

## **Management Report**

The accompanying consolidated financial statements of Canadian National Railway Company and all information in this annual report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared by management in conformity with generally accepted accounting principles in Canada. These statements include some amounts that are based on best estimates and judgments. Financial information used elsewhere in the annual report is consistent with these financial statements.

Management of the Company, in furtherance of the integrity and objectivity of data in the financial statements, has developed and maintains a system of internal accounting controls and supports an extensive program of internal audits. Management believes that this system of internal accounting controls provides reasonable assurance that financial records are reliable and form a proper basis for preparation of financial statements, and that assets are properly accounted for and safeguarded.

The Board of Directors carries out its responsibility for the financial statements in this report principally through its Audit, Finance and Risk Committee, consisting solely of outside directors. The Audit, Finance and Risk Committee reviews the Company's consolidated financial statements and annual report and recommends their approval by the Board of Directors. Also, the Audit, Finance and Risk Committee meets regularly with the Chief, Internal Audit, and with the shareholders' auditors.

These consolidated financial statements have been audited by KPMG LLP, who have been appointed as the sole auditors of the Company by the shareholders.

*(s) Claude Mongeau*  
Executive Vice-President and Chief Financial Officer

January 25, 2005

*(s) Serge Pharand*  
Vice-President and Corporate Comptroller

January 25, 2005

## **Auditors' Report**

### **To the shareholders of Canadian National Railway Company**

We have audited the consolidated balance sheets of Canadian National Railway Company as at December 31, 2004 and 2003 and the consolidated statements of income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2004 and 2003, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2004, in accordance with Canadian generally accepted accounting principles.

On January 25, 2005, we reported separately to the Board of Directors of the Company on consolidated financial statements for the same period, prepared in accordance with United States generally accepted accounting principles.

*(s) KPMG LLP*  
Chartered Accountants

Montreal, Canada  
January 25, 2005

**Consolidated Statement of Income**

Canadian GAAP

<i>In millions, except per share data</i>	<i>Year ended December 31,</i>	<b>2004</b>	2003	2002
<b>Revenues</b>				
Petroleum and chemicals		\$ 1,123	\$ 1,058	\$ 1,102
Metals and minerals		713	527	521
Forest products		1,452	1,284	1,323
Coal		284	261	326
Grain and fertilizers		1,053	938	986
Intermodal		1,117	1,101	1,052
Automotive		510	525	591
Other items		296	190	209
<b>Total revenues</b>		<b>6,548</b>	5,884	6,110
<b>Operating expenses</b>				
Labor and fringe benefits		1,838	1,929	2,069
Purchased services and material		746	879	908
Depreciation and amortization		517	472	499
Fuel		528	471	459
Equipment rents		244	299	353
Casualty and other (Note 2)		445	466	724
<b>Total operating expenses</b>		<b>4,318</b>	4,516	5,012
<b>Operating income</b>		<b>2,230</b>	1,368	1,098
Interest expense (Note 14)		(282)	(317)	(353)
Other income (loss) (Note 15)		(20)	21	76
Income before income taxes		1,928	1,072	821
Income tax expense (Note 16)		(631)	(338)	(268)
<b>Net income</b>		<b>\$ 1,297</b>	\$ 734	\$ 553
<i>Basic earnings per share (Note 18)</i>		<b>\$ 4.55</b>	\$ 2.56	\$ 1.85
<i>Diluted earnings per share (Note 18)</i>		<b>\$ 4.48</b>	\$ 2.52	\$ 1.82

See accompanying notes to consolidated financial statements.

**Consolidated Balance Sheet**

Canadian GAAP

<i>In millions</i>	<i>December 31,</i>	<b>2004</b>	<b>2003</b>
<b>Assets</b>			
<b>Current assets:</b>			
Cash and cash equivalents	\$	<b>147</b>	\$ 130
Accounts receivable (Note 4)		<b>793</b>	529
Material and supplies		<b>127</b>	120
Deferred income taxes (Note 16)		<b>393</b>	125
Other		<b>194</b>	188
		<b>1,654</b>	1,092
Properties (Note 5)		<b>16,688</b>	15,158
Intangible and other assets (Note 6)		<b>929</b>	900
<b>Total assets</b>	<b>\$</b>	<b>19,271</b>	<b>\$ 17,150</b>
<b>Liabilities and shareholders' equity</b>			
<b>Current liabilities:</b>			
Accounts payable and accrued charges (Note 8)	\$	<b>1,605</b>	\$ 1,421
Current portion of long-term debt (Note 10)		<b>578</b>	483
Other		<b>76</b>	73
		<b>2,259</b>	1,977
Deferred income taxes (Note 16)		<b>3,591</b>	3,365
Other liabilities and deferred credits (Note 9)		<b>1,488</b>	1,153
Long-term debt (Note 10)		<b>4,586</b>	4,175
<b>Shareholders' equity:</b>			
Common shares (Note 11)		<b>3,587</b>	3,530
Contributed surplus		<b>164</b>	166
Currency translation		<b>(80)</b>	(38)
Retained earnings		<b>3,676</b>	2,822
		<b>7,347</b>	6,480
<b>Total liabilities and shareholders' equity</b>	<b>\$</b>	<b>19,271</b>	<b>\$ 17,150</b>

On behalf of the Board:

David G.A. McLean  
DirectorE. Hunter Harrison  
Director

See accompanying notes to consolidated financial statements.

## Consolidated Statement of Changes in Shareholders' Equity

Canadian GAAP

<i>In millions</i>	Issued and outstanding common shares	Issued and outstanding convertible preferred securities	Common shares	Convertible preferred securities	Contributed surplus	Currency translation	Retained earnings	Total shareholders' equity
<b>Balances December 31, 2001</b>	289.1	6.9	\$ 3,209	\$ 327	\$ 178	\$ 133	\$ 2,514	\$ 6,361
Net income	-	-	-	-	-	-	553	553
Stock options exercised (Notes 11, 12)	2.7	-	93	-	-	-	-	93
Conversion of convertible preferred securities (Note 11)	9.0	(6.9)	327	(327)	-	-	-	-
Share repurchase program (Note 11)	(4.5)	-	(53)	-	(3)	-	(147)	(203)
Currency translation	-	-	-	-	-	(1)	-	(1)
Dividends (\$0.57 per share)	-	-	-	-	-	-	(170)	(170)
Dividends on convertible preferred securities	-	-	-	-	-	-	(6)	(6)
<b>Balances December 31, 2002</b>	296.3	-	3,576	-	175	132	2,744	6,627
Net income	-	-	-	-	-	-	734	734
Stock options exercised and other (Notes 11, 12)	2.9	-	136	-	-	-	-	136
Share repurchase program (Note 11)	(15.0)	-	(182)	-	(9)	-	(465)	(656)
Currency translation	-	-	-	-	-	(170)	-	(170)
Dividends (\$0.67 per share)	-	-	-	-	-	-	(191)	(191)
<b>Balances December 31, 2003</b>	284.2	-	3,530	-	166	(38)	2,822	6,480
Net income	-	-	-	-	-	-	1,297	1,297
Stock options exercised and other (Notes 11, 12)	2.9	-	107	-	-	-	-	107
Share repurchase program (Note 11)	(4.0)	-	(50)	-	(2)	-	(221)	(273)
Currency translation	-	-	-	-	-	(42)	-	(42)
Dividends (\$0.78 per share)	-	-	-	-	-	-	(222)	(222)
<b>Balances December 31, 2004</b>	283.1	-	\$ 3,587	\$ -	\$ 164	\$ (80)	\$ 3,676	\$ 7,347

See accompanying notes to consolidated financial statements.

## Consolidated Statement of Cash Flows

Canadian GAAP

<i>In millions</i>	<i>Year ended December 31,</i>		
	<b>2004</b>	2003	2002
<b>Operating activities</b>			
Net income	\$ 1,297	\$ 734	\$ 553
Adjustments to reconcile net income to net cash provided from operating activities:			
Depreciation and amortization	521	478	506
Deferred income taxes (Note 16)	401	232	156
Equity in earnings of English Welsh and Scottish Railway (Note 15)	4	(17)	(33)
Charge to increase U.S. personal injury and other claims liability (Note 2)	-	-	281
Workforce reduction charge (Note 9)	-	-	120
Other changes in:			
Accounts receivable	(233)	153	(80)
Material and supplies	10	(3)	-
Accounts payable and accrued charges	5	(96)	(154)
Other net current assets and liabilities	21	(27)	(18)
Other	113	46	(158)
<b>Cash provided from operating activities</b>	<b>2,139</b>	1,500	1,173
<b>Investing activities</b>			
Net additions to properties	(1,072)	(583)	(571)
Acquisition of BC Rail (Note 3)	(984)	-	-
Acquisition of GLT (Note 3)	(547)	-	-
Other, net	192	(16)	95
<b>Cash used by investing activities</b>	<b>(2,411)</b>	(599)	(476)
Dividends paid	(222)	(191)	(179)
<b>Financing activities</b>			
Issuance of long-term debt	8,277	4,109	3,146
Reduction of long-term debt	(7,579)	(4,141)	(3,558)
Issuance of common shares (Note 11)	86	83	69
Repurchase of common shares (Note 11)	(273)	(656)	(203)
<b>Cash provided from (used by) financing activities</b>	<b>511</b>	(605)	(546)
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>17</b>	105	(28)
Cash and cash equivalents, beginning of year	130	25	53
<b>Cash and cash equivalents, end of year</b>	<b>\$ 147</b>	\$ 130	\$ 25
<b>Supplemental cash flow information</b>			
Net cash receipts from customers and other	\$ 6,501	\$ 6,022	\$ 6,285
Net cash payments for:			
Employee services, suppliers and other expenses	(3,628)	(3,736)	(4,231)
Interest (Note 14)	(282)	(327)	(390)
Workforce reductions (Note 9)	(93)	(155)	(177)
Personal injury and other claims (Note 19)	(106)	(126)	(156)
Pensions (Note 13)	(161)	(92)	(93)
Income taxes (Note 16)	(92)	(86)	(65)
<b>Cash provided from operating activities</b>	<b>\$ 2,139</b>	\$ 1,500	\$ 1,173

See accompanying notes to consolidated financial statements.

Canadian National Railway Company (CN or the Company), directly and through its subsidiaries, is engaged in the rail and related transportation business. CN spans Canada and mid-America, from the Atlantic and Pacific oceans to the Gulf of Mexico, serving the ports of Vancouver, Prince Rupert, B.C., Montreal, Halifax, New Orleans and Mobile, Alabama, and the key cities of Toronto, Buffalo, Chicago, Detroit, Duluth, Minnesota/Superior, Wisconsin, Green Bay, Wisconsin, Minneapolis/St. Paul, Memphis, St. Louis and Jackson, Mississippi, with connections to all points in North America. CN's revenues are derived from the movement of a diversified and balanced portfolio of goods, including petroleum and chemicals, grain and fertilizers, coal, metals and minerals, forest products, intermodal and automotive.

## 1 Summary of significant accounting policies

These consolidated financial statements are expressed in Canadian dollars, except where otherwise indicated, and have been prepared in accordance with accounting principles generally accepted in Canada (Canadian GAAP). Significant differences between the accounting principles applied in the accompanying financial statements and those under United States generally accepted accounting principles (U.S. GAAP) are quantified and explained in Note 21 to the financial statements. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses during the period, the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements. On an ongoing basis, management reviews its estimates, including those related to personal injury and other claims, environmental claims, depreciation, pensions and other post-retirement benefits, and income taxes, based upon currently available information. Actual results could differ from these estimates.

### A. Principles of consolidation

These consolidated financial statements include the accounts of all subsidiaries, including Great Lakes Transportation LLC's railroads and related holdings (GLT) and BC Rail for which the Company acquired control and consolidated effective May 10, 2004 and July 14, 2004, respectively. The Company's investments in which it has significant influence are accounted for using the equity method and all other investments are accounted for using the cost method.

### B. Revenues

Freight revenues are recognized on services performed by the Company, based on the percentage of completed service method. Costs associated with movements are recognized as the service is performed.

### C. Foreign exchange

All of the Company's United States (U.S.) operations are self-sustaining foreign entities with the U.S. dollar as their functional currency. The Company also has an equity investment in an international affiliate based in the United Kingdom with the British pound as its functional currency. Accordingly, the U.S. operations' assets and liabilities and the Company's foreign equity investment are translated into Canadian dollars at the rate in effect at the balance sheet date and the revenues

and expenses are translated at average exchange rates during the year. All adjustments resulting from the translation of the foreign operations are recorded in Currency translation, which forms part of Shareholders' equity.

The Company designates the U.S. dollar denominated long-term debt of the parent company as a foreign exchange hedge of its net investment in U.S. subsidiaries. Accordingly, unrealized foreign exchange gains and losses, from the dates of designation, on the translation of the U.S. dollar denominated long-term debt are also included in Currency translation.

### D. Cash and cash equivalents

Cash and cash equivalents include highly liquid investments purchased three months or less from maturity and are stated at cost, which approximates market value.

### E. Accounts receivable

Accounts receivable are recorded at cost net of the provision for doubtful accounts that is based on expected collectibility. Any gains or losses on the sale of accounts receivable are calculated by comparing the carrying amount of the accounts receivable sold to the total of the cash proceeds on sale and the fair value of the retained interest in such receivables on the date of transfer. Fair values are determined on a discounted cash flow basis. Costs related to the sale of accounts receivable are recognized in earnings in the period incurred.

### F. Material and supplies

Inventory is valued at weighted-average cost for ties, rails, fuel and new materials in stores, and at estimated utility or sales value for usable secondhand, obsolete and scrap materials.

### G. Properties

Railroad properties are carried at cost less accumulated depreciation including asset impairment write-downs. Labor, materials and other costs associated with the installation of rail, ties, ballast and other track improvements are capitalized to the extent they meet the Company's minimum threshold for capitalization. Included in property additions are the costs of developing computer software for internal use. Maintenance costs are expensed as incurred.

## 1 Summary of significant accounting policies (continued)

The cost of railroad properties, less net salvage value, retired or disposed of in the normal course of business is charged to accumulated depreciation, in accordance with the group method of depreciation. The Company reviews the carrying amounts of properties held and used whenever events or changes in circumstances indicate that such carrying amounts may not be recoverable based on future undiscounted cash flows. Assets that are deemed impaired as a result of such review are recorded at the lower of carrying amount or fair value.

Assets held for sale are measured at the lower of their carrying amount or fair value, less cost to sell. Losses resulting from significant line sales are recognized in income when the asset meets the criteria for classification as held for sale whereas losses resulting from abandonment are recognized in income when the asset ceases to be used. Gains are recognized in income when they are realized.

### H. Depreciation

The cost of properties, including those under capital leases, net of asset impairment write-downs, is depreciated on a straight-line basis over their estimated useful lives as follows:

Asset class	Annual rate
Track and roadway .....	2%
Rolling stock .....	3%
Buildings.....	6%
Other .....	4%

The Company follows the group method of depreciation for railroad properties and, as such, conducts comprehensive depreciation studies on a periodic basis to assess the reasonableness of the lives of properties based upon current information and historical activities. Changes in estimated useful lives are accounted for prospectively.

### I. Intangible assets

Intangible assets relate to customer contracts and relationships assumed through recent acquisitions and are being amortized on a straight-line basis over 40 to 50 years.

### J. Pensions

Pension costs are determined using actuarial methods. Net periodic benefit cost is charged to income and includes:

- (i) the cost of pension benefits provided in exchange for employees' services rendered during the year,
- (ii) the interest cost of pension obligations,
- (iii) the amortization of the initial net transition obligation on a straight-line basis over the expected average remaining service life of the employee group covered by the plans,

- (iv) the amortization of prior service costs and amendments over the expected average remaining service life of the employee group covered by the plans,
- (v) the expected long-term return on pension fund assets, and
- (vi) the amortization of cumulative unrecognized net actuarial gains and losses in excess of 10% of, the greater of the beginning of year balances of the projected benefit obligation or market-related value of plan assets, over the expected average remaining service life of the employee group covered by the plans.

The pension plans are funded through contributions determined in accordance with the projected unit credit actuarial cost method.

### K. Post-retirement benefits other than pensions

The Company accrues the cost of post-retirement benefits other than pensions using actuarial methods. These benefits, which are funded by the Company as they become due, include life insurance programs, medical benefits, and free rail travel benefits.

The Company amortizes the cumulative unrecognized net actuarial gains and losses in excess of 10% of the projected benefit obligation at the beginning of the year, over the expected average remaining service life of the employee group covered by the plans.

### L. Personal injury claims

In Canada, the Company accounts for costs related to employee work-related injuries based on actuarially developed estimates of the ultimate cost associated with such injuries, including compensation, health care and administration costs.

In the U.S., the Company accrues the expected cost for personal injury claims and asserted occupational disease claims, based on actuarial estimates of their ultimate cost. A liability for the minimum amount of unasserted occupational disease claims is also accrued to the extent they can be reasonably estimated.

### M. Environmental expenditures

Environmental expenditures that relate to current operations are expensed unless they relate to an improvement to the property. Expenditures that relate to an existing condition caused by past operations and which are not expected to contribute to current or future operations are expensed. Liabilities are recorded when environmental assessments and/or remedial efforts are likely, and when the costs, based on a specific plan of action in terms of the technology to be used and the extent of the corrective action required, can be reasonably estimated.

## 1 Summary of significant accounting policies (continued)

### N. Income taxes

The Company follows the asset and liability method of accounting for income taxes. Under the asset and liability method, the change in the net deferred tax asset or liability is included in the computation of net income. Deferred tax assets and liabilities are measured using substantively enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled.

### O. Derivative financial instruments

The Company uses derivative financial instruments in the management of its fuel exposure, and may use them from time to time, in the management of its interest rate and foreign currency exposures. Gains or losses on such instruments entered into for the purpose of hedging financial risk exposures are deferred and amortized in the results of operations over the life of the hedged asset or liability or over the term of the derivative financial instrument. Income and expense related to hedged derivative financial instruments are recorded in the same category as that generated by the underlying asset or liability.

### P. Stock-based compensation

The Company follows the fair value based approach for stock option awards and retroactively applied this method of accounting to all awards of employee stock options granted, modified or settled on or after January 1, 2002 and restated the 2002 comparative period to reflect this change in accounting policy, as explained in Note 2 – Accounting changes. For awards of conventional and performance-based employee stock options granted before January 1, 2002, the Company did not record compensation cost, and any consideration paid by employees on the exercise of stock options was recorded as share capital.

## 2 Accounting changes

### 2004

#### Property capitalization

Effective January 1, 2004, the Company changed its capitalization policies under Canadian GAAP, on a prospective basis, to conform with the Canadian Institute of Chartered Accountants (CICA) Handbook Section 3061, "Properties, Plant and Equipment." The change was made in response to the CICA Handbook Section 1100, "Generally Accepted Accounting Principles," issued in July 2003. This section provides new accounting guidance as to what constitutes GAAP in Canada and its sources, thereby codifying a GAAP hierarchy. The section also establishes that when financial statements are prepared in accordance with regulatory or legislative requirements that are in conflict with the new GAAP hierarchy, they cannot be described as being in accordance with Canadian GAAP.

The Company's accounting for Properties under Canadian GAAP had been based on the rules and regulations of the Canadian Transportation Agency's (CTA) Uniform Classification of Accounts, which for railways in Canada, were considered Canadian GAAP prior to the issuance of Section 1100. Under the CTA rules, the Company capitalized only the material component of track replacement costs, to the extent it met the Company's minimum threshold for capitalization. In accordance with the CICA Handbook Section 3061, "Properties, Plant and Equipment," the Company now capitalizes the cost of labor, material and related overhead associated with track replacement activities provided they meet the Company's minimum threshold for capitalization. Also, all major expenditures for work that extends the useful life and/or improves the functionality of bridges, other structures and freight cars, are capitalized.

For the year ended December 31, 2004, net income increased by \$312 million (\$464 million before tax), as a result of the change in the capitalization policy.

### 2003

#### Stock-based compensation

Effective January 1, 2003, the Company adopted the fair value based approach recommended by CICA Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments." The Company retroactively applied this method of accounting to all awards of employee stock options granted, modified or settled on or after January 1, 2002 and restated the 2002 comparative period to reflect this change in accounting policy. For the year ended December 31, 2002, the restatement had the effect of decreasing net income by \$18 million (\$0.06 per basic and diluted share), through increased labor and fringe benefits expense. The restatement also had the effect of increasing the book value of common shares and decreasing retained earnings by \$18 million at December 31, 2002.

In 2002, prior to the adoption of the fair value based approach, the Company had applied the intrinsic value method of accounting to its awards of conventional and performance-based employee stock options granted on or after January 1, 2002 and as a result, no compensation cost had been recognized for the year ended December 31, 2002 as no performance-based employee stock options were granted. For awards of conventional and performance-based employee stock options granted before January 1, 2002, the Company did not record compensation cost, and any consideration paid by employees on the exercise of stock options was recorded as share capital.

The Company granted 3.0 million and 4.8 million stock options during 2003 and 2002, respectively, which will be expensed over their vesting period based on their estimated fair values on the date of grant, determined using the Black-Scholes option-pricing model. For the years ended December 31, 2003 and 2002, the Company recognized compensation cost of \$50 million and \$18 million, respectively.

## 2 Accounting changes (continued)

### 2002

#### U.S. personal injury and other claims

In the fourth quarter of 2002, the Company changed its methodology for estimating its liability for U.S. personal injury and other claims, including occupational disease claims and claims for property damage, from a case-by-case approach to an actuarial-based approach. Consequently, for the year ended December 31, 2002, the Company recorded a charge of \$281 million (\$173 million after tax) to increase its provision for these claims.

Under the actuarial-based approach, the Company accrues the expected cost for personal injury and property damage claims and asserted occupational disease claims, based on actuarial estimates of their ultimate cost. The Company is unable to estimate the total cost for unasserted occupational disease claims. However, a liability for unasserted occupational disease claims was accrued to the extent they were reasonably estimable.

Under the case-by-case approach, a liability was recorded only when the expected loss was both probable and reasonably estimable based on currently available information. In addition, the Company did not record a liability for unasserted claims, as such amounts could not be reasonably estimated under the case-by-case approach.

In 2002, the Company's U.S. personal injury and other claims expense, including the above-mentioned charge, was \$362 million. Had the Company continued to apply the case-by-case approach to its U.S. personal injury and other claims liability, recognizing the effects of the actual claims experience for existing and new claims in the fourth quarter, these expenses would have been approximately \$135 million in 2002.

## 3 Acquisitions

### BC Rail

In November 2003, the Company entered into an agreement with British Columbia Railway Company, a corporation owned by the Government of the Province of British Columbia (Province), to acquire all the issued and outstanding shares of BC Rail Ltd. and all the partnership units of BC Rail Partnership (collectively BC Rail), and the right to operate over BC Rail's roadbed under a long-term lease, for a purchase price of \$1 billion.

On July 2, 2004, the Company reached a consent agreement with Canada's Competition Bureau, allowing for the closing of the transaction, whereby the Company reaffirmed its commitment to share merger efficiencies with BC Rail shippers and assure them competitive transportation options through its Open Gateway Rate and Service Commitment. The consent agreement also maintains competitive rates and service for grain shippers in the Peace River region.

On July 14, 2004, the Company completed its acquisition of BC Rail and began a phased integration of the companies' operations. The acquisition was financed by debt and cash on hand.

The Company accounted for the acquisition using the purchase method of accounting as required by Section 1581, "Business Combinations," and Section 3062, "Goodwill and Other Intangible Assets," of the CICA Handbook. As such, the accompanying consolidated financial statements include the assets, liabilities and results of operations of BC Rail as of July 14, 2004, the date of acquisition. The Company's cost to acquire BC Rail of \$991 million includes purchase price adjustments and transaction costs. The following table reflects the preliminary purchase price allocation, based on the fair value of BC Rail's assets acquired, owned and leased, and liabilities assumed at acquisition, which is subject to a final valuation, the impact of which is not expected to have a material effect on the results of operations.

<i>In millions</i>	July 14, 2004
Current assets	\$ 202
Deferred income taxes	397
Properties	620
Other assets	3
Total assets acquired	1,222
Current liabilities	76
Other liabilities and deferred credits	142
Long-term debt	13
Total liabilities assumed	231
Net assets acquired	\$ 991

**3 Acquisitions (continued)****Great Lakes Transportation LLC's Railroads and Related Holdings**

In October 2003, the Company, through an indirect wholly owned subsidiary, entered into an agreement for the acquisition of GLT for a purchase price of U.S.\$380 million.

As of April 2004, the Company received all necessary regulatory approvals, including the U.S. Surface Transportation Board (STB) ruling rendered on April 9, 2004.

On May 10, 2004, the Company completed its acquisition of GLT and began a phased integration of the companies' operations. The acquisition was financed by debt and cash on hand.

The Company accounted for the acquisition using the purchase method of accounting. As such, the accompanying consolidated financial statements include the assets, liabilities and results of operations of GLT as of May 10, 2004, the date of acquisition. The Company's cost to acquire GLT of U.S.\$395 million (Cdn\$547 million) includes purchase price adjustments and transaction costs. The following table reflects the preliminary purchase price allocation, based on the fair value of GLT's assets acquired and liabilities assumed at acquisition, which is subject to a final valuation, the impact of which is not expected to have a material effect on the results of operations.

<i>In millions</i>	May 10, 2004
Current assets	\$ 67
Properties	977
Intangible and other assets	87
Total assets acquired	1,131
Current liabilities	64
Deferred income taxes	290
Other liabilities and deferred credits	230
Total liabilities assumed	584
Net assets acquired	\$ 547

**4 Accounts receivable**

<i>In millions</i>	December 31,	2004	2003
Freight			
Trade		\$ 414	\$ 252
Accrued		93	55
Non-freight		356	277
		<b>863</b>	584
Provision for doubtful accounts		(70)	(55)
		<b>\$ 793</b>	\$ 529

The Company has an accounts receivable securitization program, expiring in June 2006, under which it may sell, on a revolving basis, a maximum of \$450 million of eligible freight trade and other receivables outstanding at any point in time, to an unrelated trust. The Company has a contingent residual interest of approximately 10% of receivables sold, which is recorded in Other current assets. The Company has retained the responsibility for servicing, administering and collecting freight receivables sold. Other income included \$9 million in each of 2004, 2003 and 2002, for costs related to the agreement, which fluctuate with changes in prevailing interest rates.

At December 31, 2004, pursuant to the agreement, \$445 million had been sold compared to \$448 million at December 31, 2003.

**5 Properties**

<i>In millions</i>	December 31, 2004			December 31, 2003		
	Cost	Accumulated depreciation	Net	Cost	Accumulated depreciation	Net
Track, roadway and land	\$ 16,105	\$ 3,697	\$ 12,408	\$ 15,094	\$ 3,544	\$ 11,550
Rolling stock	4,059	1,466	2,593	3,658	1,399	2,259
Buildings	1,915	771	1,144	1,773	817	956
Other	1,057	514	543	898	505	393
	<b>\$ 23,136</b>	<b>\$ 6,448</b>	<b>\$ 16,688</b>	<b>\$ 21,423</b>	<b>\$ 6,265</b>	<b>\$ 15,158</b>

**Capital leases included in properties**

Track and roadway	\$ 395	\$ 7	\$ 388	\$ 41	\$ 4	\$ 37
Rolling stock	1,155	265	890	1,213	275	938
Buildings	110	6	104	21	4	17
Other	119	7	112	105	7	98
	<b>\$ 1,779</b>	<b>\$ 285</b>	<b>\$ 1,494</b>	<b>\$ 1,380</b>	<b>\$ 290</b>	<b>\$ 1,090</b>

## 6 Intangible and other assets

<i>In millions</i>	<i>December 31,</i>		<i>2004</i>	<i>2003</i>
Prepaid benefit cost (Note 13)	\$	515	\$	411
Investments (A)		166		367
Intangible assets (B)		69		-
Deferred receivables		77		69
Note receivable from EWS		57		-
Unamortized debt issue costs		35		35
Other		10		18
	\$	929	\$	900

### A. Investments

As at December 31, 2004, the Company had \$157 million (\$356 million at December 31, 2003) of investments accounted for under the equity method and \$9 million (\$11 million at December 31, 2003) of investments accounted for under the cost method.

#### *Investment in English Welsh and Scottish Railway (EWS)*

As at December 31, 2004, the Company owned approximately 32% of EWS, a company which provides most of the rail freight services in Great Britain and operates freight trains through the English Channel tunnel, and accounted for this investment using the equity method. At December 31, 2004, the excess of the Company's share of the book value of EWS' net assets over the carrying value of the investment was not significant.

On January 6, 2004, EWS shareholders approved a plan to reduce the EWS share capital to enable cash to be returned to the shareholders by offering them the ability to cancel a portion of their EWS shares. For each share cancelled, EWS shareholders would receive a combination of cash and notes receivable. The Company elected to have the maximum allowable number of shares cancelled under the plan, thereby reducing its ownership interest in EWS to approximately 31% on a fully diluted basis (13.7 million shares) compared to approximately 37% on a fully diluted basis (43.7 million shares) prior to the capital reorganization. In the first quarter of 2004, the Company received £57.7 million (Cdn\$141 million) in cash and a note receivable of £23.9 million (Cdn\$58 million) from EWS. The note receivable is due in 2009, carries interest at 8% and is redeemable in whole or in part at any time by EWS, at the principal amount together with accrued but unpaid interest up to the date of repayment.

### B. Intangible assets

Intangible assets relate to customer contracts and relationships assumed through the GLT acquisition.

## 7 Credit facility

The Company has a U.S.\$1,000 million three-year revolving credit facility expiring in December 2005, which it intends to renew before such date. The credit facility provides for borrowings at various interest rates, including the Canadian prime rate, bankers' acceptance rates, the U.S. federal funds effective rate and the London Interbank Offer Rate, plus applicable margins. The credit facility agreement contains customary financial covenants, based on U.S. GAAP, including limitations on debt as a percentage of total capitalization and maintenance of tangible net worth above pre-defined levels. The Company has been in compliance with these financial covenants. The Company's borrowings of U.S.\$180 million (Cdn\$233 million) outstanding at December 31, 2003 at an average interest rate of 1.49% were entirely repaid in the first quarter of 2004. At December 31, 2004, the Company had borrowings under its revolving credit facility of U.S.\$90 million (Cdn\$108 million) at an average interest rate of 2.77% and letters of credit drawn of \$342 million.

The Company's commercial paper program is backed by its revolving credit facility. As at December 31, 2004, the Company had U.S.\$211 million (Cdn\$254 million) of commercial paper outstanding at an average interest rate of 2.37%, compared to no commercial paper outstanding as at December 31, 2003.

## 8 Accounts payable and accrued charges

<i>In millions</i>	<i>December 31,</i>		<i>2004</i>	<i>2003</i>
Trade payables	\$	491	\$	444
Income and other taxes		310		270
Payroll-related accruals		259		205
Accrued charges		179		131
Accrued interest		106		94
Personal injury and other claims provision		118		123
Workforce reduction provisions		90		89
Other		52		65
	\$	1,605	\$	1,421

**9 Other liabilities and deferred credits**

<i>In millions</i>	<i>December 31,</i>	<b>2004</b>	2003
Personal injury and other claims provision, net of current portion	\$	524	\$ 467
Workforce reduction provisions, net of current portion (A)		149	136
Accrual for post-retirement benefits other than pensions (B)		284	139
Accrued benefit cost for pensions (Note 13)		156	126
Environmental reserve, net of current portion		93	62
Deferred credits and other		282	223
	\$	<b>1,488</b>	\$ 1,153

**A. Workforce reduction provisions**

The workforce reduction provisions, which cover employees in both Canada and the United States, are mainly comprised of payments related to severance, early retirement incentives and bridging to early retirement, the majority of which will be disbursed within the next five years. In 2004, liabilities assumed through recent acquisitions and other charges and adjustments increased the provisions by \$107 million. Payments have reduced the provisions by \$93 million for the year ended December 31, 2004 (\$155 million for the year ended December 31, 2003). As at December 31, 2004, the aggregate provisions, including the current portion, amounted to \$239 million (\$225 million as at December 31, 2003).

In 2002, the Company had announced 1,146 job reductions in a renewed drive to improve productivity in all its corporate and operating functions, and recorded a charge of \$120 million, \$79 million after tax. Reductions relating to this charge were completed in 2003.

**B. Post-retirement benefits other than pensions***(i) Change in benefit obligation*

<i>In millions</i>	<i>Year ended December 31,</i>	<b>2004</b>	2003
Benefit obligation at beginning of year	\$	309	\$ 311
Acquisition of GLT and BC Rail		151	-
Amendments		(12)	8
Actuarial (gain) loss		(111)	29
Interest cost		17	18
Service cost		8	5
Foreign currency changes		(25)	(44)
Benefits paid		(18)	(18)
<i>Benefit obligation at end of year</i>	\$	<b>319</b>	\$ 309

The Company uses a measurement date of September 30 for its U.S. plans and December 31 for its Canadian plans.

*(ii) Funded status*

<i>In millions</i>	<i>December 31,</i>	<b>2004</b>	2003
Unfunded benefit obligation at end of year	\$	319	\$ 309
Unrecognized net actuarial gain (loss)		6	(112)
Unrecognized prior service cost		(16)	(33)
<i>Accrued benefit cost for post-retirement benefits other than pensions (Including current portion)</i>	\$	<b>309</b>	\$ 164

*(iii) Components of net periodic benefit cost*

<i>In millions</i>	<i>Year ended December 31,</i>	<b>2004</b>	2003	2002
Current service cost - employer portion	\$	8	\$ 5	\$ 4
Interest cost		17	18	15
Plan amendments		(12)	8	18
Actuarial loss (gain) on accrued benefit obligation		(111)	29	95
Cost arising in the period		(98)	60	132
Difference between cost arising in the period and cost recognized in the period in respect of:				
Actuarial loss (gain)		112	(22)	(92)
Plan amendments		15	(5)	(15)
<i>Net periodic benefit cost</i>	\$	<b>29</b>	\$ 33	\$ 25

*(iv) Weighted-average assumptions*

	<i>December 31,</i>	<b>2004</b>	2003	2002
<i>To determine benefit obligation</i>				
Discount rate		5.90%	6.00%	6.69%
Rate of compensation increase		3.75%	3.75%	4.00%
<i>To determine net periodic benefit cost</i>				
Discount rate		6.00%	6.69%	7.14%
Rate of compensation increase		3.75%	4.00%	4.00%

**9 Other liabilities and deferred credits (continued)**

(v) For measurement purposes, increases in the per capita cost of covered health care benefits were assumed to be 14% for 2005 and 15% for 2004. It is assumed that the rate will decrease gradually to 6% in 2013 and remain at that level thereafter.

A one-percentage-point change in the assumed health care cost trend rates would have the following effect:

<i>In millions</i>	One-percentage-point	
	Increase	Decrease
Effect on total service and interest costs	\$ 2	\$ (2)
Effect on benefit obligation	28	(24)

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the "Act"), signed into law in the United States in December 2003, provides for prescription drug benefits under Medicare, as well as a federal subsidy to sponsors of retiree health care benefit plans that provide prescription drug benefits that have been concluded to be actuarially equivalent to the Medicare benefit. Pursuant to guidance by the Financial Accounting Standards Board (FASB) in the United States, adopted on July 1, 2004, the Company evaluated and determined the prescription drug benefits provided by its health care plans to be actuarially equivalent to the Medicare benefit under the Act. The Company measured the effects of the Act on the accumulated post-retirement benefit obligation (APBO) as of January 1, 2004 and, as such, the APBO was reduced by \$49 million. Net periodic benefit cost for the year ended December 31, 2004 was reduced by \$7 million due to the effects of the Act.

(vi) The estimated future benefit payments for each of the next five years and the subsequent five-year period are as follows:

<i>In millions</i>	
2005	\$ 20
2006	21
2007	22
2008	22
2009	23
Years 2010 to 2014	130

## 10 Long-term debt

<i>In millions</i>	Maturity	Currency in which payable	<b>December 31,</b>	
			<b>2004</b>	<b>2003</b>
<i>Debentures and notes: (A)</i>				
Canadian National series:				
7.00% 10-year notes	March 15, 2004	U.S.\$	-	344
6.45% Puttable Reset Securities (PURS) (B)	July 15, 2006	U.S.\$	301	324
4.25% 5-year notes (C)	August 1, 2009	U.S.\$	361	-
6.38% 10-year notes (C)	Oct. 15, 2011	U.S.\$	482	518
4.40% 10-year notes (C)	March 15, 2013	U.S.\$	482	518
6.80% 20-year notes (C)	July 15, 2018	U.S.\$	241	259
7.63% 30-year debentures	May 15, 2023	U.S.\$	181	194
6.90% 30-year notes (C)	July 15, 2028	U.S.\$	572	615
7.38% 30-year debentures (C)	Oct. 15, 2031	U.S.\$	241	259
6.25% 30-year notes (C)	August 1, 2034	U.S.\$	602	-
Illinois Central series:				
7.75% 10-year notes	May 1, 2005	U.S.\$	120	129
6.98% 12-year notes	July 12, 2007	U.S.\$	60	65
6.63% 10-year notes	June 9, 2008	U.S.\$	24	26
5.00% 99-year income debentures	Dec. 1, 2056	U.S.\$	9	10
7.70% 100-year debentures	Sep. 15, 2096	U.S.\$	151	162
Wisconsin Central series:				
6.63% 10-year notes	April 15, 2008	U.S.\$	181	194
			<b>4,008</b>	<b>3,617</b>
BC Rail series:				
Non-interest bearing 90-year subordinated notes (D)	July 14, 2094	CDN\$	843	-
<i>Total debentures and notes</i>			<b>4,851</b>	<b>3,617</b>
<i>Other:</i>				
Revolving credit facility (A) (Note 7)		U.S.\$	108	233
Commercial paper (E) (Note 7)		U.S.\$	254	-
Capital lease obligations and other (F)		Various	805	822
<i>Total other</i>			<b>1,167</b>	<b>1,055</b>
			<b>6,018</b>	<b>4,672</b>
Less:				
Current portion of long-term debt			578	483
Net unamortized discount			854	14
			<b>1,432</b>	<b>497</b>
			<b>\$ 4,586</b>	<b>\$ 4,175</b>

A. The Company's debentures, notes and revolving credit facility are unsecured.

B. The PURS contain imbedded simultaneous put and call options at par. At the time of issuance, the Company sold the option to call the securities on July 15, 2006 (the reset date). If the call option is exercised, the imbedded put option is automatically triggered, resulting in the redemption of the original PURS. The call option holder will then have the right to remarket the securities at a new coupon rate for an additional 30-year term ending July 15, 2036. The new coupon rate will be determined according to a pre-set

mechanism based on market conditions then prevailing. If the call option is not exercised, the put option is deemed to have been exercised, resulting in the redemption of the PURS on July 15, 2006.

C. These debt securities are redeemable, in whole or in part, at the option of the Company, at any time, at the greater of par and a formula price based on interest rates prevailing at the time of redemption.

## 10 Long-term debt (continued)

D. The Company records these notes as a discounted debt of \$5 million, using an imputed interest rate of 5.75%. The discount of \$838 million is included in the net unamortized discount.

E. The Company has a commercial paper program, which is backed by its revolving credit facility, enabling it to issue commercial paper up to a maximum aggregate principal amount of \$800 million, or the U.S. dollar equivalent. At December 31, 2004, the amounts outstanding under both the revolving credit facility and the commercial paper program have been presented as short-term debt given the maturity in December 2005 of the revolving credit facility. During 2003, the commercial paper debt was due within one year but was classified as long-term debt, reflecting the Company's intent and contractual ability to refinance the short-term borrowing through subsequent issuances of commercial paper or drawing down on the revolving credit facility.

F. Interest rates for the capital leases range from approximately 2.23% to 13.13% with maturity dates in the years 2005 through 2025. The imputed interest on these leases amounted to \$342 million as at December 31, 2004 and \$395 million as at December 31, 2003.

The capital lease obligations are secured by properties with a net carrying amount of \$1,054 million as at December 31, 2004 and \$1,091 million as at December 31, 2003.

During 2004, the Company recorded \$160 million in assets it acquired through the exercise of purchase options on existing leases and leases for new equipment (\$47 million in 2003). An equivalent amount was recorded in debt.

G. Long-term debt maturities, including repurchase arrangements and capital lease repayments on debt outstanding as at December 31, 2004, for the next five years and thereafter, are as follows:

<i>In millions</i>	
2005	\$ 578
2006	376
2007	154
2008	230
2009	427
2010 and thereafter	3,399

H. The aggregate amount of debt payable in U.S. currency as at December 31, 2004 is U.S.\$4,022 million (Cdn\$4,845 million) and U.S.\$3,273 million (Cdn\$4,236 million) as at December 31, 2003.

I. The Company has U.S.\$200 million available under its currently effective shelf prospectus and registration statement providing for the issuance of debt securities in one or more offerings.

## 11 Capital stock and convertible preferred securities

### A. Authorized capital stock

The authorized capital stock of the Company is as follows:

- Unlimited number of Common Shares, without par value
- Unlimited number of Class A Preferred Shares, without par value issuable in series
- Unlimited number of Class B Preferred Shares, without par value issuable in series

### B. Issued and outstanding common shares

During 2004, the Company issued 2.9 million shares (2.9 million shares in 2003 and 2.7 million shares in 2002) related to stock options exercised. The total number of common shares issued and outstanding was 283.1 million as at December 31, 2004.

In 2002, the Company issued 9.0 million common shares related to the conversion of the Company's convertible preferred securities.

### C. Convertible preferred securities ("Securities")

On May 6, 2002, the Company met the conditions required to terminate the Securities holders' right to convert their Securities into common shares of the Company, and had set the conversion termination date as July 3, 2002. The conditions were met when the Company's common share price exceeded 120% of the conversion price of U.S.\$25.65 per share for a specified period, and all accrued interest on the Securities had been paid. On July 3, 2002, Securities that had not been previously surrendered for conversion were deemed converted, resulting in the issuance of 9.0 million common shares of the Company.

In 1999, the Company had issued 6.9 million 5.25% Securities due on June 30, 2029, at U.S.\$33.33 per Security. These Securities were subordinated securities convertible into common shares of CN at the option of the holder at an original conversion price of U.S.\$25.65 per common share, representing an original conversion rate of 1.2995 common shares for each Security.

### D. Share repurchase program

On October 26, 2004, the Board of Directors of the Company approved a share repurchase program which allows for the repurchase of up to 14.0 million common shares between November 1, 2004 and October 31, 2005 pursuant to a normal course issuer bid, at prevailing market prices. As at December 31, 2004, 4.0 million common shares have been repurchased for \$273 million, at an average price of \$68.31 per share.

## 11 Capital stock and convertible preferred securities (continued)

The Company's previous share repurchase program initiated in 2002 allowed for the repurchase of up to 19.5 million common shares between October 25, 2002 and October 24, 2003 pursuant to a normal course issuer bid, at prevailing market prices. By October 2003, the Company had completed its program, repurchasing 19.5 million common shares for \$859 million, at an average price of \$44.04 per share (15.0 million and 4.5 million shares in 2003 and 2002, respectively).

### E. Common stock split

On January 27, 2004, the Board of Directors of the Company approved a three-for-two common stock split which was effected in the form of a stock dividend of one-half additional common share of CN payable for each share held. The stock dividend was paid on February 27, 2004, to shareholders of record on February 23, 2004. All equity-based benefit plans were adjusted to reflect the issuance of additional shares or options due to the declaration of the stock split. All share and per share data has been adjusted to reflect the stock split.

## 12 Stock plans

The Company has various stock-based incentive plans for eligible employees. A description of the Company's major plans is provided below:

### Employee share investment plan

The Company has an Employee Share Investment Plan (ESIP) giving eligible employees the opportunity to subscribe for up to 10% (6% prior to 2003) of their gross salaries to purchase shares of the Company's common stock on the open market and to have the Company invest, on the employees' behalf, a further 35% of the amount invested by the employees, up to 6% of their gross salaries. Participation at December 31, 2004 was 10,073 employees (8,894 at December 31, 2003 and 8,911 at December 31, 2002). The total number of ESIP shares purchased on behalf of employees, including the Company's contributions, was 723,663 in 2004, 855,210 in 2003 and 746,189 in 2002, resulting in a pre-tax charge to income of \$11 million, \$8 million and \$9 million for the years ended December 31, 2004, 2003 and 2002, respectively.

### Stock-based plans

Compensation cost for awards under all stock-based plans was \$84 million, \$50 million and \$18 million for the years ended December 31, 2004, 2003 and 2002, respectively.

#### A. Restricted share units

In 2004, the Company granted approximately 1.2 million restricted share units (RSUs) to designated management employees entitling them to receive payout in cash based on the Company's share price. The RSUs granted are generally scheduled for payout after three years and vest upon the attainment of targets relating to return on invested capital over the three-year period and to the Company's share price during the three-month period ending December 31, 2006. If specified targets related to the Company's 20-day average share price are attained during any period ending on or after December 31, 2005, payout can be accelerated. For the year ended December 31, 2004, the Company recorded compensation cost of \$36 million for RSUs.

#### B. Mid-term incentive share unit plan

The mid-term incentive share unit plan, approved by the Board of Directors in 2001, entitled designated senior management employees to receive payout on June 30, 2004. The share units vested conditionally upon the attainment of targets relating to the Company's share price during the six-month period ending June 30, 2004. On June 30, 2004, upon the partial attainment of these targets, the Company recorded additional compensation cost of \$13 million based on the number of share units vested multiplied by the Company's share price on such date. For the year ended December 31, 2003, the Company recorded compensation cost of \$7 million related to the plan and no compensation cost was recorded for 2002.

#### C. Voluntary incentive deferral plan

The Company has a voluntary incentive deferral plan (VIDP), providing eligible senior management employees the opportunity to elect to receive their annual incentive bonus payment and other eligible incentive payments in deferred share units (DSUs). For each participant, the Company will grant 25% of DSUs, which will vest over a period of 4 years. A DSU is equivalent to a common share of the Company and also earns dividends when normal cash dividends are paid on common shares. The number of DSUs received by each participant is established using the average closing price for the 20 trading days prior to and including the date of the incentive payment. The value of each participant's DSUs is payable in cash at the time of cessation of employment.

## 12 Stock plans (continued)

At December 31, 2004, the total liability under the VIDP was \$22 million, representing 354,745 units outstanding under the plan. For the year ended December 31, 2004, the Company recognized an expense of \$7 million related to the plan.

### D. Stock options

The Company has stock option plans for eligible employees to acquire common shares of the Company upon vesting at a price equal to the market value of the common shares at the date of granting. The options are exercisable during a period not exceeding 10 years. The right to exercise options generally accrues over a period of four years of continuous employment. Options are not generally exercisable during the first 12 months after the date of grant. At December 31, 2004, an additional 1.2 million common shares remained authorized for future issuances under these plans.

Options issued by the Company include conventional options, which vest over a period of time, performance options, which vest upon the attainment of Company targets relating to the operating ratio and unlevered return on investment, and performance-accelerated options, which vest on the sixth anniversary of the grant or prior if certain Company targets relating to return on investment and revenues are attained. The total conventional, performance, and performance-accelerated options outstanding at December 31, 2004 were 8.9 million, 1.3 million and 2.9 million, respectively.

Changes in the Company's stock options are as follows:

	Number of options	Weighted- average exercise price
	<i>In millions</i>	
Outstanding at December 31, 2001 <sup>(1)</sup>	14.9	\$29.08
Granted	4.8	\$51.19
Canceled and expired	(0.3)	\$37.99
Exercised	<u>(2.7)</u>	\$26.11
Outstanding at December 31, 2002 <sup>(1)</sup>	16.7	\$35.67
Granted	3.0	\$40.95
Canceled and expired	(0.6)	\$45.11
Exercised	<u>(2.9)</u>	\$26.60
Outstanding at December 31, 2003 <sup>(1)</sup>	16.2	\$37.16
Granted	-	-
Canceled and expired	(0.2)	\$42.58
Exercised	<u>(2.9)</u>	\$28.70
Outstanding at December 31, 2004 <sup>(1)</sup>	<b>13.1</b>	<b>\$38.85</b>

<sup>(1)</sup> Includes IC and WC converted stock options translated to Canadian dollars using the foreign exchange rate in effect at the balance sheet date.

## 12 Stock plans (continued)

Stock options outstanding and exercisable as at December 31, 2004 were as follows:

Range of exercise prices	Options outstanding			Options exercisable	
	Number of options	Weighted-average years to expiration	Weighted-average exercise price	Number of options	Weighted-average exercise price
	<i>In millions</i>			<i>In millions</i>	
\$9.00–\$16.02	0.2	1	\$15.40	0.2	\$15.40
\$18.13–\$27.08	1.6	4	\$23.33	1.6	\$23.33
\$27.31–\$33.35	4.1	5	\$32.10	3.3	\$31.82
\$37.17–\$49.21	3.1	8	\$40.98	1.1	\$41.03
\$51.05–\$58.44	4.1	7	\$51.19	2.0	\$51.20
<i>Balance at December 31, 2004</i> <sup>(1)</sup>	<b>13.1</b>	<b>6</b>	<b>\$38.85</b>	<b>8.2</b>	<b>\$35.55</b>

(1) Includes IC and WC converted stock options translated to Canadian dollars using the foreign exchange rate in effect at the balance sheet date.

At December 31, 2003 and 2002, the Company had 7.5 million and 7.4 million options exercisable at a weighted-average exercise price of \$31.39 and \$29.34, respectively.

Compensation cost for awards of employee stock options granted, modified or settled on or after January 1, 2002 was determined using the fair value based approach in accordance with the CICA Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments," as explained in Note 2 - Accounting changes. Compensation cost recognized for stock option awards was \$28 million, \$43 million and \$18 million in 2004, 2003 and 2002, respectively.

Compensation cost related to stock option awards under the fair value based approach was calculated using the Black-Scholes option-pricing model with the following assumptions:

	Year ended December 31, 2004 <sup>(1)</sup>	2003	2002
Expected option life (years)	-	5.0	7.0
Risk-free interest rate	-	4.12%	5.79%
Expected stock price volatility	-	30%	30%
Average dividend per share	-	\$ 0.67	\$ 0.57
	Year ended December 31, 2004 <sup>(1)</sup>	2003	2002
Weighted average fair value of options granted	\$ -	\$11.88	\$20.65

(1) The Company did not grant any stock option awards in 2004.

## 13 Pensions

The Company has various retirement benefit plans under which substantially all of its employees are entitled to benefits at retirement age, generally based on compensation and length of service and/or contributions. The information in the tables that follow pertains to all such plans. However, the following descriptions relate solely to the

Company's main pension plan, the CN Pension Plan (the Pension Plan), unless otherwise specified.

### Description of Pension Plan

The Pension Plan is a contributory defined benefit pension plan that covers the majority of CN employees. It provides for pensions based mainly on years of service and final average pensionable earnings and is generally applicable from the first day of employment. Indexation of pensions is provided after retirement through a gain (loss) sharing mechanism, subject to guaranteed minimum increases. An independent trust company is the Trustee of the Canadian National Railways Pension Trust Funds (CN Pension Trust Funds). As Trustee, the trust company performs certain duties, which include holding legal title to the assets of the CN Pension Trust Funds and ensuring that the Company, as Administrator, complies with the provisions of the Pension Plan and the related legislation. The Company utilizes a measurement date of December 31 for the Pension Plan.

### Funding policy

Employee contributions to the Pension Plan are determined by the plan rules. Company contributions are in accordance with the requirements of the Government of Canada legislation, The Pension Benefits Standards Act, 1985, and are determined by actuarial valuations conducted at least on a triennial basis. These valuations are made in accordance with legislative requirements and with the recommendations of the Canadian Institute of Actuaries for the valuation of pension plans. The latest actuarial valuation of the Pension Plan was conducted as at December 31, 2003 and indicated a funding excess. Total contributions for all of the Company's pension

### 13 Pensions (continued)

plans are expected to be approximately \$120 million in each of 2005, 2006 and 2007 based on the plans' current position. All of the Company's contributions are expected to be in the form of cash.

#### Description of fund assets

The assets of the Pension Plan are accounted for separately in the CN Pension Trust Funds and consist of cash and short-term investments, bonds, mortgages, Canadian and foreign equities, real estate, and oil and gas assets. The assets of the Pension Plan have a fair market value of \$12,256 million as at December 31, 2004 (\$11,573 million at December 31, 2003). The Pension Plan's target percentage allocation and weighted-average asset allocations as at December 31, 2004 and 2003, by asset category are as follows:

#### Plan assets by category

	Target Allocation	December 31,	
		2004	2003
Equity securities	53%	56%	56%
Debt securities	40%	34%	38%
Real estate	4%	3%	3%
Other	3%	7%	3%
	<b>100%</b>	<b>100%</b>	<b>100%</b>

The Company follows a disciplined investment strategy, which limits concentration of investments by asset class, foreign currency, sector or company. The Investment Committee of the Board of Directors has approved an investment policy that establishes long-term asset mix targets based on a review of historical returns achieved by worldwide investment markets. Investment managers may deviate from these targets but their performance is evaluated in relation to the market performance of the target mix. The Company does not anticipate the return on plan assets to fluctuate materially from related capital market indices. The Investment Committee reviews investments regularly with specific approval required for major investments in illiquid securities. The policy also permits the use of derivative financial instruments to implement asset mix decisions or to hedge existing or anticipated exposures. The Pension Plan does not invest in the securities of the Company or its subsidiaries.

#### Weighted-average assumptions

December 31,	2004	2003	2002
To determine benefit obligation			
Discount rate	5.75%	6.00%	6.50%
Rate of compensation increase	3.75%	3.75%	4.00%
To determine net periodic benefit cost			
Discount rate	6.00%	6.50%	6.50%
Rate of compensation increase	3.75%	4.00%	4.00%
Expected return on plan assets	8.00%	8.00%	9.00%

To develop its expected long-term rate of return assumption used in the calculation of net periodic benefit cost applicable to the market-related value of assets, the Company considers both its past experience and future estimates of long-term investment returns, the expected composition of the plans' assets as well as the expected long-term market returns in the future. The Company has elected to use a market-related value of assets, whereby realized and unrealized gains/losses and appreciation/depreciation in the value of the investments are recognized over a period of five years, while investment income is recognized immediately.

#### Information about the Company's defined benefit pension plans:

##### (a) Change in benefit obligation

In millions	Year ended December 31,	2004	2003
Benefit obligation at beginning of year		\$ 12,020	\$ 11,376
Acquisition of GLT and BC Rail		684	-
Interest cost		733	720
Actuarial loss		349	482
Service cost		124	103
Plan participants' contributions		55	60
Foreign currency changes		(23)	(26)
Benefit payments and transfers		(805)	(695)
Benefit obligation at end of year		<b>\$ 13,137</b>	<b>\$ 12,020</b>

##### (b) Change in plan assets

In millions	Year ended December 31,	2004	2003
Fair value of plan assets at beginning of year		\$ 11,671	\$ 11,182
Acquisition of GLT and BC Rail		611	-
Employer contributions		165	90
Plan participants' contributions		55	60
Foreign currency changes		(15)	(15)
Actual return on plan assets		1,371	1,049
Benefit payments and transfers		(805)	(695)
Fair value of plan assets at end of year		<b>\$ 13,053</b>	<b>\$ 11,671</b>

**13 Pensions (continued)**

## (c) Funded status

<i>In millions</i>	<i>December 31,</i>	<b>2004</b>	2003
Deficiency of fair value of plan assets			
over benefit obligation at end of year <sup>(1)</sup>		\$ (84)	\$ (349)
Unrecognized net actuarial loss <sup>(1)</sup>		368	540
Unrecognized prior service cost		75	94
<i>Net amount recognized</i>		<b>\$ 359</b>	<b>\$ 285</b>

<sup>(1)</sup> Subject to future reduction for gain sharing under the terms of the plan.

## (d) Amount recognized in the Consolidated Balance Sheet

<i>In millions</i>	<i>December 31,</i>	<b>2004</b>	2003
Prepaid benefit cost (Note 6)		\$ 515	\$ 411
Accrued benefit cost (Note 9)		(156)	(126)
<i>Net amount recognized</i>		<b>\$ 359</b>	<b>\$ 285</b>

The accumulated benefit obligation for all defined benefit pension plans was \$12,450 million and \$11,381 million at December 31, 2004, and 2003, respectively.

## (e) Components of net periodic benefit cost

<i>In millions</i>	<i>Year ended December 31,</i>	<b>2004</b>	2003	2002
Current service cost - employer portion		\$ 124	\$ 103	\$ 108
Interest cost		733	720	722
Actual return on plan assets		(1,371)	(1,049)	39
Actuarial loss (gain) on accrued benefit obligation		349	482	(86)
Cost arising in the period		(165)	256	783
Difference between cost arising in the period and cost recognized in the period in respect of:				
Return on plan assets		514	230	(913)
Actuarial loss (gain)		(346)	(478)	88
Transition obligation		-	19	20
Plan amendments		19	22	22
<i>Net periodic benefit cost</i>		<b>\$ 22</b>	<b>\$ 49</b>	<b>\$ -</b>

## (f) Estimated future benefit payments

The estimated future benefit payments for each of the next five years and the subsequent five-year period are as follows:

<i>In millions</i>	
2005	\$ 957
2006	821
2007	845
2008	869
2009	893
Years 2010 to 2014	4,760

**14 Interest expense**

<i>In millions</i>	<i>Year ended December 31,</i>	<b>2004</b>	2003	2002
Interest on debt and capital leases		\$ 282	\$ 318	\$ 353
Interest income			(1)	-
		<b>\$ 282</b>	<b>\$ 317</b>	<b>\$ 353</b>
<i>Cash interest payments</i>		<b>\$ 282</b>	<b>\$ 327</b>	<b>\$ 390</b>

**15 Other income (loss)**

<i>In millions</i>	<i>Year ended December 31,</i>	<b>2004</b>	2003	2002
Gain on disposal of properties		\$ 32	\$ 56	\$ 41
Equity in earnings of English Welsh and Scottish Railway (Note 6)		(4)	17	33
Investment income		5	1	18
Foreign exchange gain (loss)		(2)	(3)	12
Net real estate costs		(18)	(19)	(15)
Other		(33)	(31)	(13)
		<b>\$ (20)</b>	<b>\$ 21</b>	<b>\$ 76</b>

**16 Income taxes**

The Company's consolidated effective income tax rate differs from the statutory Federal tax rate. The reconciliation of income tax expense is as follows:

<i>In millions</i>	<i>Year ended December 31,</i>	<b>2004</b>	2003	2002
Federal tax rate		22.1%	24.1%	26.1%
Income tax expense at the statutory				
Federal tax rate		\$ (426)	\$ (258)	\$ (219)
Income tax (expense) recovery resulting from:				
Provincial and other taxes		(272)	(144)	(97)
Deferred income tax adjustments due to rate enactments		2	(33)	-
Gain on disposals and dividends		10	11	6
Adjustments to prior years' income taxes <sup>(1)</sup>		11	44	-
Other		44	42	42
<i>Income tax expense</i>		<b>\$ (631)</b>	<b>\$ (338)</b>	<b>\$ (268)</b>
<i>Cash payments for income taxes</i>		<b>\$ 92</b>	<b>\$ 86</b>	<b>\$ 65</b>

<sup>(1)</sup> Adjustments relating mainly to the resolution of matters pertaining to prior years' income taxes.

## 16 Income taxes (continued)

The following table provides tax information for Canada and the United States:

<i>In millions</i>	<i>Year ended December 31,</i>		<b>2004</b>	2003	2002
<i>Income before income taxes</i>					
Canada	\$	1,552	\$	1,052	\$ 882
U.S.		376		20	(61)
	\$	<b>1,928</b>	\$	1,072	\$ 821
<i>Current income taxes</i>					
Canada	\$	(222)	\$	(94)	\$ (130)
U.S.		(8)		(12)	18
	\$	<b>(230)</b>	\$	(106)	\$ (112)
<i>Deferred income taxes</i>					
Canada	\$	(279)	\$	(244)	\$ (161)
U.S.		(122)		12	5
	\$	<b>(401)</b>	\$	(232)	\$ (156)

Significant components of deferred income tax assets and liabilities are as follows:

<i>In millions</i>	<i>December 31,</i>		<b>2004</b>	2003
<i>Deferred income tax assets</i>				
Workforce reduction provisions	\$	86	\$	81
Personal injury claims and other reserves		190		252
Post-retirement benefits		115		61
Losses and tax credit carryforwards		278		81
		<b>669</b>		475
<i>Deferred income tax liabilities</i>				
Net prepaid benefit cost for pensions		121		102
Properties and other		3,746		3,613
		<b>3,867</b>		3,715
<i>Total net deferred income tax liability</i>	\$	<b>3,198</b>	\$	3,240
<i>Total net deferred income tax liability</i>				
Canada	\$	644	\$	630
U.S.		2,554		2,610
	\$	<b>3,198</b>	\$	3,240
<i>Total net deferred income tax liability</i>	\$	<b>3,198</b>	\$	3,240
Net current deferred income tax asset		393		125
<i>Long-term deferred income tax liability</i>	\$	<b>3,591</b>	\$	3,365

It is more likely than not that the Company will realize its deferred income tax assets from the generation of future taxable income, as the payments for provisions, reserves and accruals are made and losses and tax credit carryforwards are utilized. At December 31, 2004, the Company had \$794 million of operating loss carryforwards, mainly resulting from the BC Rail acquisition, available to reduce future taxable income expiring between 2005 and 2023.

The Company recognized tax credits of \$4 million in 2004 for research and development expenditures (\$15 million in 2003 and \$9

million in 2002) not previously recognized, which reduced the cost of properties.

## 17 Segmented information

The Company operates in one business segment with operations in Canada and the United States.

### Information on geographic areas

<i>In millions</i>	<i>Year ended December 31,</i>		<b>2004</b>	2003	2002
<i>Revenues</i>					
Canada	\$	4,126	\$	3,707	\$ 3,726
U.S.		2,422		2,177	2,384
	\$	<b>6,548</b>	\$	5,884	\$ 6,110

<i>In millions</i>	<i>December 31,</i>		<b>2004</b>	2003
<i>Properties</i>				
Canada	\$	7,449	\$	6,376
U.S.		9,239		8,782
	\$	<b>16,688</b>	\$	15,158

## 18 Earnings per share

	<i>Year ended December 31,</i>		<b>2004</b>	2003	2002
Basic earnings per share	\$	4.55	\$	2.56	\$ 1.85
Diluted earnings per share	\$	4.48	\$	2.52	\$ 1.82

The following table provides a reconciliation between basic and diluted earnings per share:

<i>In millions</i>	<i>Year ended December 31,</i>		<b>2004</b>	2003	2002
Net income	\$	1,297	\$	734	\$ 553
Dividends on convertible preferred securities (Note 11)		-		-	6
	\$	<b>1,297</b>	\$	734	\$ 547
Weighted-average shares outstanding		<b>285.1</b>		286.8	295.0
Effect of dilutive securities and stock options		4.5		3.9	9.2
<i>Weighted-average diluted shares outstanding</i>		<b>289.6</b>		290.7	304.2

For the years ended December 31, 2004, 2003 and 2002, the weighted-average number of stock options that were not included in the calculation of diluted earnings per share, as their inclusion would have had an anti-dilutive impact, was 0.2 million, 6.8 million and 4.8 million, respectively. The 2003 and 2002 figures have been adjusted for the three-for-two common stock split (see Note 11(E)).

## 19 Major commitments and contingencies

### A. Leases

The Company has lease commitments for locomotives, freight cars and intermodal equipment, many of which provide the option to purchase the leased items at fixed values during or at the end of the lease term. As at December 31, 2004, the Company's commitments under operating and capital leases were \$992 million and \$1,103 million, respectively. Minimum lease payments in each of the next five years and thereafter are as follows:

<i>In millions</i>	Operating	Capital
2005	\$ 206	\$ 113
2006	194	106
2007	146	130
2008	116	52
2009	90	93
2010 and thereafter	240	609
	<u>\$ 992</u>	<u>1,103</u>
Less: imputed interest on capital leases at rates ranging from approximately 2.23% to 13.13%		342
Present value of minimum lease payments included in debt		<u>\$ 761</u>

Rent expense for operating leases was \$242 million, \$230 million and \$269 million for the years ended December 31, 2004, 2003 and 2002, respectively. Contingent rentals and sublease rentals were not significant.

### B. Other commitments

As at December 31, 2004, the Company had commitments to acquire railroad ties, rail, freight cars, locomotives and other equipment at an aggregate cost of \$194 million. Furthermore, as at December 31, 2004, the Company had outstanding information technology service contracts of \$18 million and agreements with fuel suppliers to purchase approximately 56% of its anticipated 2005 volume, 19% of its anticipated 2006 volume, and 2% of its anticipated 2007 volume at market prices prevailing on the date of the purchase.

### C. Contingencies

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to personal injuries, occupational disease and damage to property.

In Canada, employee injuries are governed by the workers' compensation legislation in each province whereby employees may be awarded either a lump sum or future stream of payments depending on the nature and severity of the injury. Accordingly, the Company accounts for costs related to employee work-related injuries based on actuarially developed estimates of the ultimate cost associated with

such injuries, including compensation, health care and administration costs. For all other legal actions, the Company maintains, and regularly updates on a case-by-case basis, provisions for such items when the expected loss is both probable and can be reasonably estimated based on currently available information.

In the United States, employee work-related injuries, including occupational disease claims, are compensated according to the provisions of the Federal Employers' Liability Act (FELA), which requires either the finding of fault through the U.S. jury system or individual settlements, and represent a major expense for the railroad industry. The Company follows an actuarial-based approach and accrues the expected cost for personal injury and property damage claims and asserted occupational disease claims, based on actuarial estimates of their ultimate cost. A liability for the minimum amount of unasserted occupational disease claims is also accrued to the extent they can be reasonably estimated. The amount recorded reflects a 25-year horizon as the Company expects that a large majority of these cases will be received over such period.

In 2004, the Company's expenses for personal injury and other claims, net of recoveries, were \$149 million (\$127 million in 2003 and \$393 million in 2002) and payments for such items were \$106 million (\$126 million in 2003 and \$156 million in 2002). As at December 31, 2004, the Company had aggregate reserves for personal injury and other claims of \$642 million (\$590 million at December 31, 2003).

Although the Company considers such provisions to be adequate for all its outstanding and pending claims, the final outcome with respect to actions outstanding or pending at December 31, 2004, or with respect to future claims, cannot be predicted with certainty, and therefore there can be no assurance that their resolution will not have a material adverse effect on the Company's financial position or results of operations in a particular quarter or fiscal year.

### D. Environmental matters

The Company's operations are subject to federal, provincial, state, municipal and local regulations under environmental laws and regulations concerning, among other things, emissions into the air; discharges into waters; the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances, and other materials; decommissioning of underground and aboveground storage tanks; and soil and groundwater contamination. A risk of environmental liability is inherent in railroad and related transportation operations; real estate ownership, operation or control; and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railroad operations and relating to its past and present ownership, operation or control of real property.

**19 Major commitments and contingencies (continued)**

While the Company believes that it has identified the costs likely to be incurred in the next several years, based on known information, for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities. The magnitude of such additional liabilities and the costs of complying with environmental laws and containing or remediating contamination cannot be reasonably estimated due to:

- (i) the lack of specific technical information available with respect to many sites;
- (ii) the absence of any government authority, third-party orders, or claims with respect to particular sites;
- (iii) the potential for new or changed laws and regulations and for development of new remediation technologies and uncertainty regarding the timing of the work with respect to particular sites;
- (iv) the ability to recover costs from any third parties with respect to particular sites; and

therefore, the likelihood of any such costs being incurred or whether such costs would be material to the Company cannot be determined at this time. There can thus be no assurance that material liabilities or costs related to environmental matters will not be incurred in the future, or will not have a material adverse effect on the Company's financial position or results of operations in a particular quarter or fiscal year, or that the Company's liquidity will not be adversely impacted by such environmental liabilities or costs. Although the effect on operating results and liquidity cannot be reasonably estimated, management believes, based on current information, that environmental matters will not have a material adverse effect on the Company's financial condition or competitive position. Costs related to any future remediation will be accrued in the year in which they become known.

In 2004, the Company's expenses relating to environmental matters, net of recoveries, were \$10 million (\$6 million in both 2003 and 2002) and payments for such items were \$8 million (\$12 million in 2003 and \$16 million in 2002). As at December 31, 2004, the Company had aggregate accruals for environmental

costs of \$113 million (\$83 million as at December 31, 2003). The Company anticipates that the majority of the liability at December 31, 2004 will be paid out over the next five years.

In addition, related environmental capital expenditures were \$13 million in 2004, \$23 million in 2003 and \$19 million in 2002. The Company expects to incur capital expenditures relating to environmental matters of approximately \$20 million in 2005, \$17 million in 2006 and \$16 million in 2007.

**E. Guarantees and indemnifications**

In the normal course of business, the Company, including certain of its subsidiaries, enters into agreements that may involve providing certain guarantees or indemnifications to third parties and others, which extend over the term of the agreement. These include, but are not limited to, residual value guarantees on operating leases, standby letters of credit and surety bonds, and indemnifications that are customary for the type of transaction or for the railway business.

Effective January 1, 2003, the Company is required to disclose its obligation undertaken in issuing certain guarantees on the date the guarantee is issued or modified. In addition, where the Company expects to make a payment in respect of a guarantee, a liability will be recognized to the extent that one has not yet been recognized.

*Guarantee of residual values of operating leases*

The Company has guaranteed a portion of the residual values of certain of its assets under operating leases with expiry dates between 2005 and 2012, for the benefit of the lessor. If the fair value of the assets, at the end of their respective lease term, is less than the fair value, as estimated at the inception of the lease, then the Company must, under certain conditions, compensate the lessor for the shortfall. At December 31, 2004, the maximum exposure in respect of these guarantees was \$97 million, of which \$6 million has been recorded. The Company has issued guarantees for which the fair value at December 31, 2004 was \$2 million. There are no recourse provisions to recover any amounts from third parties.

*Other guarantees*

The Company, including certain of its subsidiaries, has granted irrevocable standby letters of credit and surety bonds, issued by highly rated financial institutions, to third parties to indemnify them in the event the Company does not perform its contractual obligations. As at December 31, 2004, the maximum potential liability under these guarantees was \$439 million of which \$359 million was for workers' compensation and other employee benefits and \$80 million was for equipment under leases and other.

## 19 Major commitments and contingencies (continued)

As at December 31, 2004, the Company had not recorded any additional liability with respect to these guarantees, as the Company does not expect to make any additional payments associated with these guarantees. The guarantee instruments mature at various dates between 2005 and 2007.

### *CN Pension Plan, CN 1935 Pension Plan and BC Rail Ltd Pension Plan*

The Company has indemnified and held harmless the current trustee and the former trustee of the Canadian National Railways Pension Trust Funds, the trustee of the BC Rail Ltd Pension Trust Fund, and the respective officers, directors, employees and agents of such trustees, from any and all taxes, claims, liabilities, damages, costs and expenses arising out of the performance of their obligations under the relevant trust agreements and trust deeds, including in respect of their reliance on authorized instructions of the Company or for failing to act in the absence of authorized instructions. These indemnifications survive the termination of such agreements or trust deeds. As at December 31, 2004, the Company had not recorded a liability associated with these indemnifications, as the Company does not expect to make any payments pertaining to these indemnifications.

### *General indemnifications*

In the normal course of business, the Company has provided indemnifications, customary for the type of transaction or for the railway business, in various agreements with third parties, including indemnification provisions where the Company would be required to indemnify third parties and others. Indemnifications are found in various types of contracts with third parties which include, but are not limited to, (a) contracts granting the Company the right to use or enter upon property owned by third parties such as leases, easements, trackage rights and sidetrack agreements; (b) contracts granting rights to others to use the Company's property, such as leases, licenses and easements; (c) contracts for the sale of assets and securitization of accounts receivable; (d) contracts for the acquisition of services; (e) financing agreements; (f) trust indentures, fiscal agency agreements, underwriting agreements or similar agreements relating to debt or equity securities of the Company and engagement agreements with financial advisors; (g) transfer agent and registrar agreements in respect of the Company's securities; (h) trust agreements relating to pension plans and other plans, including those establishing trust funds to secure payment to certain officers and senior employees of special retirement compensation arrangements (i) master agreements with financial institutions governing derivative transactions; and (j) settlement agreements with insurance companies or other third parties whereby such insurer or third party has been indemnified for any present or future claims relating to insurance policies, incidents or events covered by the settlement agreements. To the extent of any actual claims under these agreements, the Company maintains

provisions for such items, which it considers to be adequate. Due to the nature of the indemnification clauses, the maximum exposure for future payments may be material. However, such exposure cannot be determined with certainty.

In 2004 and 2003, the Company entered into various indemnification contracts with third parties for which the maximum exposure for future payments cannot be determined with certainty. As a result, the Company was unable to determine the fair value of these guarantees. For guarantees for which the fair value was estimable, it was determined to be \$1 million. There are no recourse provisions to recover any amounts from third parties.

## 20 Financial instruments

### A. Risk management

The Company has limited involvement with derivative financial instruments in the management of its fuel, foreign currency and interest rate exposures, and does not use them for trading purposes.

#### *(i) Credit risk*

In the normal course of business, the Company monitors the financial condition of its customers and reviews the credit history of each new customer.

The Company is exposed to credit risk in the event of non-performance by counterparties to its derivative financial instruments. Although collateral or other security to support financial instruments subject to credit risk is usually not obtained, counterparties are of high credit quality and their credit standing or that of their guarantor is regularly monitored. As a result, losses due to counterparty non-performance are not anticipated. The total risk associated with the Company's counterparties was immaterial at December 31, 2004. The Company believes there are no significant concentrations of credit risk.

#### *(ii) Fuel*

To mitigate the effects of fuel price changes on its operating margins and overall profitability, the Company has a systematic hedging program which calls for regularly entering into swap positions on crude and heating oil to cover a target percentage of future fuel consumption up to two years in advance. However, in the fourth quarter of 2004, the Company did not enter into any swap positions on crude and heating oil. At December 31, 2004, the Company had hedged approximately 50% of the estimated 2005 fuel consumption, representing approximately 203 million U.S. gallons at an average price of U.S.\$0.74 per U.S. gallon, and 17% of the estimated 2006 fuel consumption, representing 69 million U.S. gallons at an average price of U.S. \$0.89 per U.S. gallon.

## 20 Financial instruments (continued)

Realized gains from the Company's fuel hedging activities, which are recorded in fuel expense, were \$112 million, \$49 million, and \$3 million for the years ended December 31, 2004, 2003 and 2002, respectively.

As a result of fuel hedging activities, the Company had an unrealized gain of \$92 million at December 31, 2004 compared to an unrealized gain of \$38 million at December 31, 2003.

### (iii) Interest rate

In the first quarter of 2004, in anticipation of future debt issuances, the Company had entered into treasury lock transactions for a notional amount of U.S.\$380 million to fix the treasury component on these future debt issuances. Upon expiration in June 2004, these treasury rate locks were rolled into new contracts expiring in September 2004, at an average locked-in rate of 5.106%. The Company settled these treasury locks at a gain of U.S.\$9 million (Cdn\$12 million) upon the pricing of the U.S.\$500 million 6.25% Debentures due 2034, subsequently issued on July 9, 2004 and recorded the gain into income, as a reduction of interest expense.

### (iv) Foreign currency

Although the Company conducts its business and receives revenues primarily in Canadian dollars, a growing portion of its revenues, expenses, assets and debt are denominated in U.S. dollars. Thus, the Company's results are affected by fluctuations in the exchange rate between these currencies. Changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby affect the Company's revenues and expenses.

For the purpose of minimizing volatility of earnings resulting from the conversion of U.S. dollar denominated long-term debt into the Canadian dollar, the Company designates the U.S. dollar denominated long-term debt of the parent company as a foreign exchange hedge of its net investment in U.S. subsidiaries. As a result, from the dates of designation, unrealized foreign exchange gains and losses on the translation of the Company's U.S. dollar denominated long-term debt are recorded in Currency translation, which forms part of Shareholders' equity.

### (v) Other

The Company does not currently have any derivative instruments not designated as hedging instruments.

## B. Fair value of financial instruments

Generally accepted accounting principles define the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company uses the following methods and assumptions to estimate the fair value of each class of financial instruments for which the carrying amounts are included in the Consolidated Balance Sheet under the following captions:

(i) *Cash and cash equivalents, Accounts receivable, Other current assets, Accounts payable and accrued charges, and Other current liabilities:*

The carrying amounts approximate fair value because of the short maturity of these instruments.

(ii) *Other assets:*

Investments: The Company has various debt and equity investments for which the carrying value approximates the fair value, with the exception of a cost investment for which the fair value was estimated based on the Company's proportionate share of its net assets.

(iii) *Long-term debt:*

The fair value of the Company's long-term debt is estimated based on the quoted market prices for the same or similar debt instruments, as well as discounted cash flows using current interest rates for debt with similar terms, company rating, and remaining maturity.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments as at December 31, 2004 and 2003 for which the carrying values on the Consolidated Balance Sheet are different from their fair values:

<i>In millions</i>	<i>December 31, 2004</i>		<i>December 31, 2003</i>	
	<i>Carrying amount</i>	<i>Fair value</i>	<i>Carrying amount</i>	<i>Fair value</i>
<i>Financial assets</i>				
Investments	\$ 166	\$ 220	\$ 367	\$ 420
<i>Financial liabilities</i>				
Long-term debt (including current portion)	\$ 5,164	\$ 5,857	\$ 4,658	\$ 5,128

## 21 Reconciliation of Canadian and United States generally accepted accounting principles

The Consolidated financial statements of the Company are expressed in Canadian dollars and are prepared in accordance with Canadian GAAP which conform, in all material respects, with U.S. GAAP except as follows:

### A. Reconciliation of net income

The application of U.S. GAAP would have the following effects on the net income as reported:

<i>In millions</i>	<i>Year ended December 31,</i>		
	<b>2004</b>	2003	2002
<b>Net income – Canadian GAAP</b>	<b>\$ 1,297</b>	\$ 734	\$ 553
Adjustments in respect of:			
Property capitalization, net of depreciation	<b>(81)</b>	384	363
Stock-based compensation cost	<b>19</b>	27	9
Interest expense	<b>(12)</b>	-	-
Income tax rate enactments	<b>3</b>	(46)	-
Interest on convertible preferred securities	-	-	(9)
Income tax (expense) recovery on current year U.S. GAAP adjustments	<b>32</b>	(133)	(116)
Income before cumulative effect of change in accounting policy	<b>1,258</b>	966	800
Cumulative effect of change in accounting policy (net of applicable taxes)	-	48	-
<b>Net income – U.S. GAAP</b>	<b>\$ 1,258</b>	\$ 1,014	\$ 800

#### (i) Property capitalization

Effective January 1, 2004, the Company changed its capitalization policy under Canadian GAAP, on a prospective basis, to conform with the CICA Handbook Section 3061, "Properties, Plant and Equipment." The change was made in response to the CICA Handbook Section 1100, "Generally Accepted Accounting Principles," issued in July 2003, as explained in Note 2 – Accounting changes.

The Company's accounting for Properties under Canadian GAAP had been based on the rules and regulations of the Canadian Transportation Agency's (CTA) Uniform Classification of Accounts, which for railways in Canada, were considered Canadian GAAP prior to the issuance of Section 1100. Under the CTA rules, the Company capitalized only the material component of track replacement costs, to the extent it met the Company's minimum threshold for capitalization. In accordance with the CICA Handbook Section 3061, "Properties, Plant and Equipment," the Company now capitalizes the cost of labor, material and related overhead associated with track replacement activities provided they meet the Company's minimum threshold for capitalization. Also, all major expenditures for work that extends the useful life and/or improves the functionality of bridges, other structures and freight cars, are capitalized.

This change effectively harmonizes the Company's Canadian and U.S. GAAP capitalization policy. However, since the change was applied prospectively, there continues to be a difference in depreciation and amortization expense between Canadian and U.S. GAAP relating to the

difference in the amounts previously capitalized under Canadian and U.S. GAAP as at January 1, 2004.

#### (ii) Interest expense

In the first quarter of 2004, in anticipation of future debt issuances, the Company had entered into treasury lock transactions for a notional amount of U.S.\$380 million to fix the treasury component on these future debt issuances. Under U.S. GAAP, these derivatives were accounted for as cash flow hedges whereby the cumulative change in the market value of the derivative instruments was recorded in Other comprehensive loss. On July 9, 2004, upon the pricing and subsequent issuance of U.S.\$500 million 6.25% Debentures due 2034, the Company settled these treasury-rate locks and realized a gain of \$12 million. Under U.S. GAAP, this gain was recorded in Other comprehensive loss and will be amortized and recorded into income, as a reduction of interest expense, over the term of the debt based on the interest payment schedule. Under Canadian GAAP, this gain was recorded immediately into income, as a reduction of interest expense.

#### (iii) Stock-based compensation cost

As explained in Note 2, effective January 1, 2003, the Company adopted the fair value based approach of the CICA's Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments." The Company retroactively applied the fair value method of accounting to all awards of employee stock options granted,

## 21 Reconciliation of Canadian and United States generally accepted accounting principles (continued)

modified or settled on or after January 1, 2002 and restated the 2002 comparative period to reflect this change in accounting policy. Under U.S. GAAP, effective January 1, 2003, the Company voluntarily adopted the recommendations of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation," and applied the fair value based approach prospectively to all awards of employee stock options granted, modified or settled on or after January 1, 2003. Compensation cost attributable to employee stock options granted prior to January 1, 2003 continues to be a reconciling difference.

### (iv) Convertible preferred securities

As explained in Note 11, the Convertible preferred securities (Securities) were converted into common shares of the Company on July 3, 2002. Prior to such date, the Securities were treated as equity under Canadian GAAP, whereas under U.S. GAAP they were treated as debt. Consequently, the interest on the Securities until July 3, 2002 was treated as a dividend for Canadian GAAP but as interest expense for U.S. GAAP.

### (v) Income tax expense

The provincial and federal governments enact new corporate tax rates resulting in either lower or higher tax liabilities under both U.S. and Canadian GAAP. The difference in the deferred income tax expense or recovery recorded is a function of the net deferred income tax liability position, which is larger under U.S. GAAP due essentially to the difference in the property capitalization policy prior to 2004. In addition, under U.S. GAAP, the resulting deferred income tax expense or recovery is recorded when the rates are enacted, whereas under Canadian GAAP, when they are substantively enacted. In 2004, under U.S. GAAP, the Company recorded a decrease to its net deferred income tax liability of \$5 million resulting from the enactment of lower corporate tax rates in the province of Alberta, with the corresponding decrease of \$2 million under Canadian GAAP. In 2003, under U.S. GAAP, the Company recorded an increase to its net deferred income tax liability resulting from the enactment of higher corporate tax rates in the province of Ontario. As a result, the Company recorded deferred income tax expense of \$79 million and \$2 million in income and Other comprehensive loss, respectively. For Canadian GAAP, the corresponding increase to the net deferred income tax liability was \$33 million.

### (vi) Cumulative effect of change in accounting policy

In 2003, under U.S. GAAP, in accordance with SFAS No. 143, "Accounting for Asset Retirement Obligations," the Company changed its accounting policy for certain track structure assets to exclude removal costs as a component of depreciation expense where the inclusion of such costs would result in accumulated depreciation balances exceeding the historical cost basis of the assets. As a result, a cumulative benefit of \$75 million, or \$48 million after tax, was recorded for the amount of removal costs accrued in accumulated depreciation on certain track structure assets at January 1, 2003. Under Canadian GAAP, the recommendations of Handbook Section 3110, "Asset Retirement Obligations," which are similar to those under SFAS No. 143 (U.S. GAAP), were effective for the Company's fiscal year beginning January 1, 2004 and did not have an impact on the Canadian GAAP financial statements since removal costs, as a component of depreciation expense, have not resulted in accumulated depreciation balances exceeding the historical cost basis of the assets.

## B. Earnings per share

The earnings per share calculation under Canadian GAAP differs from U.S. GAAP essentially due to differences in the earnings figures:

### (i) Basic earnings per share

Year ended December 31,	2004	2003	2002
Income before cumulative effect of change in accounting policy - U.S. GAAP	\$ 4.41	\$ 3.38	\$ 2.71
Cumulative effect of change in accounting policy	-	0.16	-
<b>Net income - U.S. GAAP</b>	<b>\$ 4.41</b>	<b>\$ 3.54</b>	<b>\$ 2.71</b>
Weighted-average number of common shares outstanding (millions) - U.S. GAAP	285.1	286.8	295.0

### (ii) Diluted earnings per share

Year ended December 31,	2004	2003	2002
Income before cumulative effect of change in accounting policy - U.S. GAAP	\$ 4.34	\$ 3.33	\$ 2.65
Cumulative effect of change in accounting policy	-	0.16	-
<b>Net income - U.S. GAAP</b>	<b>\$ 4.34</b>	<b>\$ 3.49</b>	<b>\$ 2.65</b>
Weighted-average number of common shares outstanding (millions) - U.S. GAAP	289.9	290.7	304.2

**21** Reconciliation of Canadian and United States generally accepted accounting principles (*continued*)

## C. Reconciliation of significant balance sheet items

<i>In millions</i>	December 31 2004	December 31 2003
<b>Current assets - Canadian GAAP</b>	<b>\$ 1,654</b>	<b>\$ 1,092</b>
Derivative instruments	81	33
Deferred income taxes related to derivative instruments	(29)	-
Other	4	2
<b>Current assets - U.S. GAAP</b>	<b>\$ 1,710</b>	<b>\$ 1,127</b>
<b>Properties - Canadian GAAP</b>	<b>\$ 16,688</b>	<b>\$ 15,158</b>
Property capitalization, net of depreciation	2,952	3,072
Cumulative effect of change in accounting policy	75	75
<b>Properties - U.S. GAAP</b>	<b>\$ 19,715</b>	<b>\$ 18,305</b>
<b>Intangible and other assets - Canadian GAAP</b>	<b>\$ 929</b>	<b>\$ 900</b>
Derivative instruments	11	5
<b>Intangible and other assets - U.S. GAAP</b>	<b>\$ 940</b>	<b>\$ 905</b>
<b>Deferred income tax liability - Canadian GAAP</b>	<b>\$ 3,591</b>	<b>\$ 3,365</b>
Cumulative effect of prior years' adjustments to income	1,204	1,071
Income taxes on current year U.S. GAAP adjustments to income	(32)	133
Income taxes on cumulative effect of change in accounting policy	27	27
Income taxes on translation of Canadian to U.S. GAAP adjustments	(28)	(15)
Income taxes on minimum pension liability adjustment	(7)	(10)
Income taxes on derivative instruments	1	12
Income taxes on settlement of interest rate swaps recorded in Other comprehensive loss	4	-
Income tax rate enactments	(41)	(38)
Other	4	5
<b>Deferred income tax liability - U.S. GAAP</b>	<b>\$ 4,723</b>	<b>\$ 4,550</b>
<b>Other liabilities and deferred credits - Canadian GAAP</b>	<b>\$ 1,488</b>	<b>\$ 1,153</b>
Stock-based compensation	-	20
Minimum pension liability	22	30
Other	3	-
<b>Other liabilities and deferred credits - U.S. GAAP</b>	<b>\$ 1,513</b>	<b>\$ 1,203</b>

**21** Reconciliation of Canadian and United States generally accepted accounting principles (*continued*)

<i>In millions</i>	December 31 2004	December 31 2003
<b>Common shares - Canadian GAAP</b>	<b>\$ 3,587</b>	<b>\$ 3,530</b>
Capital reorganization	1,300	1,300
Stock-based compensation	18	17
Foreign exchange loss on convertible preferred securities	12	12
Costs related to the sale of shares	(33)	(33)
Share repurchase program	(178)	(162)
<b>Common shares - U.S. GAAP</b>	<b>\$ 4,706</b>	<b>\$ 4,664</b>
<b>Contributed surplus - Canadian GAAP</b>	<b>\$ 164</b>	<b>\$ 166</b>
Dividend in kind with respect to land transfers	248	248
Costs related to the sale of shares	33	33
Other transactions and related income tax effect	18	18
Share repurchase program	26	24
Capital reorganization	(489)	(489)
<b>Contributed surplus - U.S. GAAP</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Currency translation - Canadian GAAP</b>	<b>\$ (80)</b>	<b>\$ (38)</b>
Unrealized foreign exchange loss on translation of Canadian to U.S. GAAP adjustments, net of applicable taxes	(89)	(63)
Derivative instruments, net of applicable taxes	62	26
Unamortized gain on settlement of interest rate swaps, net of applicable taxes	8	-
Income tax rate enactments	(34)	(34)
Minimum pension liability adjustment, net of applicable taxes	(15)	(20)
<b>Accumulated other comprehensive loss - U.S. GAAP</b>	<b>\$ (148)</b>	<b>\$ (129)</b>
<b>Retained earnings - Canadian GAAP</b>	<b>\$ 3,676</b>	<b>\$ 2,822</b>
Cumulative effect of prior years' adjustments to income	1,928	1,696
Cumulative effect of change in accounting policy	48	48
Current year adjustments to net income	(39)	232
Share repurchase program	152	138
Cumulative dividend on convertible preferred securities	38	38
Capital reorganization	(811)	(811)
Dividend in kind with respect to land transfers	(248)	(248)
Other transactions and related income tax effect	(18)	(18)
<b>Retained earnings - U.S. GAAP</b>	<b>\$ 4,726</b>	<b>\$ 3,897</b>

*(i) Shareholders' equity*

As permitted under Canadian GAAP, the Company eliminated its accumulated deficit of \$811 million as of June 30, 1995 through a reduction of the capital stock in the amount of \$1,300 million, and created a contributed surplus of \$489 million. Such a reorganization within Shareholders' equity is not permitted under U.S. GAAP.

Under Canadian GAAP, the dividend in kind declared in 1995 (with respect to land transfers) and other capital transactions were deducted from Contributed surplus. For U.S. GAAP purposes, these amounts would have been deducted from Retained earnings.

Under Canadian GAAP, costs related to the sale of shares have been deducted from Contributed surplus. For U.S. GAAP purposes, these amounts would have been deducted from Common shares.

Under Canadian GAAP, the cost resulting from the repurchase of shares was allocated first to Common shares, then to Contributed

surplus and finally to Retained earnings. Under U.S. GAAP, the cost would have been allocated to Common shares followed by Retained earnings.

For Canadian and U.S. GAAP purposes, the Company designates the U.S. dollar denominated long-term debt of the parent company as a foreign exchange hedge of its net investment in U.S. subsidiaries. Under Canadian GAAP, the resulting net unrealized foreign exchange loss from the date of designation, has been included in Currency translation. For U.S. GAAP purposes, the resulting net unrealized foreign exchange loss has been included as part of Accumulated other comprehensive loss, a separate component of Shareholders' equity, as required under SFAS No. 130, "Reporting Comprehensive Income."

## 21 Reconciliation of Canadian and United States generally accepted accounting principles *(continued)*

### *(ii) Minimum pension liability adjustment*

At each measurement date, if the Company's pension plans have an accumulated benefit obligation in excess of the fair value of the plan assets, under U.S. GAAP, this gives rise to an additional minimum pension liability. As a result, an intangible asset is recognized up to the amount of the unrecognized prior service cost and the difference is recorded in Accumulated other comprehensive loss, a separate component of Shareholders' equity. There are no requirements under Canadian GAAP to record a minimum pension liability adjustment.

### *(iii) Derivative instruments*

Under U.S. GAAP, pursuant to SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," the Company records in its balance sheet the fair value of derivative instruments used in its hedging activities. Changes in the market value of these derivative instruments have been recorded in Accumulated other comprehensive loss, a separate component of Shareholders' equity. There are no similar requirements under Canadian GAAP.

### *(iv) Convertible preferred securities*

As explained in Note 11, the Convertible preferred securities (Securities) were converted into common shares of the Company on July 3, 2002. Prior to such date, the Securities were treated as equity under Canadian GAAP, whereas under U.S. GAAP they were treated as debt. Consequently, the initial costs related to the issuance of the Securities, net of amortization, which were previously deferred and amortized for U.S. GAAP, have since been reclassified to equity.

## 22 Comparative figures

Certain figures, previously reported for 2003 and 2002, have been reclassified to conform with the basis of presentation adopted in the current year.