

AIR CANADA 

Second Quarter 2014

INTERIM UNAUDITED

Condensed Consolidated
Financial Statements and
Notes

August 7, 2014



CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Unaudited (Canadian dollars in millions)	June 30, 2014	December 31, 2013
ASSETS		
Current		
Cash and cash equivalents	\$ 861	\$ 750
Short-term investments	1,754	1,458
Total cash, cash equivalents and short-term investments	2,615	2,208
Restricted cash	47	92
Accounts receivable	761	589
Aircraft fuel inventory	67	71
Spare parts and supplies inventory	83	65
Prepaid expenses and other current assets	246	263
Total current assets	3,819	3,288
Property and equipment	5,584	5,073
Intangible assets	303	304
Goodwill	311	311
Deposits and other assets	505	494
Total assets	\$ 10,522	\$ 9,470
LIABILITIES		
Current		
Accounts payable and accrued liabilities	\$ 1,353	\$ 1,129
Advance ticket sales	2,283	1,687
Current portion of long-term debt and finance leases	409	374
Total current liabilities	4,045	3,190
Long-term debt and finance leases	4,324	3,959
Pension and other benefit liabilities	2,944	2,687
Maintenance provisions	689	656
Other long-term liabilities	342	375
Total liabilities	\$ 12,344	\$ 10,867
EQUITY		
Shareholders' equity		
Share capital	834	827
Contributed surplus	72	80
Deficit	(2,793)	(2,367)
Total shareholders' equity	(1,887)	(1,460)
Non-controlling interests	65	63
Total equity	(1,822)	(1,397)
Total liabilities and equity	\$ 10,522	\$ 9,470

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

CONSOLIDATED STATEMENT OF OPERATIONS

Unaudited (Canadian dollars in millions except per share figures)	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Operating revenues				
Passenger	\$ 2,965	\$ 2,757	\$ 5,573	\$ 5,284
Cargo	122	115	241	226
Other	218	185	556	499
Total revenues	3,305	3,057	6,370	6,009
Operating expenses				
Aircraft fuel	962	831	1,880	1,701
Wages, salaries and benefits	Note 4	548	565	1,117
Capacity purchase agreements	294	276	575	548
Airport and navigation fees	256	245	503	477
Aircraft maintenance	180	168	361	343
Sales and distribution costs	171	152	346	316
Depreciation, amortization and impairment	133	130	263	300
Ground package costs	77	59	247	209
Aircraft rent	78	81	157	162
Food, beverages and supplies	77	72	147	138
Communications and information technology	49	47	102	96
Other	235	257	489	522
Total operating expenses	3,060	2,883	6,187	5,941
Operating income	245	174	183	68
Non-operating income (expense)				
Foreign exchange gain (loss)	40	(74)	(121)	(114)
Interest income	9	8	18	15
Interest expense	(81)	(77)	(158)	(150)
Interest capitalized	10	13	15	21
Net financing expense relating to employee benefits	Note 4	(34)	(52)	(68)
Fuel and other derivatives	Note 7	36	(13)	(15)
Other	(2)	(2)	(8)	(4)
Total non-operating expense	(22)	(197)	(301)	(351)
Income (loss) before income taxes	223	(23)	(118)	(283)
Income taxes	-	-	-	-
Net income (loss) for the period	\$ 223	\$ (23)	\$ (118)	\$ (283)
Net income (loss) attributable to:				
Shareholders of Air Canada	222	(24)	(120)	(285)
Non-controlling interests	1	1	2	2
Net income (loss) for the period	\$ 223	\$ (23)	\$ (118)	\$ (283)
Net income (loss) per share attributable to shareholders of Air Canada	Note 5			
Basic earnings (loss) per share	\$ 0.77	\$ (0.09)	\$ (0.42)	\$ (1.04)
Diluted earnings (loss) per share	\$ 0.75	\$ (0.09)	\$ (0.42)	\$ (1.04)

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

Unaudited (Canadian dollars in millions)	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Comprehensive income (loss)				
Net income (loss) for the period	\$ 223	\$ (23)	\$ (118)	\$ (283)
Other comprehensive income, net of taxes of nil:				
Items that will not be reclassified to net income				
Remeasurements on employee benefit liabilities	Note 4 (90)	31	(293)	147
Total comprehensive income (loss)	\$ 133	\$ 8	\$ (411)	\$ (136)
Comprehensive income (loss) attributable to:				
Shareholders of Air Canada	\$ 132	\$ 7	\$ (413)	\$ (138)
Non-controlling interests	1	1	2	2
	\$ 133	\$ 8	\$ (411)	\$ (136)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

Unaudited (Canadian dollars in millions)	Share capital	Contributed surplus	Deficit	Total shareholders' equity	Non-controlling interests	Total equity
January 1, 2013	\$ 813	\$ 62	\$ (4,281)	\$ (3,406)	\$ 59	\$ (3,347)
Net income (loss)	–	–	(285)	(285)	2	(283)
Remeasurements on employee benefit liabilities	–	–	147	147	–	147
Total comprehensive income (loss)	–	–	(138)	(138)	2	(136)
Share-based compensation	–	13	–	13	–	13
June 30, 2013	\$ 813	\$ 75	\$ (4,419)	\$ (3,531)	\$ 61	\$ (3,470)
January 1, 2014	\$ 827	\$ 80	\$ (2,367)	\$ (1,460)	\$ 63	\$ (1,397)
Net income (loss)	–	–	(120)	(120)	2	(118)
Remeasurements on employee benefit liabilities	–	–	(293)	(293)	–	(293)
Total comprehensive income (loss)	–	–	(413)	(413)	2	(411)
Share-based compensation	–	(4)	(13)	(17)	–	(17)
Shares issued	1	–	–	1	–	1
Shares vested for employee recognition award	6	(4)	–	2	–	2
June 30, 2014	\$ 834	\$ 72	\$ (2,793)	\$ (1,887)	\$ 65	\$ (1,822)

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

CONSOLIDATED STATEMENT OF CASH FLOW

Unaudited (Canadian dollars in millions)	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Cash flows from (used for)				
Operating				
Net income (loss) for the period	\$ 223	\$ (23)	\$ (118)	\$ (283)
Adjustments to reconcile to net cash from operations				
Depreciation, amortization and impairment	133	130	263	300
Foreign exchange loss (gain)	(46)	106	128	159
Employee benefit funding (greater) less than expense	Note 4 (23)	4	(36)	17
Fuel and other derivatives	Note 7 (30)	(3)	(16)	(12)
Discontinued operations - Aveos	-	(5)	-	(27)
Change in maintenance provisions	21	11	32	25
Changes in non-cash working capital balances	141	187	508	487
Other	(33)	4	(31)	6
Net cash flows from operating activities	386	411	730	672
Financing				
Proceeds from borrowings	626	149	784	162
Reduction of long-term debt and finance lease obligations	(348)	(219)	(390)	(315)
Other	-	(15)	-	(15)
Net cash flows from (used in) financing activities	278	(85)	394	(168)
Investing				
Short-term investments	(264)	(95)	(294)	(78)
Additions to property, equipment and intangible assets	(422)	(264)	(732)	(378)
Proceeds from sale of assets	1	4	3	8
Other	7	(30)	10	(20)
Net cash flows used in investing activities	(678)	(385)	(1,013)	(468)
Increase (decrease) in cash and cash equivalents	(14)	(59)	111	36
Cash and cash equivalents, beginning of period	875	849	750	754
Cash and cash equivalents, end of period	\$ 861	\$ 790	\$ 861	\$ 790
Cash payments of interest	\$ 97	\$ 35	\$ 139	\$ 127
Cash payments of income taxes	\$ -	\$ -	\$ -	\$ -

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

NOTES TO THE INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(CANADIAN DOLLARS IN MILLIONS – EXCEPT PER SHARE AMOUNTS)**1. GENERAL INFORMATION**

The accompanying unaudited interim condensed consolidated financial statements (the “financial statements”) are of Air Canada (the “Corporation”). The term “Corporation” also refers to, as the context may require, Air Canada and/or one or more of its subsidiaries, including its principal wholly-owned operating subsidiaries, Touram Limited Partnership (“Air Canada Vacations”) and Air Canada *rouge* LP doing business under the brand name Air Canada *rouge*TM (“Air Canada *rouge*”). These financial statements also include certain aircraft leasing entities, which are consolidated under IFRS 10 Consolidated Financial Statements.

Air Canada is incorporated and domiciled in Canada. The address of its registered office is 7373 Côte-Vertu Boulevard West, Saint-Laurent, Quebec.

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

2. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Corporation prepares its financial statements in accordance with generally accepted accounting principles in Canada ("GAAP") as set out in the CPA Canada Handbook – Accounting ("CPA Handbook") which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). These financial statements have been prepared in accordance with IFRS applicable to the preparation of interim financial statements, including IAS 34 "Interim Financial Reporting". In accordance with GAAP, these financial statements do not include all of the financial statement disclosures required for annual financial statements and should be read in conjunction with the Corporation's annual consolidated financial statements for the year ended December 31, 2013. In management's opinion, the financial statements reflect all adjustments that are necessary for a fair presentation of the results for the interim period presented.

These financial statements were approved for issue by the Board of Directors of the Corporation on August 6, 2014.

These financial statements are based on the accounting policies consistent with those disclosed in Note 2 to the 2013 annual consolidated financial statements, except for a change in the policy described in Note 2T Property and equipment. Previously, cabin interior equipment and modifications were depreciated over the lesser of 5 years or the remaining useful life of the aircraft. Effective April 1, 2014, cabin interior equipment and modifications are depreciated over the lesser of 8 years or the remaining useful life of the aircraft. The adjustment to their useful lives was made prospectively as a change in accounting estimate and reflects product developments, and is in line with fleet strategy. The impact of this change in accounting estimate is a decrease of \$1 in depreciation expense in the second quarter of 2014.

Refer to Note 2 to the 2013 annual consolidated financial statements for information on new accounting standards and amendments not yet effective. The following is an overview of the accounting standard changes since those disclosed at that time.

IFRS 15 – Revenue from Contracts with Customers

IFRS 15 replaces IAS 18 Revenue and related interpretations. The core principle of the new standard is to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard is intended to enhance disclosures about revenue, provide more comprehensive guidance for transactions that were not previously addressed and improve guidance for multiple-element arrangements. IFRS 15 is effective for annual periods beginning on January 1, 2017, with early adoption permitted. The Corporation continues to evaluate the impact of this standard on its consolidated financial statements.

3. LONG-TERM DEBT AND FINANCE LEASES

	Final Maturity	Weighted Average Interest Rate (%)	June 30 2014	December 31 2013
Aircraft financing				
Fixed rate US dollar financing (a)	2015 – 2025	6.35	\$ 1,762	\$ 1,706
Floating rate US dollar financing (b)	2015 – 2026	1.73	762	609
Floating rate Japanese yen financing	2020	0.27	111	116
Senior secured notes – US dollar	2019 – 2020	7.61	747	745
Senior unsecured notes – US dollar (c)	2021	7.75	427	-
Senior secured notes – CDN dollar	2019	7.63	300	300
Other secured financing – US dollar (d)	2015 – 2019	5.60	404	467
Other secured financing – CDN dollar	2016	-	-	126
Long-term debt		5.84	4,513	4,069
Finance lease obligations	2015 – 2033	10.08	298	328
Total debt and finance leases		6.10	4,811	4,397
Unamortized debt issuance costs			(78)	(64)
Current portion			(409)	(374)
Long-term debt and finance leases			\$ 4,324	\$ 3,959

The above table provides terms of instruments disclosed in Note 8 to the 2013 annual consolidated financial statements of the Corporation as well as terms of instruments concluded during the six months ended June 30, 2014 described below.

(a) Financing associated with one Boeing 777 aircraft was drawn during the first quarter of 2014 upon delivery of the aircraft, representing the final draw on proceeds under the private offering of enhanced equipment trust certificates which was completed in 2013.

(b) Financing of US\$184 associated with the delivery of two Boeing 787 aircraft was completed in the second quarter of 2014. The financing is supported by a loan guarantee by the Export Import Bank of the United States ("EXIM"), with principal and interest repayable quarterly until maturity in 2026.

(c) In April 2014, the Corporation completed a private offering of US\$400 of 7.75% senior unsecured notes due 2021, with interest payable semi-annually. The Corporation received net proceeds of approximately \$432 from the sale to be used for general corporate purposes.

(d) In the first quarter of 2014, the maturity date of a term loan due 2015 was extended to January 2018. The carrying value of the debt as at June 30, 2014 was \$80 (US\$75).

Refer to Note 6 for the Corporation's principal and interest repayment requirements as at June 30, 2014.

4. PENSIONS AND OTHER BENEFIT LIABILITIES

Pension and Other Employee Future Benefit Expense

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

	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Consolidated Statement of Operations				
Operating expenses				
Wages, salaries and benefits				
Pension benefits	\$ 45	\$ 68	\$ 105	\$ 136
Other employee benefits	9	16	20	31
	\$ 54	\$ 84	\$ 125	\$ 167
Non-operating income (expense)				
Net financing expense relating to employee benefit liabilities				
Pension benefits	\$ (20)	\$ (38)	\$ (40)	\$ (77)
Other employee benefits	(14)	(14)	(28)	(27)
	\$ (34)	\$ (52)	\$ (68)	\$ (104)
Consolidated Other Comprehensive Income (Loss)				
Remeasurements on employee benefit liabilities				
Pension benefits	\$ (41)	\$ (55)	\$ (179)	\$ 69
Other employee benefits	(49)	86	(114)	78
	\$ (90)	\$ 31	\$ (293)	\$ 147

The funding of employee benefits as compared to the expense recorded in the consolidated statement of operations is summarized in the table below.

	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Net defined pension and other future employee benefits expense recorded in the consolidated statement of operations				
Wages, salaries and benefits	\$ 54	\$ 84	\$ 125	\$ 167
Net financing expense relating to employee benefit liabilities	34	52	68	104
	\$ 88	\$ 136	\$ 193	\$ 271
Employee benefit funding by Air Canada				
Pension benefits	\$ 99	\$ 118	\$ 206	\$ 231
Other employee benefits	12	14	23	23
	\$ 111	\$ 132	\$ 229	\$ 254
Employee benefit funding (greater) less than expense	\$ (23)	\$ 4	\$ (36)	\$ 17

The net benefit obligation of only those pension plans that are not fully funded is as follows:

	December 31, 2013
Domestic registered plans	\$ 574
US, UK, and Japan	63
Supplementary plans	798
	\$ 1,435

5. EARNINGS PER SHARE

The following table outlines the share amounts used in the calculation of basic and diluted earnings per share.

(in millions)	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Weighted-average number of shares outstanding – basic	286	275	286	275
Effect of potential dilutive securities:				
Stock options	7	3	7	3
Warrants	-	4	-	4
Shares held in Trust for employee share-based compensation award	-	1	-	1
Total potential dilutive securities	7	8	7	8
Exclude anti-dilutive impact	-	(8)	(7)	(8)
Adjusted denominator for diluted earnings per share	293	275	286	275

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. All of the remaining shares held in trust for the Employee Recognition Award vested in the first quarter of 2014.

Excluded from the calculation of diluted earnings per share were outstanding options and warrants where the exercise prices were greater than the average market price of the ordinary shares.

6. COMMITMENTS

Aircraft and Related Financing

The discussion and presentation related to Air Canada's aircraft and related financing and commitments are as at June 30, 2014 and do not account for the Corporation's third firm order Boeing 787 aircraft delivered in July 2014 and financed with support from EXIM covering 85% of the aircraft delivery and, therefore, such discussion and presentation are provided as if that third firm order Boeing 787 aircraft had not been delivered or financed.

As described in Note 16 to the 2013 annual consolidated financial statements, the Corporation has outstanding purchase commitments with The Boeing Company ("Boeing") for the acquisition of 37 Boeing 787 aircraft, with the first six deliveries scheduled for 2014, two of which were delivered in the second quarter. The last of five Boeing 777-300ER aircraft acquired by the Corporation was delivered in February 2014, and financed through proceeds from the private offering of enhanced equipment trust certificates as described in Note 3 Long-term Debt and Finance Leases.

On March 31, 2014, the Corporation concluded an agreement with Boeing for the purchase of Boeing 737 MAX aircraft. The agreement includes firm orders for 33 737 MAX 8 and 28 737 MAX 9 aircraft, with substitution rights between them as well as for the 737 MAX 7 aircraft. It also provides for options for 18 aircraft and certain rights to purchase an additional 30 aircraft. Deliveries are scheduled to begin in 2017 with two aircraft, and the remaining deliveries between 2018 and 2021, subject to certain deferral and acceleration rights.

The Corporation has financing commitments, subject to certain conditions, covering up to 61 of the Boeing 737 MAX firm aircraft orders. The financing terms are for 80% of the aircraft delivery price and the term to maturity is 10 years with mortgage-style repayments.

Subject to certain conditions, the Corporation also has financing commitments covering up to 29 of the remaining 35 Boeing 787 firm aircraft orders. This includes final commitments from EXIM, subject to documentation and other conditions, for three additional Boeing 787 aircraft scheduled for delivery in 2014, and preliminary commitments from EXIM for two other 787 aircraft.

The financing terms for the firm commitments (subject to conditions) for the remaining 24 of the 29 financing commitments for the Boeing 787 aircraft are as follows. For 22 of the 787 aircraft, the financing terms are for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments. For the other two of the 787 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 installment payments of principal and interest over the term to maturity.

Certain of the financing commitments for the Boeing 787 aircraft and/or the Boeing 737 MAX aircraft will be reduced based on allocations to be determined by the Corporation, although the specifics of the reduction have not yet been determined. Taking the estimated financing reduction into consideration, the total committed financing on these aircraft, including commitments from EXIM, will be at least \$4,400.

Capital Commitments

The estimated aggregate cost of the future firm Boeing 787 and Boeing 737 MAX aircraft deliveries and other capital purchase commitments as at June 30, 2014 approximates \$7,844. US dollar amounts are converted using the June 30, 2014 closing rate of CDN\$1.0670. 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 June 30, 2014.

	Remainder of 2014	2015	2016	2017	2018	Thereafter	Total
Capital commitments	\$ 561	\$ 957	\$ 1,305	\$ 1,621	\$ 1,376	\$ 2,024	\$ 7,844

Maturity Analysis

Principal and interest repayment requirements as at June 30, 2014 on Long-term debt and finance lease obligations are as follows.

Principal	Remainder of 2014	2015	2016	2017	2018	Thereafter	Total
Long-term debt obligations	\$ 155	\$ 377	\$ 341	\$ 453	\$ 436	\$ 2,751	\$ 4,513
Finance lease obligations	31	61	26	27	30	123	298
	\$ 186	\$ 438	\$ 367	\$ 480	\$ 466	\$ 2,874	\$ 4,811

Interest	Remainder of 2014	2015	2016	2017	2018	Thereafter	Total
Long-term debt obligations	\$ 126	\$ 240	\$ 221	\$ 226	\$ 178	\$ 280	\$ 1,271
Finance lease obligations	14	23	19	16	13	37	122
	\$ 140	\$ 263	\$ 240	\$ 242	\$ 191	\$ 317	\$ 1,393

7. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Refer to Note 17 to the 2013 annual consolidated financial statements for information on the Corporation's risk management strategy. The following is a summary of fuel and other derivatives included in non-operating income (expense) on the consolidated statement of operations for the periods indicated:

Summary of gain (loss) on Fuel and other derivatives

	Three Months Ended June 30		Six Months Ended June 30	
	2014	2013	2014	2013
Fuel derivatives	\$ 8	\$ (7)	\$ 6	\$ (18)
Share forward contracts	28	(5)	14	4
Interest rate swaps	-	(1)	1	(1)
Fuel and other derivatives	\$ 36	\$ (13)	\$ 21	\$ (15)

Fuel Price Risk Management

During the second quarter of 2014, the Corporation recorded a gain of \$8 in Fuel and other derivatives related to fuel derivatives (\$6 gain for the six months ended June 30, 2014; loss of \$7 and \$18, respectively, for the three and six months period ended June 30, 2013). During the second quarter of 2014, the Corporation purchased crude-oil and refined products-based call options covering a portion of 2014 fuel exposure. The cash premium related to these contracts was \$10 (\$20 for the six months ended June 30, 2014; \$16 and \$27, respectively, for the three and six months ended June 30, 2013). Fuel derivative contracts settled with a net fair value of \$11 in favour of the Corporation in the second quarter of 2014 (\$18 in favour of the Corporation for the six months ended June 30, 2014; nil and \$1, respectively, for the three and six months period ended June 30, 2013).

As of June 30, 2014, approximately 40% of the Corporation's anticipated purchases of jet fuel for the remainder of 2014 are hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US\$106 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2014 period are comprised of call options with notional volumes of 5,418,000 barrels. The fair value of the fuel derivatives portfolio at June 30, 2014 is \$28 in favour of the Corporation (December 31, 2013 – \$20 in favour of the Corporation) and is recorded within Prepaid expenses and other current assets.

Share Forward Contracts

In the second quarter of 2014, the Corporation recorded a gain of \$28 on share forward contracts which hedge share units granted under the Corporation's long-term incentive plan that may vest with settlement dates between 2015 and 2017, subject to the terms of vesting (gain of \$14 for the six months ended June 30, 2014). Share forward contracts cash settled with a fair value of \$7 in favour of the Corporation in the second quarter of 2014. As at June 30, 2014, the fair value of the share forward contracts was \$63 in favour of the Corporation (December 31, 2013 - \$56 in favour of the Corporation).

Foreign Exchange Risk Management

As at June 30, 2014, the Corporation had outstanding foreign currency options and swap agreements, settling in 2014 and 2015, to purchase at maturity \$3,001 of US dollars at a weighted average rate of \$1.0727 per US\$1.00. The Corporation also has protection in place to sell a portion of its excess Euros and Sterling against US dollars. The increase in level of foreign exchange derivatives outstanding at June 30, 2014 as compared to December 31, 2013 reflects the significant capital expenditure program for 2014 and an increase in target coverage from 50% to 60% of the net US dollar exposure on a rolling 18 month basis. As at June 30, 2014, based on the notional amount of currency derivatives outstanding at that time, approximately 89% of net US cash outflows were hedged for the remainder of 2014 and approximately 47% for 2015.

The weighted average foreign exchange rate of the derivative portfolio is unfavourable as compared to the closing exchange rate on June 30, 2014. In addition, the hedging structures put in place have various option pricing features, such as knock-out terms and multipliers, and based on the assumed volatility used in the fair value calculation, the fair value of these foreign currency contracts as at June 30, 2014 was \$112 in favour of the counterparties (December 31, 2013 – \$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 the second quarter of 2014, a loss of \$89 was recorded in Foreign exchange gain (loss) related to these derivatives (a loss of \$93 for the first six months of 2014; gain of \$21 and \$44, respectively, for the three and six months ended June 30, 2013). During the second quarter of 2014, foreign exchange derivative contracts cash settled with a net fair value of \$9 in favour of the Corporation (\$32 for the first six months of 2014; \$18 and \$30, respectively, for the three and six months ended June 30, 2013 in favour of the Corporation).

As a result of a weakening Canadian dollar and a lower notional value of derivatives outstanding, as at July 31, 2014, the fair value in favour of the counterparties was reduced to \$10.

The Corporation also holds US cash reserves as an economic hedge against changes in the value of the US dollar. US dollar cash and short-term investment balances as at June 30, 2014 amounted to \$967 (US\$905) (December 31, 2013 – \$791 (US\$743)). During the first six months of 2014, an unrealized loss of \$8 (unrealized gain of \$39 for the first six months of 2013) was recorded in Foreign exchange gain (loss) reflecting the change in Canadian equivalent market value of the US dollar cash and short-term investment balances held.

Sensitivity Analysis

The Corporation's foreign exchange rate risk related to Long-term debt has been impacted with the issuance of the senior unsecured notes (US\$400), additional aircraft related financings (US\$328) for two Boeing 787 aircraft and one Boeing 777 aircraft, and repayments of debt. In relation to the current debt balances at June 30, 2014, a 5% strengthening or weakening in rates of the Canadian dollar versus the U.S. dollar would result in a \$222 increase or decrease to pre-tax income, respectively. The sensitivity to total USD debt exposure is partially offset by US\$962 held in cash and cash equivalents, short-term investments and deposits and other assets for operational activities as at June 30, 2014 for which a 5% strengthening or weakening in rates of the Canadian dollar would impact pre-tax income by approximately \$51.

The majority of the new debt has fixed interest rates and as a result, there is no significant impact to interest rate risk sensitivity analysis as compared to amounts disclosed at December 31, 2013. Refer to Note 17 to the 2013 annual consolidated financial statements of the Corporation for further information regarding interest rate risk and foreign exchange risk.

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. Based on significant observable inputs (Level 2 in the fair value hierarchy), the estimated fair value of debt approximates its carrying value.

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. There are no changes in classifications or methods of measuring fair value from those disclosed in Note 17 to the 2013 annual consolidated financial statements. There were no transfers within the fair value hierarchy or change in the fair value of Level 3 assets during the six months ended June 30, 2014.

	June 30, 2014	Fair value measurements at reporting date using:		
		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	\$ 364	\$ –	\$ 364	\$ –
Short-term investments	1,754	–	1,754	–
Deposits and other assets				
Prepayment option on senior secured notes	2	–	–	2
Derivative instruments				
Fuel derivatives	28	–	28	–
Share forward contracts	63	–	63	–
Interest rate swaps	9	–	9	–
Total	2,220	–	2,218	2
Financial Liabilities				
Derivative instruments				
Foreign exchange derivatives	112	–	112	–
Total	\$ 112	\$ –	\$ 112	\$ –

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.