number of shares included is also computed using the treasury stock method unless they are anti-dilutive.

P) CASH AND CASH EQUIVALENTS

Cash and cash equivalents include $356 pertaining to investments with original maturities of three months or less at December 31, 2011 ($497 as at December 31, 2010 and $323 as at January 1, 2010). Investments include bankers' acceptances and bankers' discount notes, which may be liquidated promptly and have original maturities of three months or less.

Q) SHORT-TERM INVESTMENTS

Short-term investments, comprised of bankers' acceptances and bankers' discount notes, have original maturities over three months, but not more than one year.

R) RESTRICTED CASH

The Corporation has recorded Restricted cash under Current assets representing funds held in trust by Air Canada Vacations in accordance with regulatory requirements governing advance ticket sales, recorded under Current liabilities, for certain travel related activities.

Restricted cash with maturities greater than one year from the balance sheet date is recorded in Deposits and other assets. This restricted cash relates to funds on deposit with various financial institutions as collateral for letters of credit and other items.

S) AIRCRAFT FUEL INVENTORY AND SPARE PARTS AND SUPPLIES INVENTORY

Inventories of aircraft fuel and spare parts, other than rotables, and supplies are measured at the lower of cost and net realizable value, with cost being determined using a weighted average formula.

The Corporation did not recognize any write-downs on inventories or reversals of any previous write-downs during the periods presented. Included in Aircraft maintenance is $39 related to spare parts and supplies consumed during the year (2010 – $36).

T) PROPERTY AND EQUIPMENT

In accordance with IFRS 1, the Corporation elected to value its aircraft and spare engines at the date of transition to IFRS on January 1, 2010 at their fair value and to use this fair value as deemed cost. Subsequent to transition, Property and equipment is recognized using the cost model. Property under finance leases and the related obligation for future lease payments are initially recorded at an amount equal to the lesser of fair value of the property or equipment and the present value of those lease payments.

The Corporation allocates the amount initially recognized in respect of an item of property and equipment to its significant components and depreciates separately each component. Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Aircraft and flight equipment are componentized into airframe, engine, and cabin interior equipment and modifications. Airframe and engines are depreciated over 20 to 25 years, with 10% to 20% estimated residual values. Cabin interior equipment and modifications are depreciated over the lesser of 5 years or the remaining useful life of the aircraft. Spare engines and related parts ("rotables") are depreciated over the average remaining useful life of the fleet to which they relate with 10% to 20% estimated residual values. Cabin interior equipment and modifications to aircraft on operating leases are amortized over the term of the lease. Major maintenance of airframes and engines, including replacement spares and parts, labour costs and/or third party maintenance service costs, are capitalized and amortized over the average expected life between major maintenance events. Major maintenance events typically consist of more complex inspections and servicing of the aircraft. All maintenance of fleet assets provided under power-by-the-hour contracts are charged to operating expenses in the income statement as incurred, respectively.

Buildings and leasehold improvements are depreciated on a straight-line basis over their useful lives not exceeding 50 years or the term of any related lease, whichever is less. Leasehold improvements are amortized over the lesser of the lease term or 5 years. Ground and other equipment is depreciated over 3 to 25 years.

Residual values and useful lives are reviewed at least annually and depreciation rates are adjusted accordingly on a prospective basis. Gains and losses on disposals of property and equipment are determined by comparing the proceeds with the carrying amount of the asset and are included as part of non-operating gains and losses in the consolidated statement of operations.

U) INTEREST CAPITALIZED

Borrowing costs are expensed as incurred, except for interest attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use, in which case they are capitalized as part of the cost of that asset. Capitalization of borrowing costs commences when expenditures for the asset and borrowing costs are being incurred and the activities to prepare the asset for its intended use are in progress. Borrowing costs are capitalized up to the date when the project is completed and the related asset is available for its intended use.

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization is determined at the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization is determined by applying a capitalization rate to the expenditures on that asset. The capitalization rate is the weighted average of the borrowing costs applicable to the borrowings of the Corporation that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

V) LEASES

Leases are classified as finance leases when the lease arrangement transfers substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases. Gains and losses on sale and operating leaseback transactions are recognized immediately in the statement of operations when it is clear that the transactions are established at fair value. If the sale price is below fair value, any loss is recognized immediately except that, if the loss is compensated for by future lease payments at below market price, it is deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the gain is deferred and amortized over the period for which the asset is expected to be used. In the context of sale and finance leaseback transactions, any gain on the sale is deferred and amortized over the lease term.

W) INTANGIBLE ASSETS

Intangible assets are initially recorded at cost. Indefinite life intangible assets are not amortized while assets with finite lives are amortized on a straight line basis over their estimated useful lives.

	Estimated Useful Life	Remaining amortization period as at December 31, 2011
International route rights and slots	Indefinite	not applicable
Marketing based trade names	Indefinite	not applicable
Contract and customer based	10 years	3 years
Technology based (internally developed)	5 years	1 to 5 years

Development costs that are directly attributable to the design and testing of identifiable software products are recognized as technology based intangible assets if certain criteria, including technical feasibility and intent and ability to develop and use the technology to generate probable future economic benefits are met; otherwise they are expensed as incurred. Directly attributable costs that are capitalized as part of the technology based intangible assets include software-related, employee and third party development costs and an appropriate portion of relevant overhead.

Air Canada has international route and slot rights which enable the Corporation to provide services internationally. The value of the recorded intangible assets relates to the cost of route and slot rights at Tokyo's Narita International Airport, Washington's Reagan National Airport and London's Heathrow Airport. Air Canada expects to provide service to these international locations for an indefinite period.

Air Canada and certain of its subsidiaries have trade names, trademarks, and domain names (collectively, "Trade Names"). These items are marketing based intangible assets as they are primarily used in the selling and promotion of Air Canada's products and services. The Trade Names create brand recognition with customers and potential customers and are capable of contributing to cash flows for an indefinite period of time. Air Canada intends to continuously re-invest and market the Trade Names to support classification as indefinite life intangibles. If there were plans to cease using any of the Trade Names, the specific names would be classified as finite and amortized over the expected remaining useful life.

X) GOODWILL

Goodwill represents the excess of the cost of an acquisition over the fair value of the Corporation's share of the net identifiable assets of the acquired business at the date of acquisition. Goodwill is tested at least annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. For the purpose of impairment testing, goodwill is tested for impairment at the lowest level within the entity at which the goodwill is monitored for internal management purposes, being the operating segment level (Note DD). No impairment losses have been recorded against the value of goodwill since its acquisition.

Y) IMPAIRMENT OF LONG-LIVED ASSETS

Long-lived assets include property and equipment, finite lived intangible assets, indefinite lived intangible assets and goodwill. Assets that have an indefinite useful life, including goodwill are tested at least annually for impairment or when events or circumstances indicate that the carrying value may not be recoverable. Assets that are subject to depreciation or amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment test is performed by comparing the carrying amount of the asset or group of assets to their recoverable amount. Recoverable amount is calculated as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash inflows (cash-generating units or CGUs). Management has determined that the appropriate level for assessing impairments is at the North American (for narrowbody aircraft) and international (for widebody aircraft) fleet levels for aircraft and related assets supporting the operating fleet. Parked aircraft not used in operations and aircraft leased or subleased to third parties are assessed for impairment at the individual asset level. Value in use is calculated based upon a discounted cash flow analysis. An impairment loss is recognized for the amount by which the asset's or cash generating unit's carrying amount exceeds its recoverable amount.

Long-lived assets, other than goodwill, that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date. Management assesses whether there is any indication that an impairment loss recognized in a prior period no longer exists or has decreased. In assessing whether there is a possible reversal of an impairment loss, management considers the indicators that gave rise to the impairment loss. If any such indicators exist that an impairment loss has reversed, management estimates the recoverable amount of the long-lived asset. An impairment loss recognized in prior periods for an asset other than goodwill shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. The carrying amount of any individual asset in the CGU is not increased above the carrying value that would have been determined had the original impairment not occurred. A reversal of an impairment loss is recognized immediately in the statement of operations.

Z) NON-CURRENT ASSETS (OR DISPOSAL GROUPS) HELD FOR SALE

Non-current assets (or disposal groups) are classified as assets held for sale when their carrying amount is to be recovered principally through a sale transaction and a sale is considered highly probable. They are stated at the lower of carrying amount and fair value less costs to sell. There are currently no assets held for sale.

AA) PROVISIONS

Provisions are recognized when there is a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate can be made of the obligation. If the effect is significant, the expected cash flows are discounted using a rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as Interest expense within Other non-operating expense.

The Corporation records an asset and related provision for the costs associated with the retirement of long-lived tangible assets when a legal or constructive obligation to retire such assets exists. The provision recorded in Other long-term liabilities is measured as the best estimate of the expenditure required to settle the present obligation at each reporting period. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and then amortized in accordance with the accounting policy in Note 3T. In subsequent periods, the asset retirement provision is adjusted for the passage of time through charges to Interest expense. Any change in the amount of the underlying cash flows, due to changes in the discount rate or changes in the estimate of the expenditure required to settle the present obligation, adjusts both the asset retirement provision and the related asset. Refer to Note 11 for a continuity schedule of recorded provisions.

BB) AIRCRAFT LEASE PAYMENTS IN EXCESS OF OR LESS THAN RENT EXPENSE

Total aircraft operating lease rentals over the lease term are amortized to operating expense (aircraft rent) on a straight-line basis. Included in Deposits and other assets and Other long-term liabilities are the differences between the straight line aircraft rent expense and the payments as stipulated under the lease agreement.

CC) EXCEPTIONAL ITEMS

Exceptional items are those items that in management's view are required to be separately disclosed by virtue of their size or incidence to enable a full understanding of the Corporation's financial performance.

DD) SEGMENT REPORTING

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The chief operating decision maker, who is responsible for allocating resources and assessing performance of operations, has been identified as the Chief Executive Officer. Air Canada is managed as one operating segment based on how financial information is produced internally for the purposes of making operating decisions.

EE) ACCOUNTING STANDARDS AND AMENDMENTS ISSUED BUT NOT YET ADOPTED

The following is an overview of accounting standard changes that the Corporation will be required to adopt in future years. Except as otherwise noted below for IFRS 9 and IAS 32, the standards are effective for the Corporation's annual periods beginning on or after January 1, 2013, with earlier application permitted. The Corporation does not expect to adopt any of these standards before their effective dates. The Corporation continues to evaluate the impact of these standards on its consolidated statement of operations and financial position.

IFRS 9 – Financial Instruments

IFRS 9 introduces new requirements for the classification and measurement of financial assets. IFRS 9 requires all recognized financial assets that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement to be subsequently measured at amortized cost or fair value. Specifically, financial assets that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of subsequent accounting periods. All other financial assets including equity investments are measured at their fair values at the end of subsequent accounting periods.

Requirements for financial liabilities were added in October 2010 and they largely carried forward existing requirements in IAS 39, Financial Instruments – Recognition and Measurement, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss would generally be recorded in other comprehensive income.

IFRS 9 is effective for annual periods beginning on or after January 1, 2015.

IFRS 10 – Consolidation

IFRS 10 requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12 Consolidation—Special Purpose Entities and parts of IAS 27 Consolidated and Separate Financial Statements.

IFRS 11 – Joint Arrangements

IFRS 11 requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, Interests in Joint Ventures, and SIC-13, Jointly Controlled Entities—Non-monetary Contributions by Venturers.

IFRS 12 – Disclosure of Interests in Other Entities

IFRS 12 establishes disclosure requirements for interests in other entities, such as joint arrangements, associates, special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities.

IFRS 13 – Fair Value Measurement

Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements. IFRS 13 is a more comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement.

Amendments to IAS 19 – Employee Benefits

The amendments to IAS 19 make significant changes to the recognition and measurement of defined benefit pension expense and termination benefits, and to enhance the disclosures for all employee benefits. Actuarial gains and losses are renamed 'remeasurements' and will be recognized immediately in OCI. Remeasurements recognized in OCI will not be recycled through profit or loss in subsequent periods. The amendments also accelerate the recognition of past service costs whereby they are recognized in the period of a plan amendment. The annual expense for a funded benefit plan will be computed based on the application of the discount rate to the net defined benefit asset or liability. The amendments to IAS 19 will also impact the presentation of pension expense as benefit cost will be split between (i) the cost of benefits accrued in the current period (service cost) and benefit changes (past-service cost, settlements and curtailments); and (ii) finance expense or income.

A number of other amendments have been made to recognition, measurement and classification including those re-defining short-term and other long-term benefits guidance on the treatment of taxes related to benefit plans, guidance on risk/cost sharing factors and expanded disclosures.

The Corporation's current accounting policy for employee benefits for the presentation of pension expense and the immediate recognition of actuarial gains and losses in OCI is consistent with the requirements in the new standard, however, additional disclosures and the computation of annual expense based on the application of the discount rate to the net defined benefit asset or liability will be required in relation to the revised standard.

Amendments to IAS 1 – Financial Statement Presentation

The amendments to IAS 1 require entities to separate items presented in OCI into two groups, based on whether or not they may be recycled to profit or loss in the future. Items that will not be recycled such as remeasurements resulting from the amendments to IAS 19 will be presented separately from items that may be recycled in the future, such as deferred gains and losses on cash flow hedges. Entities that choose to present OCI items before tax will be required to show the amount of tax related to the two groups separately.

Amendments to Other Standards

In addition, there have been amendments to existing standards, including IFRS 7 Financial Instruments: Disclosure, IAS 27, Separate Financial Statements, IAS 28, Investments in Associates and Joint Ventures, and IAS 32, Financial Instruments: Presentation. IFRS 7 amendments require disclosure about the effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. IAS 27 addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements. IAS 28 has been amended to include joint ventures in its scope and to address the changes in IFRS 10 – 13. IAS 32 addresses inconsistencies when applying the offsetting requirements, and is effective for annual periods beginning on or after January 1, 2014.

4. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying notes. These estimates and associated assumptions are based on historical experience, future operating plans and various other factors believed to be reasonable under the circumstances, and the results of such estimates form the basis of judgments about carrying values of assets and liabilities. These underlying assumptions are reviewed on an ongoing basis. Actual results could differ materially from those estimates.

Significant estimates made in the preparation of these financial statements include, but are not limited to, the following areas, with further information contained in the applicable accounting policy or note:

- Employee future benefits
  - The cost and related liabilities of the Corporation's pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions including discount rates, expected rates of return on assets, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty. Refer to Note 10 for additional information.
- Passenger revenues
  - The Corporation performs regular evaluations on the advance ticket sales liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures; the complex nature of interline and other commercial agreements used throughout the industry; historical experience over a period of many years; and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual amounts that are different from those estimates.
- Depreciation and amortization period for long-lived assets
  - The Corporation makes estimates about the expected useful lives of long-lived assets and the expected residual values of the assets based on the estimated current fair value of the assets, the Corporation's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $17 to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.
- Impairment considerations on long-lived assets
  - An impairment test is performed by comparing the carrying amount of the asset or cash-generating unit to their recoverable amount, which is calculated as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. Value in use is calculated based upon a discounted cash flow analysis, which requires management to make a number of significant assumptions including assumptions relating to future operating plans, discount rates and future growth rates. Refer to Notes 6 and 7 for additional information.
- Maintenance provisions
  - The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. Refer to Note 11(a) for additional information.

5. PROPERTY AND EQUIPMENT

	Aircraft and flight equipment	Buildings, and leasehold improvements	Ground and other equipment	Purchase deposits, including capitalized interest	Total
At January 1, 2010					
Cost	$ 5,800	$ 794	$ 211	$ 38	$ 6,843
Accumulated depreciation	(246)	(218)	(92)	–	(556)
Net book value	$ 5,554	$ 576	$ 119	$ 38	$ 6,287
Year ended December 31, 2010					
At January 1, 2010	$ 5,554	$ 576	$ 119	$ 38	$ 6,287
Additions	98	7	16	48	169
Reclassifications	37	14	–	(51)	–
Disposals	(66)	(5)	–	–	(71)
Depreciation	(646)	(47)	(14)	–	(707)
Impairment	(49)	–	–	–	(49)
At December 31, 2010	$ 4,928	$ 545	$ 121	$ 35	$ 5,629
At December 31, 2010					
Cost	$ 5,820	$ 809	$ 226	$ 35	$ 6,890
Accumulated depreciation	(892)	(264)	(105)	–	(1,261)
	$ 4,928	**$ 545**	**$ 121**	**$ 35**	**$ 5,629**
Year ended December 31, 2011					
At January 1, 2011	$ 4,928	$ 545	$ 121	$ 35	$ 5,629
Additions	64	5	14	77	160
Reclassifications	(20)	8	28	(16)	–
Disposals	(4)	(9)	–	–	(13)
Depreciation	(622)	(43)	(23)	–	(688)
At December 31, 2011	$ 4,346	$ 506	$ 140	$ 96	$ 5,088
At December 31, 2011					
Cost	$ 5,929	$ 794	$ 295	$ 96	$ 7,114
Accumulated depreciation	(1,583)	(288)	(155)	–	(2,026)
	$ 4,346	**$ 506**	**$ 140**	**$ 96**	**$ 5,088**

As at December 31, 2011, property and equipment includes finance leased assets including 19 aircraft (2010 – 19) with a cost of $396 (2010 – $400) less accumulated depreciation of $158 (2010 – $83) for a net book value of $238 (2010 – $317) and facilities with a cost of $66 (2010 – $66) less accumulated depreciation $16 (2010 – $13) for a net book value of $50 (2010 – $53).

Included in flight equipment as at December 31, 2011 are rotable parts, including spare engines with a cost of $339 (2010 – $328) less accumulated depreciation of $94 (2010 – $48) for a net book value of $245 (2010 – $280). Also included in flight equipment are 38 aircraft and 11 spare engines (2010 – 42 aircraft and 11 spare engines) which are leased to Jazz (Note 17) and third parties with a cost of $463 (2010 – $477) less accumulated depreciation of $124 (2010 – $80) including accumulated impairment losses of $46 related to its fleet of A340-300 as described below (2010 – $46) for a net book value of $339 (2010 – $397). Depreciation expense for 2011 for this flight equipment amounted to $46 (2010 – $80 including an impairment charge of $46).

As at December 31, 2011, flight equipment included 21 aircraft (2010 – 17) that are retired from active service with a net carrying value of $12 (2010 – $4). In 2010, the Corporation recorded an impairment charge of $49 in Depreciation, amortization and impairment on its fleet of A340-300 and retired B767-200 aircraft due to the carrying value exceeding the estimated recoverable amount.

Interest capitalized during 2011 amounted to $4 at an interest rate of 12.16% (2010 $1 at an interest rate of 12.16%).

During 2010:

- The Corporation received additional net proceeds of $20 upon completion of the remaining part of the sale-leaseback transaction of three Boeing 777 aircraft which was substantially completed in the fourth quarter of 2009. The Corporation recorded a loss on assets of $1 in 2010 for this remaining part of the transaction.
- The Corporation sold a spare engine for proceeds of $25 with a book value of $24, resulting in a gain on sale of $1.

Certain property and equipment are pledged as collateral as further described under the applicable debt instrument in Note 9.

6. INTANGIBLE ASSETS

	International route rights and slots	Marketing based trade names	Contract and customer based	Technology based (internally developed)	Total
At January 1, 2010					
Cost	$ 92	$ 87	$ 20	$ 245	$ 444
Accumulated amortization	–	–	–	(115)	(115)
Net book value	$ 92	$ 87	$ 20	$ 130	$ 329
Year ended December 31, 2010					
At January 1, 2010	$ 92	$ 87	$ 20	$ 130	$ 329
Additions	5	–	–	23	28
Amortization	–	–	(4)	(36)	(40)
At December 31, 2010	$ 97	$ 87	$ 16	$ 117	$ 317
At December 31, 2010					
Cost	$ 97	$ 87	$ 20	$ 268	$ 472
Accumulated amortization	–	–	(4)	(151)	(155)
	$ 97	**$ 87**	**$ 16**	**$ 117**	**$ 317**
Year ended December 31, 2011					
At January 1, 2011	$ 97	$ 87	$ 16	$ 117	$ 317
Additions	–	–	–	30	30
Amortization	–	–	(4)	(31)	(35)
At December 31, 2011	$ 97	$ 87	$ 12	$ 116	$ 312
At December 31, 2011					
Cost	$ 97	$ 87	$ 20	$ 298	$ 502
Accumulated amortization	–	–	(8)	(182)	(190)
	$ 97	**$ 87**	**$ 12**	**$ 116**	**$ 312**

International route rights and slots are pledged as security for senior secured notes as described in Note 9(b).

An annual impairment review is conducted on all intangible assets that have an indefinite life. International route rights and slots and marketing based trade names are considered to have an indefinite life. The impairment review is carried out at the level of a cash-generating unit. On this basis, an impairment review was performed at the North American and international fleet levels for aircraft and related assets supporting the operating fleet. A summary of the allocation of the indefinite lived intangible assets to the cash-generating units is presented below.

	2011	2010
North American	41	41
International	143	143
	$ 184	$ 184

The recoverable amount of the cash-generating units has been measured based on its value in use, using a discounted cash flow model. Cash flow projections are based on the annual business plan approved by the Board of Directors of Air Canada. In addition, management-developed projections are made covering a three-year period. These cash flows are management's best estimate of future events taking into account past experience and future economic assumptions, such as the forward curves for crude-oil and the exchange rates. Cash flows beyond the three-year period are projected to increase consistent with the long-term growth assumptions of the airline considering various factors such as industry growth assumptions. The pre-tax discount rate applied to the cash flow projections is derived from the Corporation's weighted average cost of capital adjusted for taxes. Key assumptions used for value in use calculations are as follows:

	2011	2010
Pre-tax discount rate	15.6%	16.6%
Long-term growth rate	2.5%	2.5%
Jet fuel price range per barrel	$125 – $135	$85 – $95

The recoverable amount of both cash-generating units based on value in use exceeded their respective carrying values by approximately $1,400. If the discount rate were increased by 380 basis points, the excess of recoverable amount over carrying value would be reduced to nil.

During fiscal 2010, the most recent calculations from the preceding period were carried forward as the calculation of the recoverable amount exceeded the carrying amount by a substantial margin, the assets and liabilities making up the CGU had not changed significantly and no events had occurred or circumstances had changed which would indicate that the likelihood of the recoverable asset not exceeding the carrying value was remote.

7. GOODWILL

Goodwill is tested at least annually for impairment. For the purpose of impairment testing, goodwill is tested for impairment at the operating segment level. Air Canada is managed as one operating segment based on how financial information is produced internally for the purposes of operating decisions.

In assessing the goodwill for impairment, the Corporation compares the aggregate recoverable amount, based on the fair value less cost to sell, of the entity as a whole to its carrying value. If the carrying value exceeds the recoverable amount, an impairment charge is recognized to the extent that the carrying value exceeds the recoverable amount.

No impairment charge has arisen as a result of the review performed as at December 31, 2011 and 2010 and January 1, 2010. Reasonably possible changes in key assumptions would not cause the recoverable amount of goodwill to fall below the carrying value.

8. DEPOSITS AND OTHER ASSETS

		2011	2010
Aircraft related deposits (a)		$ 138	$ 131
Restricted cash	Note 3R	182	140
Prepayments under maintenance agreements	Note 3J	65	65
Investment in Aveos	Note 20	51	51
Other deposits		24	24
Aircraft lease payments in excess of rent expense	Note 3BB	54	52
Deposit related to the Pension and Benefits Agreement	Note 20	20	20
Asset backed commercial paper	Note 18	24	29
Other		37	37
		$ 595	**$ 549**

(a) Represents the amount of deposits with lessors for the lease of aircraft and flight simulators.

9. LONG-TERM DEBT AND FINANCE LEASES

	Final Maturity	Weighted Average Interest Rate (%)	2011	2010
Aircraft financing (a)				
Fixed rate US dollar financing	2012 – 2021	7.52	$ 1,515	$ 1,863
Floating rate US dollar financing	2015 – 2021	2.52	701	620
Floating rate Japanese yen financing	2020	0.33	199	207
Floating rate CDN dollar financing	2012	2.98	2	10
Senior secured notes – US dollar (b)	2015 – 2016	9.94	813	796
Senior secured notes – CDN dollar (b)	2015	10.13	300	300
Other secured financing – US dollar (c)	2013 – 2015	5.72	235	250
Other secured financing – CDN dollar (d)	2012 – 2032	4.61	204	134
Long-term debt			**3,969**	**4,180**
Finance lease obligations (e)	2013 – 2033	10.01	426	493
Total debt and finance leases			**4,395**	**4,673**
Unamortized discount			(12)	(16)
Unamortized debt issuance costs			(53)	(62)
Current portion			(424)	(567)
Long-term debt and finance leases			**$ 3,906**	**$ 4,028**

(a) Aircraft financing (US$2,178, JPY15,073 and $2) is secured primarily by specific aircraft with a carrying value of $3,550 (2010 – $3,963). For the majority of the financing, principal and interest is repayable quarterly until maturity and can be repaid at any time with the payment of applicable fees. US$347 and JPY15,073 of the financing is supported by a loan guarantee by the Export-Import Bank of the United States ("EXIM"). In 2010, the Corporation concluded a credit agreement to refinance amounts related to sixteen aircraft. In 2011, the Corporation received net financing proceeds of $125 (US$128) after financing fees of $2, through draws on the facility for twelve aircraft and the facility will be available in 2012 to refinance up to US$42 of the amount related to four aircraft.

(b) In 2010, the corporation completed a private offering of two series of senior secured notes, consisting of US$600 senior secured first lien notes due 2015 (the "U.S. Dollar First Lien Notes") and $300 senior secured first lien notes due 2015 (the "Canadian Dollar First Lien Notes" and, collectively with the U.S. Dollar First Lien Notes, the "First Lien Notes"). The Corporation also completed a private offering of US$200 senior secured second lien notes due 2016 (the "Second Lien Notes" and, together with the First Lien Notes, the "Notes"). The Corporation received net proceeds of $1,075, after deduction of fees, expenses and discounts.

Prepayment options within the First Lien Notes and Second Lien Notes are considered embedded derivatives. The value of these embedded derivatives at December 31, 2011 and 2010 is negligible. Upon specified change of control events or upon certain sales of assets, the Corporation must offer to repurchase the Notes.

The Notes are senior secured obligations of the Corporation, (i) secured on a first-lien basis (in the case of the First Lien Notes) or on a junior lien basis (in the case of the Second Lien Notes), subject to certain permitted liens, by accounts receivable, certain real estate interests, certain spare engines, ground equipment, certain airport slots and gate leaseholds, and the Corporation's licenses to operate its Pacific routes and the airport slots and gate leaseholds utilized in connection with these Pacific routes and (ii) guaranteed on a senior secured basis by a subsidiary of the Corporation, subject to certain thresholds and exclusions.

(c) Other US dollar secured financings are fixed and floating rate financings that are secured by certain assets including certain items of property and equipment with a current carrying value of $318 (2010 – $355).

(d) Other CDN dollar secured financings are fixed rate financings that are secured by certain assets that amount to $225, of which $154 relates to certain items of property and equipment and $71 relates to cash and cash equivalents (2010 – $160 relates to certain items of property and equipment and $3 relates to cash and cash equivalents).

(e) Finance leases, related to facilities and aircraft, total $426 ($80 and US$340) ($493 ($82 and US$413) as at December 31, 2010). During 2011, the Corporation recorded interest expense on finance lease obligations of $46 (2010 – $54). The carrying value of aircraft and facilities under finance leases amounted to $238 and $50 respectively (2010 – $317 and $53).

Certain aircraft and other secured finance agreements contain collateral fair value tests. Under the tests the Corporation may be required to provide additional collateral or prepay part of the financings. The maximum amount payable in 2012, assuming the collateral is worth nil, is $513 (US$504). The maximum payable amount declines over time in relation to the outstanding principal. For certain aircraft if the Corporation is required under the test to prepay obligations, these amounts are recoverable from the third party residual value support providers upon expiry to the extent that the adjusted obligation taking into account prepayments is less than the residual value support. Total collateral provided under the test for these aircraft as at December 31, 2011 is $55 (US$54) (2010 – $53 (US$54)), in the form of cash deposits included in Deposits and other assets.

Cash interest paid on Long-term debt and finance leases in 2011 by the Corporation was $281 (2010 – $276).

Refer to Note 17 for the Corporation's principal and interest repayment requirements as at December 31, 2011.

10. PENSIONS AND OTHER BENEFIT LIABILITIES

The Corporation maintains several defined benefit and defined contribution plans providing pension, other post-retirement and post-employment benefits to its employees, and former employees for whom the related pension assets and liabilities have not yet been settled.

The Corporation is the administrator and sponsoring employer of ten Domestic Registered Plans ("Domestic Registered Plans") under the Pension Benefits Standard Act, 1985 (Canada). The US plan, UK plan and Japan plan are international plans covering employees in those countries. In addition, the Corporation maintains a number of supplementary pension plans which are not registered. The defined benefit pension plans provide benefits upon retirement, termination or death based on the member's years of service and final average earnings for a specified period.

The other employee benefits consist of health, life and disability. These benefits consist of both post-employment and post-retirement benefits. The post-employment benefits relate to disability benefits available to eligible active employees, while the post-retirement benefits are comprised of health care and life insurance benefits available to eligible retired employees.

Cost Recovery for Assigned Employees

Certain Corporation employees performed work for Aveos until July 14, 2011, the date of transition to employment at Aveos and then ceased to accrued benefits under the Corporation-sponsored defined benefit pension plans and under the Corporation-sponsored health, life and disability benefit plans. Other Corporation employees performed work for Aeroplan until June 1, 2009, the date of transition to employment at Aeroplan and then ceased to accrue benefits under the Corporation-sponsored defined benefit pension plans and under the Corporation-sponsored health, life and disability benefit plans.

In 2009, approximately 750 Air Canada employees chose to transition to employment at Aeroplan. For those employees who transferred to Aeroplan, their service, which largely determines benefit levels under the Air Canada pension and other employee benefit plans, ceased to accrue as of the date of employment with Aeroplan. Air Canada and Aeroplan continue to discuss the terms surrounding the transfer of pension benefits and certain implications relating to the same remain to be resolved. Air Canada continues to retain plan assets and report plan liabilities for services accrued for the transferred Aeroplan employees as at December 31, 2011, pending final determination of this matter. Post transition, Aeroplan is contributing current service costs in their pension plan for service accruing with Aeroplan.

These consolidated financial statements include all of the assets and liabilities of all Corporation-sponsored plans. The employee benefit expense in these consolidated financial statements includes the expenses for all employees and past employees participating in the plans less a cost recovery which is charged to Aveos and Aeroplan for those employees contractually assigned. The cost recovery includes current service costs for pensions and a portion of post-employment and post-retirement benefits based on actuarial calculation for their specific employee group. This cost recovery amounted to $21 for the year ended December 31, 2011 (2010 – $27).

Pension and Benefits Agreement with Aveos

Air Canada and Aveos are parties to a Pension and Benefits Agreement covering the future transfer of certain pension and benefit assets and obligations to Aveos. In 2010, the Office of the Superintendent of Financial Institutions ("OSFI") provided its approval for the transfer of pension assets and liabilities from the Air Canada pension plans to the Aveos pension plan for certain non-unionized employees of Air Canada who became employees of Aveos effective October 16, 2007. The amount of the asset transfer was established as a pro-rata share, based on solvency liabilities, of assets in the Air Canada pension plans as at October 16, 2007. The resulting amount was adjusted by investment returns and benefit payments until the actual date funds were transferred. The transaction, completed in 2010, included an asset transfer of $43, as well as a reduction of $43 to the benefit obligation, in addition to transferring cash payments previously made under the Pension and Benefits Agreement of $2.

As described in Note 20, the transfer of pension assets and liabilities from the Air Canada pension plans to the Aveos pension plan for certain unionized employees of Air Canada who became employees of Aveos effective July 14, 2011 has yet to occur and is subject to approval by OSFI.

Amendments to the Defined Benefit Pension Plans

In 2011, Air Canada reached an agreement with the Canadian Auto Workers union ("CAW") Local 2002 which represents approximately 4,000 call centre and airport check-in and gate agents employed by Air Canada and the Canadian Union of Public Employees ("CUPE"), the union representing the airline's 6,800 flight attendants. The agreements include amendments to the defined benefit pension plans of CAW and CUPE members which are subject to regulatory approval and will be accounted for at the time this approval has been received. In addition, a hybrid pension regime consisting of defined contribution and defined benefit components applies to new employees represented by the CAW and CUPE, hired after the date of ratification of the new agreements. The expense and obligations relating to the hybrid pension plan as at December 31, 2011 are negligible.

Pension Plan Cash Funding Obligations

As at January 1, 2011, based on the actuarial valuations which were used to determine certain pension funding requirements in 2011, the aggregate solvency deficit in the domestic registered pension plans was $2,167. The next required valuations are as of January 1, 2012, and will be completed in the first half of 2012, but as described below, they will not increase the 2012 pension past service cost funding obligations.

In July 2009, the Government of Canada adopted the Air Canada 2009 Pension Regulations. The Air Canada 2009 Pension Regulations relieved Air Canada from making any past service contributions (i.e. special payments to amortize the plan deficits) to its ten domestic defined benefit registered pension plans in respect of the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution is the lesser of (i) $150, $175, and $225 in respect of 2011, 2012, and 2013, respectively, on an accrued basis, and (ii) the maximum past service contribution permitted under the Canadian Income Tax Act. Current service contributions continue to be made in the normal course while the Air Canada 2009 Pension Regulations are in effect.

The Air Canada 2009 Pension Regulations were adopted during the third quarter of 2009 in coordination with pension funding agreements reached with all of the Corporation's Canadian-based unions ("the Pension MOUs"). Pursuant to the Pension MOUs, on October 26, 2009, Air Canada issued to a trust, 17,647,059 Class B Voting Shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All future net proceeds of sale of such shares by the trust are to be contributed to the pension plans. For so long as the trust continues to hold at least 2% of the issued and outstanding shares of Air Canada, the trustee will have the right to designate one nominee (who shall not be a member or officer of any of Air Canada's Canadian-based unions) to Air Canada's board of directors, subject to completion of Air Canada's usual governance process for selection and confirmation of director nominees.

After consideration of the effect of the Air Canada 2009 Pension Regulations as outlined above, total employer pension funding contributions during 2011 amounted to $385. Expected total employer contributions to pension benefit plans for 2012 are $426.

Discount Rate

The discount rate used to determine the pension obligation was determined by reference to market interest rates on corporate bonds rated "AA" or better with cash flows that approximate the timing and amount of expected benefit payments. An increase in the discount rate of 0.25% results in a decrease of $473 to the pension obligation and $7 to the pension expense. A decrease in the discount rate of 0.25% results in an increase of $473 to the pension obligation and $5 to the pension expense.

Expected Return on Assets Assumption

The expected long-term rate of return on assets assumption is selected based on the facts and circumstances that exist as of the measurement date and the specific portfolio mix of plan assets. Air Canada's management, in conjunction with its actuaries, reviews anticipated future long-term performance of individual asset categories and considers the asset allocation strategy adopted by Air Canada, including the longer duration in its bond portfolio in comparison to other pension plans. These factors are used to determine the average rate of expected return on the funds invested to provide for the pension plan benefits. The determination of the long-term rate considers a number of factors including recent fund performance, and historical returns, to the extent that the past is indicative of the expected long-term, prospective rate. There can be no assurance that any of the plans will earn the expected rate of return.

Benefit Obligation and Plan Assets

The net benefit obligation is recorded in the statement of financial position as follows:

	2011	2010
Accrued benefit liabilities for		
Pension benefits obligation	$ 4,519	$ 2,398
Other employee future benefits	1,116	1,000
Net benefit obligation	**5,635**	**3,398**
Current portion	(72)	(70)
Pension and other benefit liabilities	**$ 5,563**	**$ 3,328**

The current portion of the net benefit obligation represents an estimate of other employee future benefits claims to be paid during 2012. The current portion is included in Accounts payable and accrued liabilities.

The following table presents financial information related to the changes in the pension and other post-employment benefits plans:

	Pension Benefits		Other Employee Future Benefits	
	2011	2010	2011	2010
Change in benefit obligation				
Benefit obligation at beginning of year	$ 13,619	$ 11,937	$ 1,000	$ 851
Current service cost	204	160	58	53
Interest cost	736	748	55	53
Employees' contributions	75	76	–	–
Benefits paid	(740)	(770)	(53)	(59)
Actuarial loss	558	1,501	51	110
Foreign exchange (gain) loss	9	(33)	5	(8)
	14,461	13,619	1,116	1,000
Change in plan assets				
Fair value of plan assets at beginning of year	11,542	10,751	–	–
Expected return on plan assets	775	726	–	–
Actuarial gain (loss) on plan assets	(137)	544	–	–
Employer contributions	385	243	53	59
Employees' contributions	75	76	–	–
Benefits paid	(740)	(770)	(53)	(59)
Foreign exchange gain (loss)	7	(28)	–	–
	11,907	11,542	–	–
Deficit at end of year	**2,554**	**2,077**	**1,116**	**1,000**
Additional minimum funding liability	1,965	321	–	–
Net benefit obligation	**$ 4,519**	**$ 2,398**	**$ 1,116**	**$ 1,000**
Weighted average assumptions used to determine the accrued benefit liability				
Discount rate	5.20%	5.50%	4.90%	5.35%
Rate of compensation increase	2.50%	2.50%	not applicable	not applicable

The actual return on plan assets was $638 (2010 – $1,270).

Under the terms of the domestic registered and supplementary plans, there is no indexation provided after January 1, 2007.

Included in plan assets is 17,647,059 Class B Voting Shares of Air Canada with a fair value of $17 (2010 – $61) which were issued in 2009 in co-ordination with pension funding agreements reached with all of the Corporation's Canadian-based unions. All future net proceeds of sale of such shares are to be contributed to the pension plans.

The pension benefit deficit of only those plans that are not fully funded at the end of the year is as follows:

	2011	2010
Domestic registered plans	$ 1,608	$ 1,238
US, UK, and Japan	157	98
Supplementary plans	804	755
	$ 2,569	**$ 2,091**

The net benefit obligation for pension benefits was $4,519 (2010 – $2,398). The increase is mainly the result of the increase to the accrued benefit obligation resulting from the decrease in the discount rate and lower than expected returns on plan assets.

Pension and Other Employee Future Benefit Expense

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

	Pension Benefits		Other Employee Future Benefits	
	2011	2010	2011	2010
Consolidated Statement of Operations				
Components of cost				
Current service cost	$ 204	$ 160	$ 58	$ 53
Actuarial (gains) losses	–	–	7	(6)
Total cost	204	160	65	47
Recovered from Aveos and Aeroplan	(13)	(16)	(8)	(11)
Net cost recognized in Wages, salaries and benefits	**$ 191**	**$ 144**	**$ 57**	**$ 36**
Interest cost	736	748	55	53
Expected return on plan assets	(775)	(726)	–	–
Net financing expense relating to employee benefits	**(39)**	**22**	**55**	**53**
Total cost recognized in statement of operations	**$ 152**	**$ 166**	**$ 112**	**$ 89**
Consolidated Other Comprehensive Income (Loss)				
Actuarial loss, including foreign exchange	697	944	49	115
Minimum funding liability	1,645	(1,639)	–	–
Total cost recognized in OCI	**$ 2,342**	**$ (695)**	**$ 49**	**$ 115**
Cumulative actuarial loss (gains) recognized in OCI	$ 1,641	$ 944	$ 164	$ 115
Weighted average assumptions used to determine the accrued benefit cost				
Discount rate	5.50%	6.40%	5.35%	6.14%
Expected long-term rate of return on plan assets	6.90%	7.00%	not applicable	not applicable
Rate of compensation increase	2.50%	2.50%	not applicable	not applicable

Other Benefits – Sensitivity Analysis

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 7.50% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2011 (2010 – 8.25%). The rate is assumed to decrease gradually to 5% by 2015. A one percentage point increase in assumed health care trend rates would have increased the current service and interest costs by $5 and the obligation by $57. A one percentage point decrease in assumed health care trend rates would have decreased the current service and interest costs by $4 and the obligation by $55.

Composition of Pension Plan Assets

Domestic Registered Plans

The composition of the Domestic Registered Plan assets and the target allocation are the following:

	2011	2010	Target Allocation[(1)]
Non-matched assets (mainly equities)	53.0%	54.0%	54.4%
Matched assets (mainly Canadian bonds)	47.0%	46.0%	45.6%
	100.0%	100.0%	100.0%

(1) *Weighted average of the Master Trust Fund target allocation (99% of Domestic Registered Plan assets) and the Bond Trust Fund target allocation. The Bond Trust Fund serves the purpose of altering the asset mix of some of the participating plans. These plans exhibit characteristics that differ from the majority of the participating plans, which are solely invested in the Master Trust.*

For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Funds, as amended during 2011. The investment return objective is to achieve a total annualized rate of return that exceeds by a minimum of 1.0% before investment fees on average over the long term (i.e. 10 years) the total annualized return that could have been earned by passively managing the Liability Benchmark. The Liability Benchmark, which is referenced to widely used Canadian fixed income performance benchmarks (DEX), is composed of a mix of the DEX Universe Provincial Bond Index, DEX Long Term Provincial Bond Index and DEX Real Return Bond Index that closely matches the characteristics of the pension liabilities.

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

- Non-matched assets are mainly equities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 25% to 39% of the total market value of the Master Trust Fund. Limitations are placed on the overall allocation to any individual security at both cost and market value. Investments in non-publicly traded securities and in non-traditional asset classes are allowed up to 10% of the total market value of the Master Trust Fund.

- Matched assets are mainly Canadian bonds, oriented toward long term investment grade securities rated "BBB" or higher. With the exception of Government of Canada securities or a province thereof, in which the plan may invest the entire fixed income allocation, these investments are required to be diversified among individual securities and sectors.

Derivatives are permitted provided that they are used for managing a particular risk (including interest rate risk related to pension liabilities) or to create exposures to given markets and currencies and that counterparties have a minimum credit rating of A. As of December 31, 2011, a 15% derivatives exposure to matched assets is in place to mitigate interest rate risk related to pension liabilities.

Similar investment policies are established for the International pension plans sponsored by the Corporation.

The trusts for the supplemental plans are invested 50% in indexed equity investments, in accordance with their investment policies, with the remaining 50% held by the Canada Revenue Agency as a refundable tax, in accordance with tax legislation.

Defined Contribution Plans

The Corporation's management, administrative and certain unionized employees may participate in defined contribution plans. Contributions range from 3% to 6% of annual pay for those employees in Canada and 3% to 7% of annual pay for those participants in the United Kingdom. The Corporation contributes an equal amount. The Corporation’s expense for defined contribution plans amounted to $3 for the year ended December 31, 2011 (2010 – $2).

11. PROVISIONS FOR OTHER LIABILITIES

The following table provides a continuity schedule of all recorded provisions. Refer to Note 19 for additional information on Litigation provisions. Current provisions are recorded in Accounts payable and accrued liabilities.

	Maintenance (a)	Labour (b)	Asset retirement (c)	Litigation	Total provisions
At December 31, 2010					
Current	$ –	$ 15	$ –	$ 71	$ 86
Non-current	493	25	23	–	541
	493	**40**	**23**	**71**	**627**
Changes arising during the year	$ 64	$ 10	$ –	$ –	74
Amounts disbursed	(8)	(14)	–	(31)	(53)
Changes in estimates	25	–	(3)	(3)	19
Accretion expense	13	2	1	–	16
Foreign exchange loss	13	–	–	–	13
At December 31, 2011	**$ 600**	**$ 38**	**$ 21**	**$ 37**	**$ 696**
Current	$ 52	$ 8	$ –	$ 37	$ 97
Non-current	548	30	21	–	599
	$ 600	**$ 38**	**$ 21**	**$ 37**	**$ 696**

(a) Maintenance provisions relate to the provision for the costs to meet the contractual return conditions on aircraft under operating leases. The provision relates to leases with expiry dates ranging from 2012 to 2024 with the average remaining lease term of approximately four years. The maintenance provisions take into account current costs of maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Assuming the aggregate cost for return conditions increases by 2%, holding all other factors constant, there would be a cumulative balance sheet adjustment to increase the provision by $12 at December 31, 2011 and an increase to maintenance expense in 2012 of approximately $1. If the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $13 at December 31, 2011. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

(b) The Corporation offers certain severance programs to certain employees from time to time. The cost of these programs is recorded within Operating expenses. As a result of a review of the outstanding provisions, it was determined that a portion of the provisions amounting to $3 was no longer required and was adjusted in 2010. The non-current provision is recorded in Other long-term liabilities.

(c) Under the terms of certain land and facilities leases, the Corporation, including each Fuel Facility Corporation, has an obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which it is responsible. If it were found that the Fuel Facility Corporations had to contribute to any remediation costs, each contracting airline would share pro rata, based on system usage, in the costs. The related leases expire over terms ranging from 2012 to 2039. These provisions are based on numerous assumptions including the overall cost of decommissioning and remediation and the selection of alternative decommissioning and remediation approaches. The non-current provision is recorded in Other long-term liabilities.

12. OTHER LONG-TERM LIABILITIES

		2011	2010
Proceeds from contractual commitments (a)		$ 107	$ 107
Deferred income tax	Note 13	48	48
Collateral held in leasing arrangements and other deposits		40	46
Aircraft rent in excess of lease payments	Note 3BB	55	57
Long-term employee liabilities	Note 11(b)	30	25
Other	Note 11(c)	189	185
		$ 469	$ 468

(a) Proceeds from contractual commitments represent non-refundable proceeds received, net of related costs and deposits, in consideration of various contractual commitments and will be recognized as reductions in the cost of those contractual commitments when incurred.

13. INCOME TAX

Income Tax Expense

	2011	2010
Current income tax recovery in respect of prior years	$ (1)	$ (4)
Deferred income tax	–	3
Recovery of income taxes	**$ (1)**	**$ (1)**

The provision for (recovery of) income taxes differs from the amount that would have resulted from applying the statutory income tax rate to income before income tax expense as follows:

	2011	2010
Loss before income taxes	$ (250)	$ (25)
Statutory income tax rate based on combined federal and provincial rates	28.05%	29.96%
Tax recovery based on statutory tax rates	(70)	(7)
Effects of:		
Non-taxable portion of capital (gains) losses	10	(23)
Non-deductible expenses (non-taxable income)	14	(24)
Tax rate changes on deferred income taxes	11	24
Unrecognized deferred income tax assets	41	41
Adjustment in respect of current income tax of prior years	(1)	(4)
Other	(6)	(8)
Recovery of income taxes	**$ (1)**	**$ (1)**

The applicable statutory tax rates are 28.05% in 2011 and 29.96% in 2010. The Corporation's applicable tax rate is the Canadian combined rates applicable in the jurisdictions in which the Corporation operates. The decrease is mainly due to the reduction of the Federal income tax rate in 2011 from 18% to 16.5%.

The income tax expense (recovery) relating to components of Other comprehensive income is as follows:

	2011	2010
Net gain (loss) on employee benefit liabilities	$ (597)	$ 160
Reclassification of net realized losses on fuel derivatives to income	–	56
Unrecognized deferred income tax assets	597	(216)
Provision for income taxes in Other comprehensive income	**$ –**	**$ –**

Deferred Income Tax

Certain intangible assets with no tax cost and a carrying value of $184, have indefinite lives and accordingly, the associated deferred income tax liability of $48 is not expected to reverse until the assets are disposed of or become amortizable. In addition, the Corporation has other deferred income tax liabilities in the amount of $42, against which a deferred income tax asset of similar amount has been recognized. The recognized net deferred income tax liability of $48 is included in Other long-term liabilities.

Deferred income tax assets are recognized to the extent that the realization of the related tax benefit is probable. The Corporation has unrecognized tax loss carryforwards of $1,817 (2010 – $1,739) and temporary differences of $7,232 (2010 – $4,670) for which no deferred income tax assets could be recognized. However, the future tax deductions underlying these deferred income tax assets remain available for use in the future to reduce taxable income.

The balances of loss carryforwards vary amongst different taxing jurisdictions. The following are the Federal non-capital tax loss expiry dates:

	Tax Losses
2026	$ 2
2027	594
2028	957
2029	406
2030	11
2031	6
	$ 1,976

Cash income taxes paid in 2011 by the Corporation were less than $1 (2010 – $4).

14. SHARE CAPITAL

		Number of shares	Value
At January 1, 2010		278,147,059	$ 844
Shares issued on the exercise of stock options		5,625	–
Shares issued on the exercise of warrants		819,700	2
At December 31, 2010		**278,972,384**	**846**
Shares purchased in trust for employee recognition award	Note 15	(3,344,250)	(11)
Shares issued for employee recognition award	Note 15	1,807,258	5
Shares purchased and cancelled under issuer bid		(239,524)	–
Shares issued on the settlement of performance share units	Note 15	175,000	–
Shares issued on the exercise of stock options	Note 15	625	–
At December 31, 2011		**277,371,493**	**$ 840**

The issued and outstanding ordinary shares of Air Canada, along with the potential ordinary shares, were as follows:

		2011	2010
Issued and outstanding			
Class A variable voting shares		42,204,645	64,275,209
Class B voting shares		235,166,848	214,697,175
Total issued and outstanding		**277,371,493**	**278,972,384**
Potential ordinary shares			
Warrants		89,430,300	89,430,300
Shares held in trust	Note 15	1,536,992	–
Stock options	Note 15	6,581,242	3,287,931
Total potential ordinary shares		**97,548,534**	**92,718,231**

Ordinary Shares

As at December 31, 2011, the ordinary shares issuable by Air Canada consist of an unlimited number of Class A Variable Voting Shares ("Variable Voting Shares") and an unlimited number of Class B Voting Shares ("Voting Shares"). The two classes of ordinary shares have equivalent rights as common shareholders except for voting rights. Holders of Variable Voting Shares are entitled to one vote per share unless (i) the number of Variable Voting Shares outstanding, as a percentage of the total number of voting shares of Air Canada exceeds 25% or (ii) the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting exceeds 25% of the total number of votes that may be cast at such meeting. If either of the above noted thresholds would otherwise be surpassed at any time, the vote attached to each Variable Voting Share will decrease proportionately such that (i) the Variable Voting Shares as a class do not carry more than 25% of the aggregate votes attached to all issued and outstanding voting shares of Air Canada and (ii) the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting do not exceed 25% of the votes that may be cast at such meeting.

Variable Voting Shares may only be held, beneficially owned or controlled, directly or indirectly, by persons who are not Canadians (within the meaning of the Canada Transportation Act). An issued and outstanding Variable Voting Share shall be converted into one Voting Share automatically and without any further act of Air Canada or the holder, if such Variable Voting Share becomes held, beneficially owned and controlled, directly or indirectly, otherwise than by way of security only, by a Canadian, as defined in the Canada Transportation Act.

Voting Shares may only be held, beneficially owned and controlled, directly or indirectly, by Canadians. An issued and outstanding Voting Share shall be converted into one Variable Voting Share automatically and without any further act of Air Canada or the holder, if such Voting Share becomes held, beneficially owned or controlled, directly or indirectly, otherwise than by way of security only, by a person who is not a Canadian.

Issuer Bid

In December 2011, Air Canada announced that it received approval from the Toronto Stock Exchange ("TSX") to implement a normal course issuer bid to purchase, for cancellation, up to 24,737,753 Class A Variable Voting Shares and/or Class B Voting Shares (the "Shares"), representing, at that time, 10% of the total public float of the Shares.

The repurchase program, which commenced on December 12, 2011 and will end no later than December 11, 2012, will be conducted through the facilities of the TSX, or alternative trading systems, if eligible, and will conform to their regulations.

The average daily trading volume of Air Canada's Variable Voting Shares and Voting Shares, taken together, was 958,098 Shares over the period between June 1, 2011 and November 30, 2011. Consequently, under TSX rules, Air Canada is allowed to purchase daily, through the TSX's facilities, a maximum of 239,524 Shares representing 25% of such average daily trading volume. In addition, Air Canada may make, once per week, a block purchase (as such term is defined in the TSX Company Manual) of Shares not directly or indirectly owned by insiders of Air Canada, in accordance with TSX rules. The Shares purchased pursuant to the normal course issuer bid will be cancelled.

Purchases under the normal course issuer bid may be made by means of open market transactions or such other means as the TSX or as securities regulatory authorities may permit, including pre-arranged crosses, exempt offers and private agreements under an issuer bid exemption order issued by a securities regulatory authority. The price to be paid by Air Canada for any Share will be the market price at the time of acquisition, plus brokerage fees, or such other price as the TSX may permit.

During 2011, the Corporation purchased and cancelled 239,524 shares for cash at an average cost of $1.08 per share.

Warrants

A summary of warrants outstanding as at December 31, 2011 is as follows:

Grant date	Number of Warrants Outstanding	Exercise Prices	Expiry Dates	Remaining Life (Years)
30-Jul-09	5,000,000	$1.51	30-Jul-13	1.6
19-Oct-09	5,000,000	$1.44	19-Oct-13	1.8
27-Oct-09	79,430,300	$2.20	27-Oct-12	0.8
	89,430,300			

During 2011, no warrants were exercised (2010 – 819,700 warrants for cash consideration of $2).

Each Warrant will entitle the holder thereof to acquire one Variable Voting Share or one Voting Share (each, a "Warrant Share") at the exercise price per Warrant Share, at any time prior to its expiry date.

In the event that, prior to the time of expiry of the 79,430,300 Warrants issued with an exercise price of $2.20, the 20-day volume weighted average trading price of the Variable Voting Shares on the Toronto Stock Exchange ("TSX") is equal to or greater than $4.00 or the 20-day volume weighted average trading price of the Voting Shares on the TSX is equal to or greater than $4.00 (each, an "Acceleration Event"), Air Canada shall have the right, at its option, within 10 business days after the Acceleration Event, to accelerate the time of expiry of those Warrants upon 30 days notice.

Shareholder Rights Plan

In 2011, the shareholders of Air Canada ratified a shareholder rights plan agreement (the "Plan") designed to foster fair treatment of all shareholders in connection with any take-over bid for Air Canada.

The Plan has been designed to give the Board and shareholders more time to fully consider any take-over bid and to provide the Board with more time to pursue, if appropriate, other alternatives to maximize shareholder value. Under the terms of the Plan, one right (a "Right") has been issued with respect to each Class B Voting Share and each Class A Variable Voting Share (each a "Share") of Air Canada issued and outstanding as of the close of business on March 30, 2011 or subsequently issued. These Rights would become exercisable only when a person, including any party related to it, acquires or announces its intention to acquire 20% or more of the outstanding Class A Variable Voting Shares, or 20% or more of the outstanding Class B Voting Shares of Air Canada, without complying with the "Permitted Bid" provisions of the Plan or, in certain cases, without the approval of the Board. Until such time, the Rights are not separable from the shares, are not exercisable and no separate rights certificates are issued.

To qualify as a "Permitted Bid" under the Plan, a bid must, among other things: (i) be made to all holders of Shares, (ii) remain open for a period of not less than 60 days, (iii) provide that no Shares shall be taken up unless more than 50% of the then outstanding Class A Variable Voting Shares and Class B Voting Shares, on a combined basis, other than the Shares held by the person pursuing the acquisition and parties related to it, have been tendered and not withdrawn, and (iv) provide that if such 50% condition is satisfied, the bid will be extended for at least 10 business days to allow other shareholders to tender.

Following the occurrence of an event which triggers the right to exercise the Rights and subject to the terms and conditions of the Plan, each Right would entitle the holders thereof, other than the acquiring person or any related persons, to exercise their Rights and purchase from Air Canada $200 worth of Class A Variable Voting Shares or Class B Voting Shares for $100 (i.e. at a 50% discount to the market price at that time). Upon such exercise, holders of rights beneficially owned and controlled by Qualified Canadians would receive Class B Voting Shares and holders of rights beneficially owned or controlled by persons who are not Qualified Canadians would receive Class A Variable Voting Shares.

The Plan is scheduled to expire at the close of business on the date immediately following the date of Air Canada's annual meeting of shareholders to be held in 2014, unless terminated earlier in accordance with the terms of the Plan.

15. SHARE-BASED COMPENSATION

Air Canada Long-Term Incentive Plan

Certain of the Corporation's employees participate in the Air Canada Long-term Incentive Plan (the "Long-term Incentive Plan"). The Long-term Incentive Plan provides for the grant of options and performance share units to senior management and officers of Air Canada. 19,470,294 shares are authorized for issuance under the Long-term Incentive Plan in respect of either of stock options or performance share units.

Stock Options

The options to purchase shares granted under the Long-term Incentive Plan have a maximum term of 10 years and an exercise price based on the fair market value of the shares at the time of the grant of the options. Fifty percent of options are time-based and vest over four years. The remaining options will vest based upon performance conditions. The performance vesting conditions are based on operating margin (operating income over operating revenues) and net income targets established by the Air Canada Board over the same time period. Each option entitles the employee to purchase one ordinary share at the stated exercise price. The terms of the Long-term Incentive Plan specify that following retirement an employee may exercise options granted with the rights to exercise accruing within three years from the retirement date.

The number of Air Canada stock options granted to employees, the related compensation expense recorded and the assumptions used to determine stock-based compensation expense, using the Black-Scholes option valuation model are as follows:

	2011	2010
Compensation expense ($ millions)	$ 2	$ 1
Number of stock options granted to Air Canada employees	3,439,471	50,000
Weighted average fair value per option granted ($)	$ 1.13	$ 1.06
Aggregated fair value of options granted ($ millions)	$ 4	$ –
Weighted average assumptions:		
Share price	$ 2.33	$ 2.02
Risk-free interest rate	2.48%-3.18%	2.55%-3.23%
Expected volatility	73.9%-85.1%	80.0%-83.6%
Dividend yield	0%	0%
Expected option life (years)	4.50	4.50

Expected volatility was determined using the Air Canada share price on a historical basis. It reflects the assumption that the historical volatility is indicative of future trends, which may not necessarily be the actual outcome.

A summary of the Long-term Incentive Plan option activity is as follows:

	2011		2010	
	Options	Weighted Average Exercise Price/Share	Options	Weighted Average Exercise Price/Share
Beginning of year	3,287,931	$ 6.17	3,963,474	$ 8.66
Granted	3,439,471	2.39	50,000	1.85
Exercised	(625)	1.59	(5,625)	1.59
Forfeited	(145,535)	11.85	(719,918)	19.63
Outstanding options, end of year	**6,581,242**	**$ 4.07**	**3,287,931**	**$ 6.17**
Options exercisable, end of year	**1,644,809**	**$ 10.07**	**1,038,986**	**$ 14.42**

The weighted average share price on the date of exercise for options exercised in 2011 was $2.51 ($3.38 for options exercised in 2010).

		2011 Outstanding Options			2011 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
$21.00	2013	566,457	2	$ 21.00	566,457	$ 21.00
$11.08 – $18.60	2014	239,539	3	14.72	239,539	14.72
$8.51	2015	5,500	4	8.51	4,125	8.51
$0.97 – $1.59	2016	2,291,875	5	1.32	822,188	1.32
$1.78 – $1.91	2017	50,000	6	1.85	12,500	1.85
$2.34 – $3.35	2018	3,427,871	7	2.39	–	–
		6,581,242		**$ 4.07**	**1,644,809**	**$ 10.07**

		2010 Outstanding Options			2010 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
$21.00	2013	566,457	3	$ 21.00	566,457	$ 21.00
$11.08 – $18.60	2014	345,474	4	14.89	180,404	14.89
$8.51	2015	11,000	5	8.51	2,750	8.51
$0.97 – $1.59	2016	2,315,000	6	1.32	289,375	1.32
$1.78 – $1.91	2017	50,000	7	1.85	–	–
		3,287,931		**$ 6.17**	**1,038,986**	**$ 14.42**

Performance Share Units

The Long-term Incentive Plan also includes performance share units ("PSUs"), which are accounted for as cash settled instruments. The vesting term of PSUs is three years and generally includes time based vesting features as well as performance based vesting features, which are based upon achievement of earnings targets established over the vesting period. The terms of the plan specify that upon the retirement of an employee, the number of PSUs that vest are prorated based on the total number of completed months of active service during the PSU vesting term. The PSUs granted may only be redeemed for Air Canada shares purchased on the secondary market and/or equivalent cash at the discretion of the Board of Directors.

The compensation expense (recovery) related to PSUs in 2011 was ($1) (2010 – $4).

A summary of the Long-term Incentive Plan performance share unit activity is as follows:

	2011	2010
Beginning of year	3,589,449	1,653,064
Granted	3,310,900	2,532,337
Exercised	(345,692)	–
Forfeited	(438,817)	(595,952)
Outstanding PSUs, end of year[(1)]	**6,115,840**	**3,589,449**

(1) 837,782 PSUs were eligible for vesting as at December 31, 2011, of which 753,611 were vested in accordance with the terms of the program, with the remainder being forfeited. These PSUs which vested in 2011 are planned to be settled in 2012 and have an intrinsic value of $1 as at December 31, 2011.

Refer to Note 18 for a description of derivative instruments used by the Corporation to mitigate the cash flow exposure to the PSUs granted.

Employee Recognition Award

In 2011, Air Canada's Board of Directors approved a special one-time Employee Recognition Award in the form of Air Canada shares granted to all eligible unionized and certain non-unionized employees worldwide, where permitted. Under the award, eligible employees were granted an aggregate of approximately 3.3 million shares with a grant date fair value of $11. Half of these shares vested immediately upon issuance and the other half vest at the end of three years. Pursuant to the award, the Corporation purchased approximately 3.3 million shares for $11, of which half were distributed to the eligible employees and the other half are held in trust over the vesting period. The shares held in trust are recorded at cost of $6 and are reported net against Share capital. Compensation expense for these shares will be recognized over the vesting period. The compensation expense recorded in 2011 was $2. Refer to Note 15 for the number of remaining shares held in trust as at period end.

Employee Share Purchase Plan

Eligible employees can participate in the employee share purchase plan under which employees can invest up to 6% of their base salary for the purchase of shares on the secondary market. Air Canada will match 33.3% of the investments made by the employee. During 2011, the Corporation recorded compensation expense of less than $1 (2010 – less than $1).

16. EARNINGS PER SHARE

The following table outlines the calculation of basic and diluted earnings per share:

(in millions, except per share amounts)	2011	2010
Numerator:		
Numerator for basic and diluted earnings per share:		
Net loss attributable to shareholders of Air Canada	$ (255)	$ (33)
Denominator:		
Weighted-average shares	278	278
Effect of potential dilutive securities:		
Warrants	9	13
Stock options	1	1
Shares held in Trust for employee share-based compensation award	1	–
	11	14
Add back anti-dilutive impact	(11)	(14)
Adjusted denominator for diluted earnings per share	**278**	**278**
Basic and diluted loss per share	**$ (0.92)**	**$ (0.12)**

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

Basic EPS is calculated based on the weighted average number of ordinary shares in issue after deducting shares held in trust for the purposes of the Employee Recognition Award.

Excluded from the 2011 calculation of diluted earnings per share were 5,897,000 (2010 – 2,368,000) outstanding options where the options' exercise prices were greater than the average market price of the ordinary shares for the year. In 2011 a weighted average of 80,478,701 warrants were excluded from the calculation of diluted earnings per share as the warrants' exercise prices were greater than the average market price of the ordinary shares for the year. All outstanding warrants were included in the 2010 calculation of diluted earnings per share.

17. COMMITMENTS

Boeing

As at December 31, 2011, the Corporation had outstanding purchase commitments with The Boeing Company ("Boeing") for the acquisition of 37 Boeing 787 aircraft and two Boeing 777 aircraft following the exercise of its purchase rights described below. The Corporation also has purchase rights for 16 Boeing 777 (entitling Air Canada to purchase aircraft based on previously determined pricing), purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery position), and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's then current pricing). In 2011, the Corporation exercised purchase rights for two Boeing 777 with scheduled deliveries in mid-2013.

The first seven deliveries of its Boeing 787 aircraft are currently scheduled for delivery in 2014 and the remaining 30 between 2015 and 2019.

The Corporation has financing commitments from Boeing and the engine manufacturer covering 31 of the 37 Boeing 787 firm aircraft orders. The financing terms for 28 out of the 31 covered aircraft is for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments. For the remaining three out of the 31 covered aircraft, the financing under the commitment covers up to 90% of the capital expenditure and the term to maturity is 15 years with principal payments made on a mortgage style basis resulting in equal instalment payments of principal and interest over the term to maturity.

Operating Lease and Capital Commitments

The estimated aggregate cost of the future firm Boeing 787 aircraft deliveries and other capital purchase commitments as at December 31, 2011 approximates $4,976 (of which $3,110 is subject to committed financing, subject to the fulfillment of certain terms and conditions). US dollar amounts are converted using the December 31, 2011 closing rate of CDN$1.017. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day US LIBOR rate at December 31, 2011. Other capital purchase commitments relate principally to building and leasehold improvement projects.

	2012	2013	2014	2015	2016	Thereafter	Total
Capital commitments	$ 155	$ 318	$ 755	$ 575	$ 1,017	$ 2,156	**$ 4,976**

As at December 31, 2011 the future minimum lease payments under existing operating leases of aircraft and other property amount to $2,117 using year end exchange rates.

	2012	2013	2014	2015	2016	Thereafter	Total
Aircraft	$ 345	$ 320	$ 257	$ 211	$ 177	$ 494	**$ 1,804**
Other property	50	42	39	36	28	118	**313**
Total	**$ 395**	**$ 362**	**$ 296**	**$ 247**	**$ 205**	**$ 612**	**$ 2,117**

The above minimum lease payments include residual value guarantees, except for those for which the Corporation has obtained residual value support.

Non-cancellable Sublease Receipts

The Corporation subleases 43 aircraft and 11 spare engines which have final maturities ranging from 2012 to 2015 and the future minimum rentals receivable under subleases amount to $181 using year end exchange rates.

	2012	2013	2014	2015	2016	Thereafter	Total
Subleases	$ 88	$ 49	$ 25	$ 15	$ 4	$ –	**$ 181**

For accounting purposes, the Corporation acts as an agent and subleases certain aircraft to Jazz on a flow-through basis, which are reported net on the statement of operations. These subleases relate to 25 Bombardier CRJ-200 aircraft and 15 Bombardier CRJ-705 aircraft which have final maturities ranging from 2015 to 2024. The sublease revenue and lease expense related to these aircraft each amounted to $75 in 2011 (2010 – $79) The operating lease commitments under these aircraft, which are recovered from Jazz, are not included in the aircraft operating lease commitments table above but are summarized as follows:

	2012	2013	2014	2015	2016	Thereafter	Total
Jazz flow – through leases	$ 77	$ 78	$ 78	$ 75	$ 70	$ 390	**$ 768**

The subleases with Jazz have the same terms and maturity as the Corporation's corresponding lease commitments to the lessors.

The future minimum non-cancellable commitment for the next 12 months under the Jazz CPA is approximately $760 (2010 – $749) and under the capacity purchase agreements with other regional carriers is $57 (2010 – $29). The rates under the Jazz CPA are subject to change based upon, amongst other things, changes in Jazz's costs and the results of benchmarking exercises, which compare Jazz costs to other regional carriers. Rate negotiations and one of the benchmarking exercises are currently underway. The results of this benchmarking will be implemented with retroactive effect to January 1, 2010.

Maturity Analysis

Principal and interest repayment requirements as at December 31, 2011 on Long-term debt and finance lease obligations are as follows:

Principal	2012	2013	2014	2015	2016	Thereafter	Total
Long-term debt obligations	$ 367	$ 535	$ 261	$ 1,261	$ 455	$ 1,090	**$ 3,969**
Finance lease obligations	57	61	57	52	25	174	**426**
	$ 424	**$ 596**	**$ 318**	**$ 1,313**	**$ 480**	**$ 1,264**	**$ 4,395**

Interest	2012	2013	2014	2015	2016	Thereafter	Total
Long-term debt obligations	$ 231	$ 226	$ 193	$ 142	$ 51	$ 108	**$ 951**
Finance lease obligations	41	34	28	22	18	65	**208**
	$ 272	**$ 260**	**$ 221**	**$ 164**	**$ 69**	**$ 173**	**$ 1,159**

Principal repayments in the table above exclude transaction costs and discounts of $65 which are offset against Long-term debt and finance leases in the Consolidated Statement of Financial Position.

The following is a maturity analysis, based on contractual undiscounted cash flows, for financial liabilities. The analysis includes both the principal and interest component of the payment obligations on long-term debt and is based on interest rates and the applicable foreign exchange rate effective as at December 31, 2011 and does not include the impact of the future financing amounts available under the facility as described in Note 9. If drawn upon, the remaining amounts available will reduce the net cash flows by the amount of the related debt maturities refinanced in 2012 of $43, offset by the principal and interest repayments under the loan facility.

	2012	2013	2014	2015	2016	Thereafter	Total
Long-term debt obligations	$ 598	$ 761	$ 454	$ 1,403	$ 506	$ 1,198	**$ 4,920**
Finance lease obligations	98	95	85	74	43	239	**634**
Accounts payable and accrued liabilities	1,175	–	–	–	–	–	**1,175**
	$ 1,871	**$ 856**	**$ 539**	**$ 1,477**	**$ 549**	**$ 1,437**	**$ 6,729**

Minimum Committed Purchase of Aeroplan Miles

The CPSA between the Corporation and Aeroplan outlines a requirement for the Corporation to purchase a minimum number of Aeroplan Miles® from Aeroplan. The estimated minimum requirement for 2012 is $222. The annual commitment is based on 85% of the average total Aeroplan Miles® actually issued in respect of Air Canada flights or Air Canada airline affiliate products and services in the three preceding calendar years. During 2011, the Corporation purchased $270 of Aeroplan Miles® from Aeroplan.

18. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Summary of Financial Instruments

	Carrying Amounts					
	December 31, 2011					December 31, 2010
	Financial instruments classification					
	Held for trading	Loans and receivables	Available for sale	Liabilities at amortized cost	Total	
Financial Assets						
Cash and cash equivalents	$ 848	$ –	–	$ –	$ 848	$ 1,090
Short–term investments	1,251	–	–	–	1,251	1,102
Restricted cash	76	–	–	–	76	80
Accounts receivable	–	712	–	–	712	641
Deposits and other assets						
Restricted cash	182	–	–	–	182	140
Asset backed commercial paper	24	–	–	–	24	29
Aircraft related and other deposits	–	182	–	–	182	175
Investment in Aveos	–	–	51	–	51	51
Derivative instruments						
Fuel derivatives	11	–	–	–	11	33
Share forward contracts	5	–	–	–	5	9
Foreign exchange derivatives	5	–	–	–	5	–
Interest rate swaps	15	–	–	–	15	13
	$ 2,417	$ 894	$ 51	$ –	$ 3,362	$ 3,363
Financial Liabilities						
Accounts payable	$ –	$ –	–	$ 993	$ 993	$ 1,023
Current portion of long–term debt and finance leases	–	–	–	424	424	567
Long–term debt and finance leases	–	–	–	3,906	3,906	4,028
Derivative instruments						
Interest rate swaps	13	–	–	–	13	–
Foreign exchange derivatives	–	–	–	–	–	3
	$ 13	$ –	$ –	$ 5,323	$ 5,336	$ 5,621

There have been no changes in classification of financial instruments since December 31, 2010.

For cash flow purposes, the Corporation may settle, from time to time, certain cash equivalents and short-term investments prior to their original maturity. For this reason, these financial instruments do not meet the criteria of held to maturity and are therefore designated as held for trading. They are recorded at fair value with changes in fair value recorded in Interest income.

Collateral Held in Leasing Arrangements

The Corporation holds security deposits with a carrying value of $10 (2010 – $11), which approximates fair value, as security for certain aircraft leased and sub-leased to third parties. These deposits do not pay interest to the lessee or sub-lessee. Of these deposits, $7 (2010 – $7) have been assigned as collateral to secure the Corporation's obligations to the lessors and financiers of the aircraft, with the remaining cash held by Air Canada being unrestricted during the term of the lease. Any collateral held by the Corporation is returned to the lessee or sub-lessee, as the case may be, at the end of the lease or sub-lease term provided there have been no events of default under the leases or sub-leases.

Summary of Loss on Financial Instruments Recorded at Fair Value

	2011	2010
Fuel derivatives	$ (26)	$ (11)
Interest rate swaps	(22)	7
Share forward contracts	(10)	4
Other	(5)	(3)
Loss on financial instruments recorded at fair value	**$ (63)**	**$ (3)**

Risk Management

Under its risk management policy, the Corporation manages its interest rate risk, foreign exchange risk, share-based compensation risk and market risk (e.g. fuel price risk) through the use of various interest rate, foreign exchange, fuel and other derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

As noted below, the Corporation uses derivative instruments to provide economic hedges to mitigate various risks. The derivative fair values represent the amount of the consideration that could be exchanged in an arm's length transaction between willing parties who are under no compulsion to act. Fair value of these derivatives is determined using active markets, where available. When no such market is available, valuation techniques are applied such as discounted cash flow analysis. The valuation technique incorporates all factors that would be considered in setting a price, including the Corporation's own credit risk and the credit risk of the counterparty.

Interest Rate Risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Corporation enters into both fixed and floating rate debt and also leases certain assets where the rental amount fluctuates based on changes in short term interest rates. The Corporation manages interest rate risk on a portfolio basis and seeks financing terms in individual arrangements that are most advantageous taking into account all relevant factors, including credit margin, term and basis. The risk management objective is to minimize the potential for changes in interest rates to cause adverse changes in cash flows to the Corporation. The short-term investment portfolio which earns a floating rate of return is an economic hedge for a portion of the floating rate debt.

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in the Corporation's capital structure and is based upon a long term objective of 60% fixed and 40% floating but allows flexibility to 75% fixed in the short-term to adjust to prevailing market conditions. The ratio at December 31, 2011 is 69% fixed and 31% floating, including the effects of interest rate swap positions (69% and 31%, respectively as at December 31, 2010).

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2011:

- Certain payments based upon aircraft rental amounts for the delivery of 15 Q400 aircraft are based on medium-term US interest rates at the time of delivery. To hedge against the exposure to increases in interest rates until the expected delivery date, the Corporation entered into forward start interest rate swaps with an aggregate notional value of US$234. The swaps have contractual terms of maturity that coincide with the term of the rental agreements. However, the derivatives will be settled on each expected delivery date of the aircraft with maturities ranging to July 2012. The aggregate notional value outstanding at December 31, 2011 is US$109 for future delivery of seven Q400 aircraft. These derivatives have not been designated as hedges for accounting purposes. The fair value of these contracts as at December 31, 2011 is $13 in favour of the counterparties, with a loss of $28 recorded in Loss on financial instruments.

- As at December 31, 2011, the Corporation had two interest rate swap agreements in place with terms to July 2022 and January 2024 relating to two Boeing 767 aircraft financing agreements with an aggregate notional value of $74 (US$73) (2010 – $80 (US$80)). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2011 was $15 in favour of the Corporation (2010 – $13 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2011, a gain of $6 was recorded in Gain on financial instruments recorded at fair value related to these derivatives (2010 – $6 gain).

Interest income includes $32 (2010 – $15) related to Cash and cash equivalents and Short-term investments, which are classified as held for trading. Interest expense reflected on the Consolidated Statement of Operations relates to financial liabilities recorded at amortized cost.

Foreign Exchange Risk

Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

The Corporation's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

The Corporation's cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in US dollars. This unbalanced mix results in an annual US dollar shortfall from operations. In order to mitigate this imbalance, the Corporation has adopted the practice of converting excess revenues from offshore currencies into US dollars. In 2011, this conversion generated coverage of approximately 20% of the imbalance. The remaining 80% was covered through the use of a variety of foreign exchange derivatives, including spot transactions and US dollar investments, which had maturity dates corresponding to the forecasted shortfall dates. The level of foreign exchange derivatives expiring at any one point in time is dependent upon a number of factors, which include the amount of foreign revenue conversion available, US dollar net cash flows, as well as the amount attributed to aircraft and debt payments.

The following are the current derivatives employed in foreign exchange risk management activities and the adjustments recorded during 2011:

- As at December 31, 2011, the Corporation had outstanding foreign currency options and swap agreements to purchase US dollars against Canadian dollars on $1,008 (US$991) which mature in 2012 (2010 – $223 (US$224) which matured in 2011). The Corporation did not have any agreements outstanding at December 31, 2011 to buy Euro dollars against Canadian dollars (2010 – Euro dollars against Canadian dollars on $15 (EUR 11) which matured in 2011). The fair value of these foreign currency contracts as at December 31, 2011 was $5 in favour of the Corporation (2010 – $3 in favour of the counterparties). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2011, a gain of $26 was recorded in Foreign exchange gain (loss) related to these derivatives (2010 – $2 gain).

Share-based Compensation Risk

The Corporation issues share-based compensation to its employees in the form of stock options and PSUs as described in Note 15. Each PSU entitles the employees to receive a payment in the form of one Air Canada ordinary share, cash in the amount equal to market value of one ordinary share, or a combination thereof, at the discretion of the Board of Directors.

Share-based compensation risk refers to the risk that future cash flows to settle the PSUs will fluctuate because of changes in the Corporation's share price. To hedge the exposure to outstanding PSUs, the Corporation entered into share forward contracts during 2010 and 2011 which now hedge an average of approximately 82% of the PSUs that may vest between 2011 and 2014, subject to the performance vesting criteria. The contracts were prepaid by the Corporation for $11, representing the initial price of $1.785 per share for 2,700,000 Air Canada ordinary shares and $2.374 on 2,658,670 Air Canada ordinary shares. The forward dates for the share forward contracts coincide with the planned settlement date in 2012 of 825,000 PSUs which were eligible for vesting in 2011, and the vesting term of 1,875,000 PSUs in 2012 and 2,658,670 in 2014 and will be cash settled. These contracts were not designated as hedging instruments for accounting purposes. Accordingly, changes in the fair value of these contracts are recorded in Gain (loss) on financial instruments recorded at fair value in the period in which they arise. During 2011, a loss of $10 was recorded (2010 – gain of $4). As at December 31, 2011, the fair value of the share forward contracts is $5 in favour of the Corporation (2010 – $9 in favour of the Corporation) and is recorded in Deposits and other assets.

Liquidity risk

Liquidity risk is the risk that the Corporation will encounter difficulty in meeting obligations associated with its financial liabilities and other contractual obligations, including pension funding obligations as described in Note 10 and covenants in credit card agreements as described below. The Corporation monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. The Corporation's principal objective in managing liquidity risk is to maintain a minimum unrestricted cash balance in excess of a target liquidity level of 15% of annual operating revenues. At December 31, 2011, Air Canada had Cash and cash equivalents and Short-term investments of $2,099, which represents 18% of 2011 operating revenues.

A maturity analysis of the Corporation's financial liabilities, other fixed operating commitments and capital commitments is set out in Note 17.

Market Risks

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: foreign exchange risk; interest rate risk; and other price risk, which includes commodity price risk.

Refer to the Asset Backed Commercial Paper section below for information regarding these instruments held by the Corporation and the associated market risks.

Sensitivity Analysis

The following table is a sensitivity analysis for each type of market risk relevant to the significant financial instruments recorded by the Corporation as at December 31, 2011. The sensitivity analysis is based on a reasonably possible movement in the relevant risk factor. These assumptions may not be representative of actual movements in these risks and should not be relied upon. Given the recent volatility in the financial and commodity markets, the actual percentage changes may differ significantly from the percentage changes outlined below. Each risk is contemplated independent of other risks.

	Interest rate risk(1)	Foreign exchange rate risk(2)		Other price risk(3)	
	Income	Income		Income	
	1% increase	5% increase	5% decrease	10% increase	10% decrease
Cash and cash equivalents	$ 8	$ (8)	$ 8	$ –	$ –
Short–term investments	$ 13	$ (11)	$ 11	$ –	$ –
Aircraft related deposits	$ –	$ (5)	$ 5	$ –	$ –
Long–term debt and finance leases	$ (13)	$ 190	$ (190)	$ –	$ –
Fuel derivatives	$ –	$ –	$ –	$ 10	$ (6)
Foreign exchange derivatives	$ –	$ (1)	$ 11	$ –	$ –
Interest rate swaps	$ 7	$ –	$ –	$ –	$ –

(1) Due to currently low market rates of interest, a 1% decrease in interest rates was not considered a reasonable scenario within the forecast period, being one year.

(2) Increase (decrease) in foreign exchange relates to a strengthening (weakening) of the Canadian dollar versus the U.S. dollar. The impact of changes in other currencies is not significant to the Corporation's financial instruments.

(3) Other price risk relates to the Corporation's fuel derivatives. The sensitivity analysis is based upon a 10% increase or decrease in the price of the underlying commodity.

Covenants in Credit Card Agreements

The Corporation has various agreements with companies that process customer credit card transactions. Approximately 85% of the Corporation's sales are processed using credit cards, with remaining sales processed through cash based transactions. The Corporation receives payment for a credit card sale generally in advance of when the passenger transportation is provided.

The Corporation's principal credit card processing agreements for card processing services requirements in North America have an expiry date of May 2012. Air Canada is in the process of negotiating longer-term arrangements. The Corporation's obligation to provide a deposit to the credit card processor under these agreements, as well as the amount of such deposit, are determined pursuant to a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for the Corporation and the unrestricted cash of the Corporation. The Corporation also has agreements with this processor for the provision of certain credit card processing services requirements for markets other than North America and for its cargo operations worldwide and such agreements contain deposit obligations similar to the obligations set forth above.

Credit Risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. As at December 31, 2011, the Corporation's credit risk exposure consists mainly of the carrying amounts of Cash and cash equivalents, Short-term investments and Accounts receivable. Cash and cash equivalents and Short-term investments are in place with major financial institutions, the Canadian government, and major corporations. Accounts receivable are generally the result of sales of tickets to individuals, often through the use of major credit cards, through geographically dispersed travel agents, corporate outlets, or other airlines. Credit rating guidelines are used in determining counterparties for fuel hedging. In order to manage its exposure to credit risk and assess credit quality, the Corporation reviews counterparty credit ratings on a regular basis and sets credit limits when deemed necessary.

Refer to the Asset Backed Commercial Paper section below for further credit risk information.

Fuel Price Risk

Fuel price risk is the risk that future cash flows arising from jet fuel purchases will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, the Corporation enters into derivative contracts with financial intermediaries. The Corporation uses derivative contracts based on jet fuel, heating oil and crude-oil based contracts. Heating oil and crude-oil derivatives are used due to the relative limited liquidity of jet fuel derivative instruments on a medium to long-term horizon since jet fuel is not traded on an organized futures exchange. The Corporation's policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. There are regular reviews to adjust the strategy in light of market conditions. The Corporation does not purchase or hold any derivative financial instrument for speculative purposes.

During 2011:

- The Corporation recorded a loss of $26 in Loss on financial instruments recorded at fair value related to fuel derivatives ($11 loss in 2010).
- The Corporation purchased crude-oil call options and collars covering a portion of 2011 and 2012 fuel exposure. The cash premium related to these contracts was $35.
- Fuel derivative contracts cash settled with a net fair value of $31 in favour of the Corporation ($27 in favour of the counterparties in 2010).

As of December 31, 2011, approximately 23% of the Corporation's anticipated purchases of jet fuel for 2012 are hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US$114 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2012 period are comprised of call options and call spreads. The fair value of the fuel derivatives portfolio at December 31, 2011 is $11 in favor of the Corporation ($33 in favour of the Corporation in 2010) and is recorded within Prepaid expenses and other current assets.

The following table outlines the notional volumes per barrel along with the WTI equivalent weighted average floor and capped price for each year currently hedged by type of derivative instruments as at December 31, 2011.

Derivative Instruments	Term	Volume (bbls)	WTI Weighted Average Floor Price (US$/bbl)	WTI Weighted Average Capped Price (US$/bbl)
Call options	2012	5,279,106	not applicable	$ 115
Call spreads	2012	360,000	not applicable	$ 107

The Corporation is expected to generate fuel hedging gains if oil prices increase above the average capped price.

The Corporation discontinued applying hedge accounting effective the third quarter of 2009. Amounts that were deferred to Accumulated Other Comprehensive Loss ("AOCL") for derivatives previously designated under hedge accounting were taken into fuel expense in the period when the previously forecasted hedge transaction occurred. During 2010, $183 was reclassified from AOCL to Aircraft fuel expense leaving no amounts remaining in AOCL.

The following information summarizes the financial statement impact of fuel derivatives:

		2011	2010
Consolidated Statement of Operations			
Operating expenses			
Aircraft fuel	Realized effective loss on fuel derivatives previously designated under hedge accounting	not applicable	$ (183)
Non-operating income (expense)			
Loss on financial instruments recorded at fair value			
	Fair market value loss on economic hedges	$ (26)	$ (11)
Consolidated Other Comprehensive Income			
	Reclassification of net realized loss on fuel derivatives previously designated under hedge accounting to Aircraft fuel expense	not applicable	$ 183
	Tax on reclassification	not applicable	$ 1

Financial Instrument Fair Values in the Consolidated Statement of Financial Position

The carrying amounts reported in the Consolidated Statement of Financial Position for short term financial assets and liabilities, which includes Accounts receivable and Accounts payable and accrued liabilities, approximate fair values due to the immediate or short-term maturities of these financial instruments. Cash equivalents and Short-term investments are classified as held for trading and therefore are recorded at fair value.

The carrying amounts of interest rate swaps, share forward contracts, foreign exchange, and fuel derivatives are equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates.

Management estimated the fair value of its long-term debt based on valuation techniques taking into account market rates of interest, the condition of any related collateral, the current conditions in credit markets and the current estimated credit margins applicable to the Corporation based on recent transactions. Based on significant observable inputs (Level 2 in the fair value hierarchy), the estimated fair value of debt is approximately $4,300 as compared to its carrying value of $4,330.

Following is a classification of fair value measurements recognized in the Consolidated Statement of Financial Position using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

		Fair value measurements at reporting date using:		
	December 31, 2011	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial Assets				
Held–for–trading securities				
Cash equivalents	$ 356	$ –	$ 356	$ –
Short–term investments	1,251	–	1,251	–
Deposits and other assets				
Asset backed commercial paper	24	–	–	24
Investment in Aveos	51	–	–	51
Derivative instruments				
Fuel derivatives	11	–	11	–
Share forward contracts	5	–	5	–
Foreign exchange derivatives	5	–	5	–
Interest rate swaps	15	–	15	–
Total	**$ 1,718**	**$ –**	**$ 1,643**	**$ 75**

		Fair value measurements at reporting date using:		
	December 31 2011	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial Liabilities				
Derivative instruments				
Interest rate swaps	$ 13	$ –	$ 13	$ –
Total	**$ 13**	**$ –**	**$ 13**	**$ –**

Financial assets held by financial institutions in the form of cash and restricted cash have been excluded from the fair value measurement classification table above as they are not valued using a valuation technique.

The change in level 3 assets in 2011 related to the charge of $5 in non-operating income (expense) for ABCP described below.

Asset Backed Commercial Paper ("ABCP")

The Corporation has $37 ($24 net of a fair value adjustment) in non-bank sponsored ABCP which has been recorded in Deposits and other assets. There is a limited private market to sell certain of these investments however management does not believe that this market qualifies as an active market and therefore has estimated the fair value of these investments using valuation techniques. The carrying value as at December 31, 2011 is based on a number of assumptions as to the fair value of the investments including factors such as estimated cash flow scenarios and risk adjusted discount rates. The assumptions used in estimating the fair value of the investments are subject to change, which may result in further adjustments to non-operating results in the future. During 2011, the Corporation recorded a charge of $5 in non-operating income (expense).

19. CONTINGENCIES, GUARANTEES AND INDEMNITIES

Contingencies and Litigation Provisions

Investigations by Competition Authorities Relating to Cargo

The European Commission, the United States Department of Justice and the Competition Bureau in Canada have investigated or are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities have sought or requested information from Air Canada as part of their investigations. Air Canada has been cooperating with these investigations, which are likely to lead, or have led, to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions. Air Canada is also named as a defendant, and may otherwise become implicated, in a number of class action lawsuits and other proceedings that have been filed before the United States District Court, in Canada and Europe in connection with these allegations. In the United States, the investigation by the US Department of Justice has concluded with no proceedings having been instituted against the Corporation.

On November 9, 2010, Air Canada announced that the European Commissions issued a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21 Euros (approximately C$29 at an exchange rate of $1.3970) was imposed on Air Canada. Air Canada is appealing this decision and filed an application for appeal before the European General Court. In the first quarter of 2011, Air Canada paid the fine, as required, pending the outcome of its appeal. Following the decision by the European Commission and a review of proceedings and investigations in other jurisdictions, Air Canada recorded a net reduction to the provision for cargo investigations of $46 in 2010.

As at December 31, 2011, Air Canada has a provision of $37 relating to outstanding claims in this matter, which is recorded in Accounts payable and accrued liabilities. This provision is an estimate based upon the status of investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. As stated above, Air Canada is appealing the decision issued by the European Commission and, if and as appropriate, based on the outcome of any updates regarding this appeal as well as developments regarding proceedings and investigations in other jurisdictions, may adjust the provision in its results for subsequent periods as required.

Billy Bishop Toronto City Airport

In February 2006, Jazz commenced proceedings before the Ontario Superior Court of Justice against Porter Airlines Inc. ("Porter") and other defendants (collectively the "Porter Defendants") after Jazz became aware that it would be excluded from operating flights from Billy Bishop Toronto City Airport. On October 26, 2007, the Porter Defendants counter-claimed against Jazz and Air Canada alleging various violations of competition law, including that Jazz and Air Canada's commercial relationship contravenes Canadian competition laws, and claiming $850 in damages. On October 16, 2009, Jazz discontinued its suit in the Ontario Superior Court against Porter.

Concurrently with the Ontario Superior Court of Justice proceedings, Jazz commenced judicial review proceedings against the Toronto Port Authority ("TPA") before the Federal Court of Canada relating to Jazz's access to the Billy Bishop Toronto City Airport. The Porter Defendants were granted intervener and party status in these proceedings. In January of 2008, Porter filed a defence and counterclaim against Jazz and Air Canada making allegations and seeking conclusions similar to those in the Ontario Superior Court counterclaim. In March 2010, Jazz discontinued its proceedings in the Federal Court of Canada against the TPA. On May 14, 2010, Porter filed a discontinuance of its counterclaim before the Federal Court of Canada.

The counterclaim filed by Porter in the Ontario Superior Court of Justice against Jazz and Air Canada was stayed pending the outcome of the mirror counterclaim in the Federal Court. This stay has now been lifted and the counterclaim has been reactivated. Management views Porter's counterclaim as being without merit.

In the first quarter of 2010, Air Canada filed legal proceedings with the Federal Court of Canada seeking to challenge the process announced by the TPA to allocate flight capacity or slots at the Billy Bishop Toronto City Airport. On July 21, 2010, the Federal Court of Canada dismissed Air Canada's challenge and Air Canada appealed this decision before the Federal Court of Appeal. On December 12, 2011, the Federal Court of Appeal dismissed Air Canada's appeal.

Pay Equity

The Canadian Union of Public Employees ("CUPE"), which represents Air Canada's flight attendants, filed a complaint before the Canadian Human Rights Commission where it alleges gender-based wage discrimination. CUPE claims the predominantly female flight attendant group should be paid the same as the predominantly male pilot and mechanics groups because their work is of equal value. The complaint dates from 1991 but was not investigated on the merits because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act. On January 26, 2006, the Supreme Court of Canada ruled that they do work in the same "establishment" and sent the case back to the Canadian Human Rights Commission, to proceed to assess the merits of CUPE's complaint. On March 16, 2007, the Canadian Human Rights Commission referred the complaint against Air Canada for investigation, and an investigation proceeded and was concluded in 2011 with a determination that the complaint will not be referred to the Canadian Human Rights Tribunal for inquiry. CUPE has initiated proceedings before the Federal Court to challenge this determination which Air Canada will seek to have upheld. Air Canada considers that any proceedings will show that it is complying with the equal pay provisions of the Canadian Human Rights Act, however, management has determined that it is not possible at this time to predict with any degree of certainty the final outcome of the proceedings.

Mandatory Retirement

Air Canada is engaged in a number of proceedings involving challenges to the mandatory retirement provisions of certain of its collective agreements, including the Air Canada-Air Canada Pilots Association collective agreement which incorporate provisions of the pension plan terms and conditions applicable to pilots requiring them to retire at age 60. Air Canada has fully or partially resolved some of these complaints and is defending others. At this time, it is not possible to determine with any degree of certainty the extent of any financial liability that may arise from Air Canada being unsuccessful in its defence of these proceedings, though any such financial liability, if imposed, would not be expected to be material.

Other Contingencies

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

With respect to 23 aircraft leases, the difference between the reduced rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement under the Companies' Creditors Arrangement Act ("CCAA") on September 30, 2004 and amounts which would have been due under the original lease contracts will be forgiven at the expiry date of the leases if no material default has occurred by such date. In the event of a material default which does not include any cross defaults to other unrelated agreements (including unrelated agreements with the counterparties to these aircraft leases), this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any additional liability would be recorded only at the time management believes the amount is likely to be incurred.

Refer to Note 11 for a continuity schedule of litigation provisions.

Guarantees

Guarantees in Fuel Facilities Arrangements

The Corporation participates in fuel facility arrangements operated through Fuel Facility Corporations, along with other airlines that contract for fuel services at various major airports in Canada. The Fuel Facility Corporations operate on a cost recovery basis. The purpose of the Fuel Facility Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the Land Rights under the land lease. The aggregate debt of the five Fuel Facility Corporations in Canada that have not been consolidated by the Corporation under SIC Interpretation 12 – Consolidation of Special Purpose Entities is approximately $187 as at December 31, 2011 (2010 – $171), which is the Corporation's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. The Corporation views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification Agreements

In the ordinary course of the Corporation's business, the Corporation enters into a variety of agreements, some of which may provide for indemnifications to counterparties that may require the Corporation to pay for costs and/or losses incurred by such counterparties. The Corporation cannot reasonably estimate the potential amount, if any, it could be required to pay under such indemnifications. Such amount would also depend on the outcome of future events and conditions, which cannot be predicted. While certain agreements specify a maximum potential exposure, certain others do not specify a maximum amount or a limited period. Historically, the Corporation has not made any significant payments under these indemnifications.

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

In aircraft financing or leasing agreements, the Corporation typically indemnifies the financing parties, trustees acting on their behalf and other related parties and/or lessors against liabilities that arise from the manufacture, design, ownership, financing, use, operation and maintenance of the aircraft and for tort liability, whether or not these liabilities arise out of or relate to the negligence of these indemnified parties, except for their gross negligence or willful misconduct. In addition, in aircraft financing or leasing transactions, including those structured as leveraged leases, the Corporation typically provides indemnities in respect of various tax consequences including in relation to the leased or financed aircraft, the use, possession, operation maintenance, leasing, subleasing, repair, insurance, delivery, import, export of such aircraft, the lease or finance arrangements entered in connection therewith, changes of law and certain income, commodity and withholding tax consequences.

When the Corporation, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, the Corporation has from time to time agreed to indemnify the service provider against certain liabilities that arise from third party claims, which may relate to services performed by the service provider.

Under its general by-laws and pursuant to contractual agreements between the Corporation and each of its officers and directors, the Corporation has indemnification obligations to its directors and officers. Pursuant to such obligations, the Corporation indemnifies these individuals, to the extent permitted by law, against any and all claims or losses (including amounts paid in settlement of claims) incurred as a result of their service to the Corporation.

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

20. AVEOS CERTIFICATION ORDER

Aveos Certification Order

On January 31, 2011, the Canada Industrial Relations Board issued an order (the "Order") determining that the sale of Air Canada's former aircraft, engine and component maintenance and repair business had occurred within the meaning of the Canada Labour Code, and establishing Aveos as a distinct employer, bound by separate collective agreements. The issuance of the order triggered the commencement of the process by which certain employees transitioned from Air Canada to employment with Aveos effective July 14, 2011.

Pursuant to the Order and a related separation program, Air Canada may be required to provide up to a maximum of 1,500 separation packages to IAMAW-represented Aveos employees employed in airframe maintenance activities as of the date of the Order (with each package including up to a maximum of 52 weeks of pay), in the event that such employees are permanently laid off or terminated as a direct result of Aveos ceasing to be the exclusive provider of airframe maintenance services to Air Canada prior to June 30, 2015. These packages will also be made available at any time up to June 30, 2013, in the event of an insolvency, liquidation or bankruptcy involving Aveos resulting in the cancellation of Air Canada-Aveos contracts and in the termination or permanent layoff of any airframe, engine or component IAMAW-represented employees. The airframe maintenance services agreement allows for its termination as of June 30, 2013.

An employee benefit liability is recognized related to this separation program. The liability is measured based on the number of employees expected to be paid the benefits and discounted to reflect the estimated timing of the benefits. The amount of the liability is not significant. Any changes in the estimate will be reflected in Wages, salaries and benefits.

Pension and Benefits Agreement

As described in Note 10, Air Canada and Aveos are parties to a Pension and Benefits Agreement covering the transfer of certain pension and benefit assets and obligations to Aveos. On July 14, 2011 (the "Certification Date"), certain unionized employees of Air Canada elected to become employees of Aveos. Under the terms of the Pension and Benefits Agreement and subject to regulatory approval, where required, the assets and obligations under the pension, other post-retirement and post-employment benefits plans pertaining to the transferred unionized employees will be transferred to Aveos.

The terms of the Pension and Benefits Agreement relating to transferred unionized employees provide for the determination of solvency liabilities and pension assets as at July 14, 2011 in respect of unionized employees transferred to Aveos employed in the airframe function and, as at October 16, 2007 in respect of unionized employees transferred to Aveos employed in all other functions. Air Canada will compensate Aveos for the present value of the accounting liability in respect of other post-retirement and post-employment liabilities as at July 14, 2011. These compensation amounts will be paid by Air Canada through quarterly payments to Aveos over a period not exceeding five years after the transfer. Airframe employees represent approximately half of the approximate 2,200 transferred employees. As part of the arrangements, a letter of credit in the amount of $20 was issued by Air Canada in favour of Aveos to secure the payment of all compensation payments owing by Air Canada to Aveos in respect of pension, disability, and retiree liabilities for which Air Canada would be liable under the Pension and Benefits Agreement. This amount is recorded in Deposits and other assets.

Until the Certification Date, the current service pension cost and the current service and interest costs for other employee benefits in respect of employees assigned to Aveos are expensed by Air Canada with a full recovery recorded as an amount charged to Aveos. From the Certification Date, transferred employees accrue employee benefits in the Aveos defined benefit plans. The financial statements do not reflect the determination of the solvency liabilities to be transferred to Aveos, the determination of amount of assets to be transferred to Aveos and the resulting compensation amount to be paid by Air Canada to Aveos, as these amounts are not yet determined. Based on the January 1, 2011 actuarial valuation, these compensation amounts are not expected to be material.

Aveos Restructuring Plan

During the first quarter of 2010, Aveos reached an agreement with its lenders and equity holders on the terms of a consensual restructuring plan to recapitalize the company. As part of this recapitalization, Air Canada and Aveos entered into agreements to settle certain issues and modify the terms of certain contractual arrangements in exchange for Air Canada receiving a minority equity interest in Aveos. This restructuring modified the terms of certain commercial agreements between Air Canada and Aveos, including terms of the Pension and Benefits Agreement and an agreement with Aveos on revised payment terms. The modified terms relating to maintenance agreements are not expected to have a material impact on maintenance expense over their terms.

As part of these agreements, the Corporation also agreed to extend repayment terms on $22 of receivables, due in 2010, over six years with annual repayments on a non-interest bearing basis, with such payments subject to satisfaction of certain conditions. This agreement is now referred to as the Term Note.

As a result of the above agreements, Air Canada's equity investment in Aveos was recorded at $49, based upon its estimated fair value, and $2 for legal fees. The Term Note of $22 was recorded at its estimated fair value of $11, based on the present value of expected cash flows on a discounted basis. Other trade receivables from Aveos of $4 were settled. For accounting purposes, $34 for consideration of agreement amendments is deferred and will be amortized over the terms of the amended agreements with Aveos of four years, on average. This accounting treatment recorded in 2010 is summarized as follows:

Share consideration received	$	49
Allocated to:		
Term Note	$	11
Trade receivables settled		4
Agreements and contract amendments		34
	$	**49**

The investment in Aveos common shares and the Term Note is recorded in Deposits and other assets.

21. GEOGRAPHIC INFORMATION

A reconciliation of the total amounts reported by geographic region for Passenger revenues and Cargo revenues on the Consolidated Statement of Operations is as follows:

Passenger Revenues	**2011**	**2010**
Canada	$ 4,015	$ 3,790
US Transborder	2,064	1,797
Atlantic	2,033	1,962
Pacific	1,177	1,087
Other	919	791
	$ 10,208	**$ 9,427**

Cargo Revenues	**2011**	**2010**
Canada	$ 66	$ 69
US Transborder	17	17
Atlantic	194	164
Pacific	146	164
Other	58	52
	$ 481	**$ 466**

Passenger and cargo revenues are based on the actual flown revenue for flights with an origin and destination in a specific country or region. Atlantic refers to flights that cross the Atlantic Ocean with origins and destinations principally in Europe. Pacific refers to flights that cross the Pacific Ocean with origins and destinations principally in Asia. Other passenger and cargo revenues refer to flights with origins and destinations principally in South America, Australia, and the Caribbean.

Other operating revenues are principally derived from customers located in Canada.

22. CAPACITY PURCHASE AGREEMENTS

Air Canada has capacity purchase agreements with Jazz Aviation LP and certain other regional carriers. The following table outlines the capacity purchase fees and pass-through expenses under these agreements for the periods presented:

	2011	2010
Capacity purchase fees	$ 1,003	$ 971
Pass-through fuel expense	383	292
Pass-through airport expense	198	193
Pass-through other expenses	26	39
	$ 1,610	**$ 1,495**

23. CAPITAL DISCLOSURES

The Corporation views capital as the sum of Long-term debt and finance leases, capitalized operating leases, Non-controlling interests, and the market value of the Corporation's outstanding shares ("market capitalization"). The Corporation includes capitalized operating leases, which is a measure commonly used in the industry ascribing a value to obligations under operating leases. The value is based on annualized aircraft rent expense multiplied by 7.0, which is a factor commonly used in the airline industry. The measure used may not necessarily reflect the fair value or net present value related to the future minimum lease payments as the measure is not based on the remaining contractual payments and the factor may not recognize discount rates implicit in the actual leases or current rates for similar obligations with similar terms and risks. Market capitalization is based on the closing price of Air Canada's shares multiplied by the number of outstanding shares. This definition of capital is used by management and may not be comparable to measures presented by other public companies.

The Corporation also monitors its adjusted net debt. Adjusted net debt is calculated as the sum of Long-term debt and finance lease obligations and capitalized operating leases less Cash and cash equivalents and Short-term investments.

The Corporation's main objectives when managing capital are:

- To structure repayment obligations in line with the expected life of the Corporation's principal revenue generating assets;
- To ensure the Corporation has access to capital to fund contractual obligations as they become due and to ensure adequate cash levels to withstand deteriorating economic conditions;
- To maintain an appropriate balance between debt supplied capital versus investor supplied capital; and
- To monitor the Corporation's credit ratings to facilitate access to capital markets at competitive interest rates.

In order to maintain or adjust the capital structure, the Corporation may adjust the type of capital utilized, including purchase versus lease decisions, defer or cancel aircraft expenditures by not exercising available options or selling current aircraft options, issuing debt or equity securities, and repurchasing outstanding shares, all subject to market conditions and the terms of the underlying agreements.

The total capital and adjusted net debt as at December 31 is calculated as follows:

	2011	2010
Long-term debt and finance leases	$ 3,906	$ 4,028
Current portion of long-term debt and finance leases	424	567
	4,330	4,595
Capitalized operating leases	2,345	2,471
Adjusted debt	6,675	7,066
Non-controlling interests	79	146
Market capitalization	275	962
Total Capital	**$ 7,029**	**$ 8,174**
Adjusted debt	$ 6,675	$ 7,066
Less Cash and cash equivalents and Short-term investments	(2,099)	(2,192)
Adjusted net debt	**$ 4,576**	**$ 4,874**

The adjusted net debt has decreased by $298 in 2011 mainly due to debt repayments of $608, partially offset by proceeds from borrowings of $232.

24. RELATED PARTY TRANSACTIONS

Compensation of Key Management

Compensation of key management is reported on the accrual basis of accounting consistent with the amounts recognized on the consolidated statement of operations. Key management includes Air Canada's Board of Directors, President and Chief Executive Officer, Executive Vice-President and Chief Operating Officer, Executive Vice-President and Chief Financial Officer, and Executive Vice-President and Chief Commercial Officer. Compensation awarded to key management is summarized as follows:

	2011	2010
Salaries and other benefits	$ 5	$ 7
Post-employment benefits	1	1
Other long-term benefits	2	1
Share-based compensation	1	2
	$ 9	$ 11

25. RECONCILIATION OF PREVIOUS CANADIAN GAAP TO IFRS

For all periods up to and including the year ended December 31, 2010, the Corporation previously prepared its consolidated financial statements in accordance with Canadian GAAP.

Accordingly, the Corporation has prepared these financial statements which comply with IFRS applicable for periods beginning on or after January 1, 2011 and the significant accounting policies to meet those requirements are disclosed in Note 3. In preparing these financial statements, the Corporation started from an opening consolidated statement of financial position as at January 1, 2010, the Corporation's IFRS transition date, and made those changes in accounting policies and other adjustments required by IFRS 1 "First-time adoption of international financial reporting standards" ("IFRS 1"). This note explains the principal adjustments made by the Corporation in transitioning its Canadian GAAP consolidated statement of financial position at the transition date on January 1, 2010 and its previously published Canadian GAAP financial statements for the year ended December 31, 2010.

In preparing these financial statements in accordance with IFRS 1, the Corporation has applied the mandatory exceptions and certain of the optional exemptions from full retrospective application of IFRS.

Exemptions and exceptions applied

IFRS 1 allows first-time adopters certain exemptions from the general requirements contained in IFRS. The Corporation has elected to apply the following optional exemptions from full retrospective application:

- Business combinations;
  - The Corporation has elected not to apply IFRS 3 (as amended in 2008) retrospectively to business combinations that occurred before January 1, 2010, the date of transition to IFRS.
- Fair value or revaluation as deemed cost;
  - The Corporation has elected to measure owned and finance leased aircraft and engines at January 1, 2010 at fair value and use that fair value as deemed cost at that date. Under Canadian GAAP, the Corporation applied fresh start reporting on September 30, 2004. As a result, all consolidated assets and liabilities of Air Canada were reported at fair values, except for future income taxes. As permitted under IFRS 1, the Corporation has elected to apply those fair values as deemed cost for IFRS as at the date of the revaluation, with the exception of (i) owned and finance leased aircraft and engines, which are being measured at fair value as at January 1, 2010 as described above, and (ii) intangible assets and goodwill, which, in such case, would be measured at historical cost without the application of the fresh start fair values. Refer to "Fresh start reporting" below for additional information.
- Employee benefits;
  - The Corporation has elected to recognize all cumulative actuarial gains and losses on pension and other post-retirement benefit plans as at January 1, 2010 directly in the Deficit. Furthermore the Corporation has elected to disclose the history of experience gains (losses) related to plan assets and plan liabilities for accounting periods prospective from the transition date.
- Borrowing costs.
  - The Corporation has applied IAS 23R for annual periods beginning on or after January 1, 2010, the date of transition to IFRS. Under Canadian GAAP, the Corporation had an accounting policy of capitalizing interest. Accordingly, the Corporation did not reverse any previously capitalized borrowing costs recognized under Canadian GAAP.

Reconciliations

A reconciliation of how the transition from Canadian GAAP to IFRS has affected the equity of the Corporation, its financial performance and cash flows is set out in the following tables and the notes that accompany the tables.

Reconciliation of equity as previously reported under Canadian GAAP to IFRS

(Canadian dollars in millions)		December 31, 2010	January 1, 2010
Non-controlling interest			
Balance in accordance with Canadian GAAP		$ –	$ –
Reclassification of non-controlling interest to equity	Note i	169	201
Consolidation of special purpose entities	Note i	(23)	(53)
Non-controlling interest in accordance with IFRS		146	148
Share capital			
Balance in accordance with Canadian GAAP		534	532
Reclassification of 2004 fresh start reporting adjustment from the deficit	Note v	312	312
Share capital in accordance with IFRS		846	844
Contributed surplus			
Balance in accordance with Canadian GAAP		1,826	1,825
Reclassification of related party transactions to the deficit	Note v	(1,747)	(1,747)
Reclassification of warrants to the deficit	Note v	(25)	(25)
Contributed surplus in accordance with IFRS		54	53
Deficit			
Balance in accordance with Canadian GAAP		(620)	(727)
Deferred tax adjustment	Note v	49	–
Aircraft fair value and consolidation adjustments	Note i & iii	(338)	(295)
Recognition of deferred gains on sale and leaseback transactions	Note iv	62	69
Pension and other employee future benefits	Note ii	(2,877)	(2,777)
Defined benefit plan gains	Note ii	580	–
Intangible assets and goodwill adjustment	Note v	(230)	(236)
Recognition of additional provisions	Note vi	(420)	(375)
Reclassification of 2004 fresh start reporting adjustment to share capital	Note v	(312)	(312)
Reclassification of related party transactions and warrants from contributed surplus	Note v	1,772	1,772
Deficit in accordance with IFRS		(2,334)	(2,881)
Accumulated other comprehensive loss			
Balance in accordance with Canadian GAAP		–	(184)
Accumulated other comprehensive loss in accordance with IFRS		–	(184)
Total deficit and accumulated other comprehensive loss in accordance with IFRS		(2,334)	(3,065)
Total equity in accordance with IFRS		**$ (1,288)**	**$ (2,020)**

Reconciliation of the Consolidated Statement of Operations as previously reported under Canadian GAAP to IFRS

(Canadian dollars in millions except per share figures)		Year ended December 31, 2010		
		Canadian GAAP[(1)]	Adjustment	IFRS
Operating revenues				
Passenger		$ 9,427	$	$ 9,427
Cargo		466		466
Other		893		893
Total revenues		10,786	–	10,786
Operating expenses				
Aircraft fuel		2,652		2,652
Wages, salaries and benefits	Note ii	1,885	28	1,913
Airport and navigation fees		961		961
Capacity purchase agreements		971		971
Depreciation, amortization and impairment	Note iii & v	679	122	801
Aircraft maintenance	Note iii & vi	682	(28)	654
Sales and distribution costs		581		581
Food, beverages and supplies		279		279
Communications and information technology		195		195
Aircraft rent	Note iv	346	7	353
Other		1,194	–	1,194
Total operating expenses		10,425	129	10,554
Operating income before exceptional item		**361**	**(129)**	**232**
Provision adjustment for cargo investigations, net		46		46
Operating income		407	(129)	278
Non-operating income (expense)				
Foreign exchange gain	Note i, ii & vi	145	39	184
Interest income		19		19
Interest expense	Note i	(378)	(19)	(397)
Net financing expense relating to employee benefit liabilities	Note ii	–	(75)	(75)
Interest capitalized		1		1
Loss on assets	Note iii	(7)	6	(1)
Loss on financial instruments recorded at fair value		(3)		(3)
Other	Note vi	(20)	(11)	(31)
		(243)	(60)	(303)
Income (loss) before the following items		**164**	**(189)**	**(25)**
Non-controlling interest	Note i	(9)	9	–
Recovery of (provision for) income taxes				
Current		4		4
Deferred	Note v	(52)	49	(3)
Net income (loss) for the year		**$ 107**	**$ (131)**	**$ (24)**

(1) Air Canada revised the presentation of certain operating expenses on the statement of operations for the year ended December 31, 2010 to conform to current year presentation. These revisions include a new expense line category within operating expenses referred to as Sales and distribution costs which includes sales commissions, credit card fees and other sales and distribution costs, including fees paid to global distribution system providers. The expense line category related to Capacity purchase agreements has been expanded to include fees paid under all capacity purchase arrangements, including those paid to Jazz and those paid to other carriers operating flights on behalf of Air Canada under commercial agreements.

Reconciliation of the Consolidated Statement of Comprehensive Income (Loss) as previously reported under Canadian GAAP to IFRS

(Canadian dollars in millions)		Year ended December 31, 2010		
		Canadian GAAP	Adjustment	IFRS
Comprehensive income (loss)				
Net income (loss) for the year		$ 107	$ (131)	$ (24)
Other comprehensive income, net of taxes:				
Net gain on employee benefit liabilities	Note ii	–	580	580
Reclassification of net realized losses on fuel derivatives to income		184		184
		184	580	764
Total comprehensive income		**$ 291**	**$ 449**	**$ 740**

Explanation of adjustments restating equity from Canadian GAAP to IFRS

i) Principles of Consolidation

Accounting policy differences

Under Canadian GAAP, consolidation is based on a controlling financial interest model. For variable interest entities, consolidation is based on an analysis of the primary beneficiary. For non-variable interest entities, consolidation of an entity is based on the continuing power to govern the financial and operating policies of an entity so as to obtain benefits from its activities and be exposed to related risks. Non-controlling interest is initially measured at the non-controlling shareholders' interest in the historical cost of the subsidiary's net assets. Non-controlling interest is presented outside of liabilities and equity on the balance sheet and as a reduction to net income on the income statement.

Under IFRS, consolidation is based on a control model. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. This control model also applies to interests in special purpose entities. Non-controlling interest is initially measured at either the non-controlling shareholders' fair value or at the non-controlling shareholders' interest's proportionate share of the net identifiable assets of the subsidiary. Non-controlling interest is presented as a component of equity separate from the equity from the owners of the parent on the balance sheet and net income and comprehensive income attributable to the owners of the parent.

Impact

Certain special purpose entities ("SPEs") that were not consolidated under Canadian GAAP, as the Corporation was determined not to be the primary beneficiary, are consolidated under IFRS based on judgements applied. This relates to aircraft leasing entities covering seven A319 aircraft, six A340 aircraft and eight A330 aircraft.

The impact arising from the change is summarized as follows:

- Consolidated Statement of Financial Position
  - This adjustment increased Property and equipment by $212 (based upon the fair value of the aircraft as at January 1, 2010 and included in the IFRS 1 Property and equipment impacts further discussed below), an increase to Long-term debt of $259, a decrease to non-controlling interest of $53 and a credit to the Deficit of $6. The additional debt consolidated in the SPEs relates to third party debt in the SPE leasing entities with a weighted average effective interest rate of approximately 8%.
  - Non-controlling interest of $201 at January 1, 2010 as determined under Canadian GAAP has been reclassified to Equity.

- Consolidated Statement of Operations
  - Interest expense increased $19 for the year ended December 31, 2010 related to the debt consolidated from the SPEs increased at an average effective interest rate of approximately 8% per year.
  - The non-controlling interests' share of net income, as adjusted, is reclassified to Income (loss) attributable to non-controlling interests in the Consolidated statement of operations.
  - Foreign exchange gain under Canadian GAAP for the year ended December 31, 2010 increased by $15 as the additional long-term debt is denominated in USD.
  - Refer to Property and Equipment section below for a discussion of changes to depreciation expense.

ii) Employee benefits

Optional exemption applied

The Corporation has elected to recognize all cumulative actuarial gains and losses on pension and other post-retirement benefit plans as at January 1, 2010 directly in the Deficit.

Accounting policy differences

Actuarial gains and losses

Under Canadian GAAP, cumulative unrecognized net actuarial gains and losses in excess of 10% of the greater of the projected benefit obligation or market-related value of plan assets at the beginning of the year were amortized over the expected remaining service life of active employees.

Under IFRS, the Corporation has elected an accounting policy to recognize net actuarial gains and losses immediately in other comprehensive income without subsequent reclassification to income.

Fair value of plan assets versus market-related value of plan assets

Under Canadian GAAP, a market-related valuation method was used to value plan assets for the purpose of calculating the expected return on plan assets. Under the selected method, the differences between investment returns during a given year and the expected investment returns were amortized on a straight line basis over four years.

Under IFRS, the expected return on plan assets is based on market expectations at the beginning of the period for returns over the entire life of the related obligation.

The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

IFRIC 14 "IAS 19 – The Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction" ("IFRIC 14") addresses the application of paragraph 58 of IAS 19 which limits the measurement of a defined benefit asset to "the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan" plus past service cost.

IFRIC 14 provides guidance regarding (a) when refunds or reductions in future contributions should be regarded as available in accordance with paragraph 58 of IAS 19, (b) how a minimum funding requirement might affect the availability of reductions in future contributions and (c) when a minimum funding requirement might give rise to a liability. The Corporation has determined that it must record an additional liability associated with the minimum funding requirements in its registered pension plans. The additional liability is computed by discounting the minimum funding requirements from the actuarial funding valuations by the discount rate as defined by IAS 19.

There is Canadian GAAP guidance related to the limit on the carrying amount of an accrued benefit asset and recognition of a related valuation allowance. However, IFRS and Canadian GAAP have different methods of calculating the defined benefit asset limit. Furthermore, Canadian GAAP did not address accounting for an additional liability due to minimum funding requirements.

Impact

The impact arising from the change is summarized as follows:

- Consolidated Statement of Financial Position
  - At January 1, 2010, this adjustment increased Pension and other benefit liabilities by $2,777 with a corresponding charge to the Deficit.

	Pension Benefits	Other Employee Future Benefits	Total
Net benefit obligation – Canadian GAAP	$ 120	$ 1,109	$ 1,229
Recognize all cumulative actuarial gains and losses on transition	1,098	(258)	840
Additional minimum funding liability under IFRIC 14	1,937	–	1,937
Net benefit obligation – IFRS	**$ 3,155**	**$ 851**	**$ 4,006**
Current portion	–	(66)	(66)
Pension and other benefit liabilities – long-term	**$ 3,155**	**$ 785**	**$ 3,940**

- Consolidated Statement of Operations
  - Wages, salaries and benefits expense under Canadian GAAP for the year ended December 31, 2010 increased by $28.
  - Net financing expense on employee benefits related to the expected return on plan assets and interest arising on defined benefit obligations of $75 for the year ended December 31, 2010 has been recognized under IFRS.
- Consolidated Statement of Comprehensive Income (Loss)
  - Net gains of $580 for the year ended December 31, 2010 have been recognized in Other comprehensive income under IFRS.

iii) Property and Equipment

Optional exemption applied

The Corporation has elected to measure owned and finance leased aircraft and engines at January 1, 2010 at fair value and use that fair value as deemed cost at that date. The aggregate deemed cost of aircraft and engines based on fair value as recorded on transition at January 1, 2010 amounted to $5,023, which included a decrease to carrying amounts as reported under previous Canadian GAAP of $301 as described below.

Accounting policy differences

Under Canadian GAAP, maintenance and repair costs for both leased and owned aircraft, including line maintenance, component maintenance, and maintenance checks, are charged to Operating expenses as incurred, with the exception of maintenance and repair costs related to return conditions on operating leases, which are accrued over the term of the lease.

Under IFRS, major maintenance events on finance leased and owned airframes and major maintenance of finance leased and owned engines, including replacement spares and labour costs, are capitalized and amortized over the average expected life between major maintenance events. Major maintenance events typically consist of more complex inspections and servicing of the aircraft and engines. All other replacement spares and other costs relating to maintenance of fleet assets (including maintenance provided under power-by-the-hour contracts) are charged to operating expenses in the income statement on consumption or as incurred. Maintenance and repair costs related to return conditions on operating leases are accrued over the term of the lease.

Impact

The impact arising from the change is summarized as follows:

- Consolidated Statement of Financial Position
  - At January 1, 2010, Property and equipment decreased by $301, with a corresponding charge to the Deficit. This includes the impact of the fair value adjustment to aircraft and spare engines as at January 1, 2010 as described above, and the impact of componentizing the aircraft including capitalized engine and airframe maintenance events. The adjustment excludes the impact of the consolidation of special purpose entities ("SPEs") as described in section i) Principles of Consolidation.
- Consolidated Statement of Operations
  - Depreciation and amortization under Canadian GAAP for the year ended December 31, 2010 increased by $128, including the impact of the impairment charge as described below.
  - Under IFRS, impairment charges of $49 were recognized on A340-300 and 767-200 aircraft in 2010. Under Canadian GAAP in 2010, the Corporation had recorded an impairment charge of $7 in Loss on assets on its fleet of retired 767-200 aircraft which was reversed under IFRS.
  - Aircraft maintenance for the year ended December 31, 2010 decreased by $84.

iv) Leases

Accounting policy differences

Under Canadian GAAP, immediate gain recognition from the sale and leaseback of an asset does not occur unless the leaseback is classified as an operating lease and the seller-lessee retains the rights to use only a minor portion of the asset sold.

Under IFRS, immediate gain recognition from the sale and leaseback of an asset depends on whether or not the sale takes place at fair value, and whether the leaseback is classified as an operating lease or a finance lease.

Impact

The impact arising from the change is summarized as follows:

- Consolidated Statement of Financial Position
  - At January 1, 2010, this adjustment decreased Other long-term liabilities by $69 with a corresponding decrease to the Deficit resulting from the recognition of previously deferred gains on sale-leaseback transactions under IFRS.
- Consolidated Statement of Operations
  - Aircraft rent under Canadian GAAP has been increased by $7 for the year ended December 31, 2010.

v) Fresh start reporting

Accounting policy differences

Under IFRS, there are no explicit standards related to fresh start reporting or when an entity undertakes a financial reorganization.

Under Canadian GAAP, the Corporation applied fresh start reporting on September 30, 2004. As a result, all consolidated assets and liabilities of Air Canada were reported at fair values, except for deferred income taxes. Goodwill is not recognized upon adoption of fresh start reporting. Under fresh start reporting, retained earnings and contributed surplus were reset to zero.

As outlined under IFRS 1 exemptions above, the majority of the Corporation's intangible assets under Canadian GAAP were carried in the balance sheet on the basis of valuations performed on September 30, 2004 following the application of fresh start reporting. In accordance with IFRS 1, the Corporation has elected to reverse the intangible assets that were established in accordance with Section 1625 of the CICA Handbook, Comprehensive Revaluation of Assets and Liabilities ("CICA 1625").

Under Canadian GAAP, the benefit of deferred income taxes that existed at fresh start, and for which a valuation allowance was recorded, were recognized first to reduce to nil any remaining intangible assets that were recorded upon fresh start reporting. The benefit of deferred income tax assets that arose after fresh start was recognized in the Consolidated Statement of Operations.

Under IFRS, the subsequent realization of unrecorded deferred income tax assets are recognized in the income statement and other comprehensive income providing dollar-for-dollar offset to any income tax expense charged.

Impact

The impact arising from the change is summarized as follows:

- Consolidated Statement of Financial Position
  - At January 1, 2010, Goodwill, which was reported by Air Canada prior to the application of fresh start reporting under Canadian GAAP of $311, was reinstated with a corresponding decrease to the Deficit.
  - Adjustments to the Deficit and Contributed surplus related to the impact of fresh start reporting were reversed with a corresponding adjustment to Share capital. At January 1, 2010, Share capital increased by $312, Contributed surplus decreased by $1,772 and the Deficit decreased by $1,460.
  - At January 1, 2010, Intangible assets decreased by $587 with the corresponding charge to the Deficit, representing the derecognition of Canadian GAAP intangible assets that were established in accordance with fresh start reporting. The associated deferred income tax liability on the intangibles with indefinite lives decreased by $40, with a corresponding charge to the Deficit. The deferred income tax liability of $48 as at December 31, 2010 is recorded within Other long-term liabilities.
- Consolidated Statement of Operations
  - Depreciation and amortization under Canadian GAAP have been decreased by $6 for the year ended December 31, 2010.

vi) Provisions and contingent liabilities (including Asset Retirement Provisions)

Provisions

Accounting policy differences

IFRS requires a provision to be recognized when: there is a present obligation as a result of a past transaction or event; it is probable that an outflow of resources will be required to settle the obligation; and a reliable estimate can be made of the obligation. "Probable" in this context means more likely than not. Under IFRS, there are a number of different estimation techniques to arrive at the best estimate, including the single most likely outcome, the weighted average of all possible outcomes or the midpoint where there is a range of equally possible outcomes.

Under Canadian GAAP, the criterion for recognition of a provision in the financial statements is "likely", which is a higher threshold than "probable". Where there is a range of equally possible outcomes, the provision is recorded at the low point of the range.

Asset Retirement Provisions

Accounting policy differences

Measurement of Asset Retirement Provisions under IFRS is based on the best estimate of the expenditure required to settle the present obligation at each reporting period discounted to present value using a discount rate specific to the liability.

Measurement of an Asset Retirement Obligation under Canadian GAAP is based on the fair value of the obligation (which takes market assumptions into account). Cash flow estimates are discounted to present value using a credit risk adjusted discount rate.

Lease return conditions

Maintenance costs for lease return conditions are recorded only for short term operating leases under the Corporation's accounting policies under Canadian GAAP.

Under IFRS, a provision will be recorded over the term of the lease for the end of lease maintenance return condition obligations within the Corporation's operating leases, offset by a prepaid maintenance asset to the extent of any related power by the hour maintenance service agreements or any recoveries under aircraft subleasing arrangements.

The provision is recorded using a discount rate specific to the liability. Interest accretion on the provision is recorded in other non-operating expense. For aircraft under operating leases which are subleased to third parties, the provision expense on the income statement is recorded net of the recovery under the sublease, as applicable.

Maintenance expense will include the accrual for maintenance provisions associated with lease return conditions, while other non-operating expense will include the accretion of the obligation over the life of the lease. Actual maintenance costs related to the end of lease return conditions will be charged against the provision. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period.

Impact

The impact arising from the change is summarized as follows:

- Consolidated Statement of Financial Position
  - At January 1, 2010, Property & Equipment increased by $7, Other long-term liabilities increased by $12 and the Deficit was increased by $5 relating to asset retirement provisions associated with the various property leases and the fuel facilities arrangements.
  - At January 1, 2010, Deposits and other assets increased by $77 relating to prepayments under power by the hour arrangements, Other long-term liabilities increased by $447 relating to provisions for lease return conditions and the deficit is increased by $370.

- Consolidated Statement of Operations
  - Aircraft maintenance for the year ended December 31, 2010 increased by $56.
  - Other non-operating expense relating to finance charges on provisions for the year ended December 31, 2010 increased by $11.
  - Foreign exchange gain under Canadian GAAP for the year ended December 31, 2010 increased by $21.

vii) Long-term Debt

Accounting policy differences on presentation

In August 2010, the Corporation concluded a credit agreement for a secured term loan facility (the "Facility") to refinance amounts related to 16 aircraft. Under Canadian GAAP, as a result of the Facility, the amounts due under the existing debt maturities within the next 12 months that would be refinanced by the commitment on a long-term basis, amounting to $106, had been classified as long-term at December 31, 2010. Under IFRS, the existing debt maturities refinanced by the Facility cannot be reclassified to long-term debt and are included in the current portion of long-term debt as at December 31, 2010.

OFFICERS

David I. Richardson	Chairman of the Board
Calin Rovinescu	President and Chief Executive Officer
Duncan Dee	Executive Vice President and Chief Operating Officer
Michael Rousseau	Executive Vice President and Chief Financial Officer
Benjamin M. Smith	Executive Vice President and Chief Commercial Officer
Lise Fournel	Senior Vice President, E-Commerce and Chief Information Officer
Kevin C. Howlett	Senior Vice President, Employee Relations
David Legge	Senior Vice President, Operations
Susan Welscheid	Senior Vice President, Customer Service
Alan D. Butterfield	Vice President, Air Canada Maintenance and Engineering
Nick Careen	Vice President, Airports
Yves Dufresne	Vice President, Alliances, International Operations and Regulatory Affairs
Marcel Forget	Vice President, Network Planning
Zeina Gedeon	President and Chief Executive Officer, Air Canada Vacations
Lucie Guillemette	Vice President, Revenue Management
Carolyn M. Hadrovic	Corporate Secretary
Chris Isford	Vice President and Controller
Amos Kazzaz	Vice President, Financial Planning and Analysis
Craig Landry	Vice President, Marketing
Priscille LeBlanc	Vice President, Corporate Communications
Scott Morey	Vice President, Labour Relations
Claude Morin	Vice President, Global Sales
David J. Shapiro	Vice President and General Counsel
Lise-Marie Turpin	Vice President, Cargo

DIRECTORS

David I. Richardson	Corporate Director and Chairman of the Board, Air Canada, Grafton, Ontario
Bernard Attali	Senior Advisor, TPG Capital, Paris, France
Michael M. Green	Chief Executive Officer and Managing Director, Tenex Capital Management, Radnor, Pennsylvania
Jean Marc Huot	Partner, Stikeman Elliott LLP, Montreal, Quebec
Pierre Marc Johnson	Counsel, Heenan Blaikie LLP, Montreal, Quebec
Joseph B. Leonard	Corporate Director, Minneapolis, Minnesota
Arthur T. Porter	Corporate Director, Montreal, Quebec
Roy J. Romanow	Senior Fellow, Public Policy, University of Saskatchewan, Saskatoon, Saskatchewan
Calin Rovinescu	President and Chief Executive Officer, Air Canada, Montreal, Quebec
Vagn Sørensen	Corporate Director, Holte, Denmark

Investor and Shareholder Information

Price Range and Trading Volume of Air Canada Variable Voting Shares (AC.A)

2011	High	Low	Volume Traded
1st Quarter	$ 3.72	$ 2.39	27,831,175
2nd Quarter	$ 2.54	$ 1.75	5,600,102
3rd Quarter	$ 2.42	$ 1.27	3,755,635
4th Quarter	$ 1.65	$ 0.96	6,757,511
			43,944,423

Price Range and Trading Volume of Air Canada Voting Shares (AC.B)

2011	High	Low	Volume Traded
1st Quarter	$ 3.72	$ 2.39	195,207,302
2nd Quarter	$ 2.50	$ 1.74	85,389,909
3rd Quarter	$ 2.43	$ 1.26	51,551,120
4th Quarter	$ 1.47	$ 0.96	53,031,833
			385,180,164

Price Range and Trading Volume of Air Canada Warrants (AC.WT)

2011	High	Low	Volume Traded
1st Quarter	$ 1.51	$ 0.60	18,370,336
2nd Quarter	$ 0.68	$ 0.27	13,646,811
3rd Quarter	$ 0.53	$ 0.16	12,230,649
4th Quarter	$ 0.245	$ 0.035	16,534,059
			60,781,855

Restrictions on Voting Securities

Currently, the *Air Canada Public Participation Act* (ACPPA) limits ownership of Air Canada's voting interests by non-residents of Canada to a maximum of 25%. The *Canada Transportation Act* (CTA) also requires that Canadians own and control at least 75% of the voting interests of licensed Canadian carriers. Accordingly, Air Canada's articles contain restrictions to ensure that it remains "Canadian" as defined under the CTA. The restrictions provide that non-Canadians can only hold variable voting shares of Air Canada, that such variable voting shares will not carry more than 25% (or any higher percentage that the Governor in Council may by regulation specify) of the aggregate votes attached to all issued and outstanding voting shares and that the total number of votes cast by the holders of such variable voting shares at any meeting of shareholders will not exceed 25% (or any such higher percentage) of the votes that may be cast at such meeting.

The Government of Canada's Bill C-10, the *Budget Implementation Act 2009*, contains provisions whereby the restrictions on voting securities in the ACPPA would be repealed and the CTA would be amended to provide the Governor in Council with flexibility to increase the foreign ownership limit from the existing 25% level to a maximum of 49%. These provisions will come into force on a date to be fixed by order of the Governor in Council made on the recommendation of the Minister of Finance, in the case of the ACPPA, and on the recommendation of the Minister of Transport, in the case of the CTA.

For Further Information

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Air Canada complies with the guidelines adopted by the Toronto Stock Exchange.

Transfer Agent and Registrar
Canadian Stock Transfer Company Inc.
as administrative agent for
CIBC Mellon Trust Company
Telephone: 1-800-387-0825

Duplicate Communication
Shareholders receiving more than one copy are requested to call 1-800-387-0825 or write to the Transfer Agent and Registrar at the following address:
2001 University Street, Suite 1600,
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Ce rapport annuel est publié dans les deux langues officielles du Canada. Pour en recevoir un exemplaire en français, veuillez communiquer avec les Relations avec les actionnaires.

Designed and produced in-house by the
Air Canada Multimedia Centre
Printing: RR Donnelley

ENGLISH OR FRENCH, IT'S THE CLIENT'S CHOICE

Official Languages at Air Canada

For Air Canada, offering service in the language chosen by its customers is essential. Verbal exchanges with clients, public-address announcements at the airport and on board as well as briefing of passengers with special needs all constitute the very heart of customer service and call upon our employees linguistic skills at all times. Our consideration to bilingualism not only makes good sense customer-wise, but also supports our legal obligations to serve the public in the two official languages of Canada.

Air Canada puts great efforts to better serve clients in the language of their choice. It is through reach-out activities with the minority language communities as well as ongoing employee awareness and training that we can face the daily challenges, whether it is the growing difficulty to recruit bilingual candidates outside the province of Quebec and the national capital region, or for our employees to maintain their language skills with very little opportunities to practice the acquired language in some regions of the country.

Corporate Profile

Air Canada is Canada's largest domestic, U.S. transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada.

In 2011, Air Canada, together with its regional airline partners, operating flights on behalf of and under commercial agreements with Air Canada, operated, on average, 1,506 daily scheduled flights to 60 destinations in Canada, 57 destinations in the U.S. and 63 destinations in the Canada-Europe, Canada-Pacific, Canada-Caribbean/Central America and Canada-South America markets. In addition, Air Canada provides certain sports and corporate charter services under the brand name "AC Jetz". In 2011, Air Canada carried almost 34 million passengers and provided passenger service to 180 direct destinations on five continents.

Air Canada is a founding member of the Star Alliance™ network. Through the 28 member airlines included in the Star Alliance network, Air Canada is able to offer its customers access to approximately 1,290 destinations in 189 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Air Canada also generates revenue from its Air Canada Cargo division and from tour operator services provided by its wholly-owned subsidiary, Touram Limited Partnership (doing business as "Air Canada Vacations").

In 2011, Air Canada was ranked Best International Airline in North America in a worldwide survey of more than 18 million airline passengers conducted by independent research firm Skytrax. Also in 2011, readers of *Global Traveler* magazine voted Air Canada "Best Airline in North America," and readers of *Business Traveler* voted Air Canada "Best North American Airline for International Travel" and "Best In-Flight Services in North America."

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