

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 the United States. 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 Committee, consisting solely of outside directors. The Audit Committee reviews the Company's consolidated financial statements and management's discussion and analysis and recommends their approval by the Board of Directors. Also, the Audit 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 24, 2006

(s) *Serge Pharand*

Vice-President and Corporate Comptroller

January 24, 2006

Report of Independent Public Accounting Firm

To the Board of Directors and to the Shareholders of Canadian National Railway Company

We have audited the consolidated balance sheets of Canadian National Railway Company as at December 31, 2005 and 2004 and the consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2005. 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, 2005 and 2004, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2005, in accordance with generally accepted accounting principles in the United States.

(s) *KPMG LLP*

Chartered Accountants

Montreal, Canada

January 24, 2006

Consolidated Statement of Income

U.S. GAAP

<i>In millions, except per share data</i>	<i>Year ended December 31,</i>	2005	2004	2003
Revenues				
Petroleum and chemicals		\$ 1,096	\$ 1,059	\$ 1,013
Metals and minerals		837	714	527
Forest products		1,738	1,505	1,320
Coal		331	284	261
Grain and fertilizers		1,119	1,063	947
Intermodal		1,270	1,117	1,101
Automotive		514	510	525
Other items		335	296	190
Total revenues		7,240	6,548	5,884
Operating expenses				
Labor and fringe benefits		1,841	1,819	1,698
Purchased services and material		814	746	703
Depreciation and amortization		627	598	554
Fuel		725	528	469
Equipment rents		192	244	293
Casualty and other		417	445	390
Total operating expenses		4,616	4,380	4,107
Operating income		2,624	2,168	1,777
Interest expense		(299)	(294)	(315)
Other income (loss) (Note 14)		12	(20)	21
Income before income taxes and cumulative effect of change in accounting policy		2,337	1,854	1,483
Income tax expense (Note 15)		(781)	(596)	(517)
Income before cumulative effect of change in accounting policy		1,556	1,258	966
Cumulative effect of change in accounting policy (net of applicable taxes) (Note 2)		-	-	48
Net income		\$ 1,556	\$ 1,258	\$ 1,014
Basic earnings per share (Note 17)				
Income before cumulative effect of change in accounting policy		\$ 5.64	\$ 4.41	\$ 3.38
Net income		\$ 5.64	\$ 4.41	\$ 3.54
Diluted earnings per share (Note 17)				
Income before cumulative effect of change in accounting policy		\$ 5.54	\$ 4.34	\$ 3.33
Net income		\$ 5.54	\$ 4.34	\$ 3.49

See accompanying notes to consolidated financial statements.

Consolidated Statement of Comprehensive Income

U.S. GAAP

<i>In millions</i>	<i>Year ended December 31,</i>		
	2005	2004	2003
Net income	\$ 1,556	\$ 1,258	\$ 1,014
Other comprehensive income (loss) (Note 20) :			
Unrealized foreign exchange gain on translation of U.S. dollar-denominated long-term debt designated as a hedge of the net investment in U.S. subsidiaries	152	326	754
Unrealized foreign exchange loss on translation of the net investment in foreign operations	(233)	(428)	(1,101)
Increase (decrease) in unrealized holding gains on fuel derivative instruments (Note 19)	(35)	54	8
Realized gain on settlement of interest rate swaps (Note 19)	-	12	-
Minimum pension liability adjustment (Note 13)	4	8	7
Other comprehensive loss before income taxes	(112)	(28)	(332)
Income tax recovery on other comprehensive loss	38	9	106
Other comprehensive loss	(74)	(19)	(226)
Comprehensive income	\$ 1,482	\$ 1,239	\$ 788

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheet

U.S. GAAP

<i>In millions</i>	<i>December 31,</i>	2005	2004
Assets			
Current assets:			
Cash and cash equivalents	\$	62	\$ 147
Accounts receivable (Note 4)		623	793
Material and supplies		151	127
Deferred income taxes (Note 15)		65	364
Other		248	279
		1,149	1,710
Properties (Note 5)		20,078	19,715
Intangible and other assets (Note 6)		961	940
Total assets	\$	22,188	\$ 22,365
Liabilities and shareholders' equity			
Current liabilities:			
Accounts payable and accrued charges (Note 8)	\$	1,478	\$ 1,605
Current portion of long-term debt (Note 10)		408	578
Other		72	76
		1,958	2,259
Deferred income taxes (Note 15)		4,817	4,723
Other liabilities and deferred credits (Note 9)		1,487	1,513
Long-term debt (Note 10)		4,677	4,586
Shareholders' equity:			
Common shares (Note 11)		4,580	4,706
Accumulated other comprehensive loss (Note 20)		(222)	(148)
Retained earnings		4,891	4,726
		9,249	9,284
Total liabilities and shareholders' equity	\$	22,188	\$ 22,365

On behalf of the Board:

David G.A. McLean
Director

E. Hunter Harrison
Director

See accompanying notes to consolidated financial statements.

Consolidated Statement of Changes in Shareholders' Equity

U.S. GAAP

<i>In millions</i>	Issued and outstanding common shares	Common shares	Accumulated other comprehensive income (loss)	Retained earnings	Total shareholders' equity
<i>Balances December 31, 2002</i>	296.3	\$ 4,785	\$ 97	\$ 3,487	\$ 8,369
Net income	-	-	-	1,014	1,014
Stock options exercised and other (Notes 11, 12)	2.9	122	-	-	122
Share repurchase program (Note 11)	(15.0)	(243)	-	(413)	(656)
Other comprehensive loss (Note 20)	-	-	(226)	-	(226)
Dividends (\$0.67 per share)	-	-	-	(191)	(191)
<i>Balances December 31, 2003</i>	<u>284.2</u>	<u>4,664</u>	<u>(129)</u>	<u>3,897</u>	<u>8,432</u>
Net income	-	-	-	1,258	1,258
Stock options exercised and other (Notes 11, 12)	2.9	108	-	-	108
Share repurchase program (Note 11)	(4.0)	(66)	-	(207)	(273)
Other comprehensive loss (Note 20)	-	-	(19)	-	(19)
Dividends (\$0.78 per share)	-	-	-	(222)	(222)
<i>Balances December 31, 2004</i>	<u>283.1</u>	<u>4,706</u>	<u>(148)</u>	<u>4,726</u>	<u>9,284</u>
Net income	-	-	-	1,556	1,556
Stock options exercised and other (Notes 11, 12)	3.3	176	-	-	176
Share repurchase programs (Note 11)	(18.0)	(302)	-	(1,116)	(1,418)
Other comprehensive loss (Note 20)	-	-	(74)	-	(74)
Dividends (\$1.00 per share)	-	-	-	(275)	(275)
<i>Balances December 31, 2005</i>	<u>268.4</u>	<u>\$ 4,580</u>	<u>\$ (222)</u>	<u>\$ 4,891</u>	<u>\$ 9,249</u>

See accompanying notes to consolidated financial statements.

Consolidated Statement of Cash Flows

U.S. GAAP

<i>In millions</i>	<i>Year ended December 31,</i>		
	2005	2004	2003
Operating activities			
Net income	\$ 1,556	\$ 1,258	\$ 1,014
Adjustments to reconcile net income to net cash provided from operating activities:			
Depreciation and amortization	630	602	560
Deferred income taxes (Note 15)	547	366	411
Equity in earnings of English Welsh and Scottish Railway (Note 14)	(4)	4	(17)
Cumulative effect of change in accounting policy (Note 2)	-	-	(48)
Other changes in:			
Accounts receivable	142	(233)	153
Material and supplies	(25)	10	(3)
Accounts payable and accrued charges	(156)	5	(96)
Other net current assets and liabilities	8	21	(29)
Other	7	106	31
Cash provided from operating activities	2,705	2,139	1,976
Investing activities			
Net additions to properties	(1,180)	(1,072)	(1,043)
Acquisition of BC Rail (Note 3)	-	(984)	-
Acquisition of GLT (Note 3)	-	(547)	-
Other, net	105	192	(32)
Cash used by investing activities	(1,075)	(2,411)	(1,075)
Dividends paid	(275)	(222)	(191)
Financing activities			
Issuance of long-term debt	2,728	8,277	4,109
Reduction of long-term debt	(2,865)	(7,579)	(4,141)
Issuance of common shares (Note 11)	115	86	83
Repurchase of common shares (Note 11)	(1,418)	(273)	(656)
Cash provided from (used by) financing activities	(1,440)	511	(605)
Net increase (decrease) in cash and cash equivalents	(85)	17	105
Cash and cash equivalents, beginning of year	147	130	25
Cash and cash equivalents, end of year	\$ 62	\$ 147	\$ 130
Supplemental cash flow information			
Net cash receipts from customers and other	\$ 7,375	\$ 6,501	\$ 6,022
Net cash payments for:			
Employee services, suppliers and other expenses	(3,872)	(3,628)	(3,262)
Interest	(306)	(282)	(325)
Workforce reductions (Note 9)	(87)	(93)	(155)
Personal injury and other claims (Note 18)	(92)	(106)	(126)
Pensions (Note 13)	(127)	(161)	(92)
Income taxes (Note 15)	(186)	(92)	(86)
Cash provided from operating activities	\$ 2,705	\$ 2,139	\$ 1,976

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 the United States (U.S. GAAP). Significant differences between the accounting principles applied in the accompanying financial statements and those under Canadian generally accepted accounting principles (Canadian 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 Other comprehensive income (loss) (Note 20).

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 Other comprehensive income (loss).

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. Major overhauls and large refurbishments are also capitalized when they result in an extension to the useful life or increase the functionality of the asset. 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 significant line abandonments 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.....	6%

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 and occupational disease claims, based on actuarial estimates of their ultimate cost.

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 occur 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 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. Derivative instruments are recorded on the balance sheet at fair value and the changes in fair value are recorded in earnings or Other comprehensive income (loss) depending on the nature and effectiveness of the hedge transaction. 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 had prospectively applied this method of accounting to all awards granted, modified or settled on or after January 1, 2003, as explained in Note 2 – Accounting changes. The Company follows the intrinsic value method for cash settled awards.

Prior to 2003, compensation cost was recorded for the intrinsic value of the Company's performance-based stock option awards and no compensation cost was recognized for the Company's conventional awards, in accordance with Accounting Principles Board Opinion (APB) 25, "Accounting for Stock Issued to Employees," and related interpretations. If compensation cost had been determined based upon fair values at the date of grant for awards under all plans, the Company's pro forma net income and earnings per share would have been as follows:

Year ended December 31,	2005	2004	2003
Net income, as reported (<i>in millions</i>)	\$ 1,556	\$ 1,258	\$ 1,014
Add (deduct) compensation cost, net of applicable taxes, determined under:			
Fair value method for all awards granted after Jan. 1, 2003 (SFAS No. 123)	86	38	10
Intrinsic value method for performance-based awards granted prior to 2003 (APB 25)	-	9	13
Fair value method for all awards (SFAS No. 123)	(110)	(78)	(53)
Pro forma net income (<i>in millions</i>)	\$ 1,532	\$ 1,227	\$ 984
Basic earnings per share, as reported	\$ 5.64	\$ 4.41	\$ 3.54
Basic earnings per share, pro forma	\$ 5.55	\$ 4.30	\$ 3.43
Diluted earnings per share, as reported	\$ 5.54	\$ 4.34	\$ 3.49
Diluted earnings per share, pro forma	\$ 5.45	\$ 4.23	\$ 3.39

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,	2005	2004 ⁽¹⁾	2003
Expected option life (<i>years</i>)	5.2	-	5.0
Risk-free interest rate	3.5%	-	4.12%
Expected stock price volatility	25%	-	30%
Average dividend per share	\$ 1.00	-	\$ 0.67

Year ended December 31,	2005	2004 ⁽¹⁾	2003
Weighted average fair value of options granted	\$ 18.38	\$ -	\$ 11.88

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

Q. Recent accounting pronouncement

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment," which requires expensing of all options issued, modified or settled based on the grant-date fair value, over the period during which an employee is required to provide service (vesting period). The standard also requires that cash settled awards be measured at fair value at each reporting date until ultimate settlement. In April 2005, the U.S. Securities and Exchange Commission extended the effective application date of this standard from interim or annual reporting periods beginning after June 15, 2005 to annual reporting periods beginning after December 15, 2005. The Company has elected to apply the modified prospective approach, which requires compensation cost to be recognized for unvested awards based on their grant-date fair value. The Company does not expect this standard to have a significant impact on its results of operations.

2 Accounting changes

2005

Conditional asset retirement obligations

Effective December 31, 2005, the Company adopted the recommendations of FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations – an interpretation of FASB Statement No. 143." The Interpretation clarifies that an obligation to perform an asset retirement activity exists, even if there may be uncertainty about the timing and/or method of settlement. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation when incurred, generally upon acquisition, construction, or development and/or through the normal operation of the asset, if the fair value of the liability can be reasonably estimated. This standard had no impact on the Company's financial statements.

2003

Asset retirement obligations

Effective January 1, 2003, the Company adopted the recommendations of SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires that the fair value of an asset retirement obligation be recorded as a liability only when there is a legal obligation associated with a removal activity. The Company has concluded that no legal obligation exists for substantially all of its asset classes that have removal programs. In accordance with SFAS No. 143, 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. This change in policy results in lower depreciation expense and higher labor and fringe benefits and other expenses in the period in which removal costs are incurred. For the year ended December 31, 2003, this change in policy resulted in an increase to net income of \$2 million (\$0.01 per basic and diluted share).

Stock-based compensation

Effective January 1, 2003, the Company voluntarily adopted the fair value based approach of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." The Company elected to prospectively apply this method of accounting to all stock option awards granted, modified or settled on or after January 1, 2003, as permitted by SFAS No. 148. Prior to 2003, the Company accounted for stock-based compensation in accordance with APB 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, compensation cost was recorded for the intrinsic value of

the Company's performance-based stock option awards and no compensation cost was recognized for the Company's conventional awards.

In 2003, the Company granted 3.0 million stock options, which will be expensed over their vesting period based on their estimated fair value on the date of grant, determined using the Black-Scholes option-pricing model. For the year ended December 31, 2003, the Company recorded compensation cost of \$23 million, of which \$10 million (\$0.03 per basic and diluted share) was related to the change in policy.

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, to acquire all the issued and outstanding shares of the former 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 SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." 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.

3 Acquisitions (continued)

The Company had estimated, on a preliminary basis, the fair value of BC Rail's assets acquired, owned and leased, and liabilities assumed at acquisition based on then current available information. The Company has since finalized the allocation of the purchase price and has not made any significant adjustments. The following table reflects the fair values of BC Rail's assets acquired, owned and leased, and liabilities assumed at acquisition:

<i>In millions</i>	
Current assets	\$ 200
Deferred income taxes	399
Properties	597
Other assets	3
Total assets acquired	1,199
Current liabilities	76
Other liabilities and deferred credits	119
Long-term debt	13
Total liabilities assumed	208
Net assets acquired	\$ 991

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 Company had estimated, on a preliminary basis, the fair value of GLT's assets acquired and liabilities assumed at acquisition based on then current available information. The Company has since finalized the allocation of the purchase price and has not made any significant adjustments. The following table reflects the fair values of GLT's assets acquired and liabilities assumed at acquisition:

<i>In millions</i>	
Current assets	\$ 67
Properties	980
Intangible and other assets	87
Total assets acquired	1,134
Current liabilities	64
Deferred income taxes	286
Other liabilities and deferred credits	237
Total liabilities assumed	587
Net assets acquired	\$ 547

If the Company had acquired BC Rail and GLT on January 1, 2003, based on their respective historical amounts, net of the amortization of the difference between the Company's cost to acquire BC Rail and GLT and their respective net assets (based on the fair values of BC Rail's and GLT's assets and liabilities), revenues, income before cumulative effect of change in accounting policy, net income, basic and diluted earnings per share for the years ended December 31, 2004 and 2003 would have been as follows:

<i>In millions, except per share data</i>	Year ended December 31,	
	2004	2003
Revenues	\$ 6,773	\$ 6,428
Income before cumulative effect of change in accounting policy	\$ 1,272	\$ 1,026
Net income	\$ 1,272	\$ 1,077
Basic earnings per share		
Income before cumulative effect of change in accounting policy	\$ 4.46	\$ 3.58
Net income	\$ 4.46	\$ 3.76
Diluted earnings per share		
Income before cumulative effect of change in accounting policy	\$ 4.39	\$ 3.53
Net income	\$ 4.39	\$ 3.70

The pro forma figures for both BC Rail and GLT do not reflect synergies, and accordingly, do not account for any potential increases in operating income, any estimated cost savings or facilities consolidation.

4 Accounts receivable

<i>In millions</i>	<i>December 31,</i>	2005	2004
Freight			
Trade		\$ 330	\$ 414
Accrued		26	93
Non-freight		347	356
		<u>703</u>	<u>863</u>
Provision for doubtful accounts		(80)	(70)
		<u>\$ 623</u>	<u>\$ 793</u>

The Company has an accounts receivable securitization program, expiring in June 2006, under which it may sell, on a revolving basis, a

maximum of \$500 million (\$450 million prior to February 2005) 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 (loss) included \$16 million in 2005 and \$9 million in each of 2004 and 2003, for costs related to the agreement, which fluctuate with changes in prevailing interest rates.

At December 31, 2005, pursuant to the agreement, \$489 million had been sold compared to \$445 million at December 31, 2004.

5 Properties

<i>In millions</i>	<i>December 31, 2005</i>			<i>December 31, 2004</i>		
	Cost	Accumulated depreciation	Net	Cost	Accumulated depreciation	Net
Track, roadway and land	\$ 21,792	\$ 6,388	\$ 15,404	\$ 21,524	\$ 6,300	\$ 15,224
Rolling stock	4,581	1,642	2,939	4,336	1,549	2,787
Buildings	1,878	724	1,154	2,009	877	1,132
Other	1,174	593	581	1,078	506	572
	<u>\$ 29,425</u>	<u>\$ 9,347</u>	<u>\$ 20,078</u>	<u>\$ 28,947</u>	<u>\$ 9,232</u>	<u>\$ 19,715</u>

Capital leases included in properties

Track and roadway	\$ 451	\$ 16	\$ 435	\$ 395	\$ 5	\$ 390
Rolling stock	1,348	279	1,069	1,155	241	914
Buildings	57	8	49	113	7	106
Other	144	24	120	119	9	110
	<u>\$ 2,000</u>	<u>\$ 327</u>	<u>\$ 1,673</u>	<u>\$ 1,782</u>	<u>\$ 262</u>	<u>\$ 1,520</u>

6 Intangible and other assets

<i>In millions</i>	<i>December 31,</i>	2005	2004
Prepaid benefit cost (Note 13)		\$ 621	\$ 515
Investments (A)		132	166
Deferred receivables		102	77
Intangible assets (B)		66	69
Note receivable from EWS		-	57
Unamortized debt issue costs		31	35
Other		9	21
		<u>\$ 961</u>	<u>\$ 940</u>

A. Investments

As at December 31, 2005, the Company had \$124 million (\$157 million at December 31, 2004) of investments accounted for under the equity method and \$8 million (\$9 million at December 31, 2004) of investments accounted for under the cost method.

Investment in English Welsh and Scottish Railway (EWS)

As at December 31, 2005, the Company owned approximately 32% of the outstanding shares of EWS, a company that 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, 2005, 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.

6 Intangible and other assets (continued)

In January 2004, EWS shareholders had 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 in exchange for 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 an 8% note receivable due 2009 of £23.9 million (Cdn\$58 million) from EWS. In April 2005, EWS fully redeemed the Company's note receivable. The Company received £26 million (Cdn\$61 million), which included principal and accrued but unpaid interest to the date of redemption.

B. Intangible assets

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

7 Credit facility

In March 2005, the Company refinanced, by way of amendment, its U.S.\$1,000 million revolving credit facility, which was scheduled to mature in December 2005, for a five-year period to March 2010. The credit facility is available for general corporate purposes, including backstopping the Company's commercial paper program, and 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 amended credit facility agreement retained one financial covenant, the customary limitation on debt as a percentage of total capitalization, with which the Company has been in compliance. The Company's borrowings under its previous revolving credit facility of U.S.\$90 million (Cdn\$108 million) outstanding at December 31, 2004 (average interest rate of 2.77%) were entirely repaid in the first quarter of 2005. At December 31, 2005, the Company had borrowings under its revolving credit facility of U.S.\$15 million (Cdn\$17 million) at an interest rate of 4.66% and letters of credit drawn of \$316 million.

The Company's commercial paper program is backed by a portion of its revolving credit facility. As at December 31, 2005, the Company had U.S.\$367 million (Cdn\$427 million) of commercial paper outstanding at an average interest rate of 4.40%, and U.S.\$211 million (Cdn\$254 million) at an average rate of 2.37%, as at December 31, 2004.

8 Accounts payable and accrued charges

<i>In millions</i>	<i>December 31,</i>		2005	2004
Trade payables	\$	475	\$	491
Income and other taxes		261		310
Accrued charges		226		179
Payroll-related accruals		207		259
Personal injury and other claims provision		115		118
Accrued interest		101		106
Workforce reduction provisions		49		90
Other		44		52
		<u>\$</u>	<u>\$</u>	<u>1,605</u>
		1,478		1,605

9 Other liabilities and deferred credits

<i>In millions</i>	<i>December 31,</i>		2005	2004
Personal injury and other claims provision, net of current portion	\$	542	\$	524
Accrual for post-retirement benefits other than pensions (A)		289		284
Accrued benefit cost for pensions (Note 13)		150		156
Environmental reserve, net of current portion		99		93
Workforce reduction provisions, net of current portion (B)		93		149
Additional minimum pension liability (Note 13)		18		22
Deferred credits and other		296		285
		<u>\$</u>	<u>\$</u>	<u>1,513</u>
		1,487		1,513

A. Post-retirement benefits other than pensions

(i) Change in benefit obligation

<i>In millions</i>	<i>Year ended December 31,</i>		2005	2004
Benefit obligation at beginning of year	\$	319	\$	309
Acquisition of GLT and BC Rail		-		151
Amendments		(4)		(12)
Transfer from other plan		8		-
Actuarial gain		(20)		(111)
Interest cost		19		17
Service cost		5		8
Foreign currency changes		(8)		(25)
Benefits paid		(19)		(18)
Benefit obligation at end of year	\$	300	\$	319

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

9 Other liabilities and deferred credits (continued)*(ii) Funded status*

<i>In millions</i>	<i>December 31,</i>	2005	2004
Unfunded benefit obligation at end of year		\$ 300	\$ 319
Unrecognized net actuarial gain		24	6
Unrecognized prior service cost		(11)	(16)
<i>Accrued benefit cost for post-retirement benefits other than pensions (including current portion)</i>		\$ 313	\$ 309

(iii) Components of net periodic benefit cost

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004	2003
Interest cost		\$ 19	\$ 17	\$ 18
Service cost		5	8	5
Amortization of prior service cost		1	3	3
Recognized net actuarial (gain) loss		(1)	1	7
<i>Net periodic benefit cost</i>		\$ 24	\$ 29	\$ 33

(iv) Weighted-average assumptions

	<i>December 31,</i>	2005	2004	2003
<i>To determine benefit obligation</i>				
Discount rate		5.30%	5.90%	6.00%
Rate of compensation increase		3.75%	3.75%	3.75%
<i>To determine net periodic benefit cost</i>				
Discount rate		5.90%	6.00%	6.69%
Rate of compensation increase		3.75%	3.75%	4.00%

(v) For measurement purposes, increases in the per capita cost of covered health care benefits were assumed to be 13% for 2006 and 14% for 2005. 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	25	(22)

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 FASB Staff Position 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003," 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>	
2006	\$ 16
2007	17
2008	18
2009	19
2010	19
Years 2011 to 2015	110

B. 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 2005, net charges and adjustments decreased the provisions by \$10 million. In 2004, liabilities assumed through acquisitions and other charges and adjustments had increased the provisions by \$107 million. Payments have reduced the provisions by \$87 million for the year ended December 31, 2005 (\$93 million for the year ended December 31, 2004). As at December 31, 2005, the aggregate provisions, including the current portion, amounted to \$142 million (\$239 million as at December 31, 2004).

10 Long-term debt

<i>In millions</i>	Maturity	Currency in which payable	<i>December 31,</i>	
			2005	2004
<i>Debentures and notes: (A)</i>				
Canadian National series:				
6.45% Puttable Reset Securities (PURS) (B)	July 15, 2006	U.S.\$	\$ 291	\$ 301
4.25% 5-year notes (C)	Aug. 1, 2009	U.S.\$	349	361
6.38% 10-year notes (C)	Oct. 15, 2011	U.S.\$	465	482
4.40% 10-year notes (C)	Mar. 15, 2013	U.S.\$	465	482
6.80% 20-year notes (C)	July 15, 2018	U.S.\$	233	241
7.63% 30-year debentures	May 15, 2023	U.S.\$	174	181
6.90% 30-year notes (C)	July 15, 2028	U.S.\$	552	572
7.38% 30-year debentures (C)	Oct. 15, 2031	U.S.\$	233	241
6.25% 30-year notes (C)	Aug. 1, 2034	U.S.\$	582	602
Illinois Central series:				
7.75% 10-year notes	May 1, 2005	U.S.\$	-	120
6.98% 12-year notes	July 12, 2007	U.S.\$	58	60
6.63% 10-year notes	June 9, 2008	U.S.\$	23	24
5.00% 99-year income debentures	Dec. 1, 2056	U.S.\$	9	9
7.70% 100-year debentures	Sept. 15, 2096	U.S.\$	145	151
Wisconsin Central series:				
6.63% 10-year notes	April 15, 2008	U.S.\$	174	181
			3,753	4,008
BC Rail series:				
Non-interest bearing 90-year subordinated notes (D)	July 14, 2094	CDN\$	842	843
<i>Total debentures and notes</i>			4,595	4,851
<i>Other:</i>				
Revolving credit facility (A) (Note 7)		U.S.\$	17	108
Commercial paper (E) (Note 7)		U.S.\$	427	254
Capital lease obligations and other (F)		Various	897	805
<i>Total other</i>			1,341	1,167
			5,936	6,018
<i>Less:</i>				
Current portion of long-term debt			408	578
Net unamortized discount			851	854
			1,259	1,432
			\$ 4,677	\$ 4,586

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 \$6 million, using an imputed interest rate of 5.75%. The discount of \$836 million is included in the net unamortized discount.

E. The Company has a commercial paper program, which is backed by a portion of 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. Commercial paper debt is due within one year but is 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. At December 31, 2004, the amounts outstanding under both the revolving credit facility and the commercial paper program were presented as short-term debt given the anticipated maturity in December 2005 of the revolving credit facility. In March 2005, the Company refinanced by way of amendment, its revolving credit facility, for a five-year period to March 2010.

F. Interest rates for capital leases range from approximately 3.00% to 13.13% with maturity dates in the years 2006 through 2025. The imputed interest on these leases amounted to \$360 million as at December 31, 2005 and \$342 million as at December 31, 2004.

The capital lease obligations are secured by properties with a net carrying amount of \$1,243 million as at December 31, 2005 and \$1,080 million as at December 31, 2004.

During 2005, the Company recorded \$222 million in assets it acquired through equipment leases (\$160 million in 2004), for which 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, 2005, for the next five years and thereafter, are as follows:

<i>In millions</i>	
2006	\$ 408
2007	169
2008	238
2009	429
2010	467
2011 and thereafter	3,374

H. The aggregate amount of debt payable in U.S. currency as at December 31, 2005 was U.S.\$4,169 million (Cdn\$4,849 million) and U.S.\$4,022 million (Cdn\$4,845 million) as at December 31, 2004.

11 Capital stock

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 2005, the Company issued 3.3 million shares (2.9 million shares in both 2004 and 2003) related to stock options exercised. The total number of common shares issued and outstanding was 268.4 million as at December 31, 2005.

C. Share repurchase programs

In July 2005, the Board of Directors of the Company approved a share repurchase program which allows for the repurchase of up to 16.0 million common shares between July 25, 2005 and July 24, 2006 pursuant to a normal course issuer bid, at prevailing market prices. As at December 31, 2005, 8.0 million common shares had been repurchased for \$670 million, at an average price of \$83.81 per share.

The Company's previous share repurchase program, initiated in 2004, allowed 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. By the second quarter of 2005, the Company had completed this share repurchase program, repurchasing 14.0 million common shares for \$1,021 million, at an average price of \$72.94 per share (10.0 million and 4.0 million in 2005 and 2004, respectively).

In October 2003, the Company completed its 19.5 million share repurchase program at a total cost of \$859 million, and an average price of \$44.04 per share (15.0 million and 4.5 million shares in 2003 and 2002, respectively).

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.

12 Stock plans (continued)

Participation at December 31, 2005 was 11,010 employees (10,073 at December 31, 2004 and 8,894 at December 31, 2003). The total number of ESIP shares purchased on behalf of employees, including the Company's contributions, was 0.8 million in 2005, 0.7 million in 2004 and 0.9 million in 2003, resulting in a pre-tax charge to income of \$12 million, \$11 million and \$8 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Stock-based plans

Compensation cost for awards under all stock-based plans was \$120 million, \$65 million and \$23 million for the years ended December 31, 2005, 2004 and 2003, respectively.

A. Restricted share units

The Company has granted restricted share units (RSUs), 0.4 million in 2005 and 1.2 million in 2004, 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, 2007 for the 2005 grant and December 31, 2006 for the 2004 grant. The 2004 grant was subject to accelerated payout if specified targets related to the Company's 20-day average share price were attained during the period ending December 31, 2005. Given that these targets were met, vesting of the 2004 grant was accelerated and increased to its maximum allowable amount under the plan, resulting in a payout of \$105 million. Of this amount, \$41 million was converted into deferred share units (see section C) at December 31, 2005, and the remaining payout of \$64 million will be paid in cash in January 2006. For the years ended December 31, 2005 and 2004, the Company recorded compensation cost of \$89 million and \$36 million, respectively, for RSUs. As at December 31, 2005, the Company had approximately 0.6 million RSUs outstanding.

B. Mid-term incentive share unit plan

The 2001 mid-term incentive share unit plan 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.

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). 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. For each participant, the Company will grant a further 25% of the amount elected in DSUs, which will vest over a period of 4 years. The election to receive eligible incentive payments in DSUs is no longer available to a participant when the value of the participant's vested DSUs is sufficient to meet the Company's stock ownership guidelines. The value of each participant's DSUs is payable in cash at the time of cessation of employment.

At December 31, 2005, the total liability under the VIDP was \$83 million (\$22 million at December 31, 2004), representing 1.0 million units outstanding (0.4 million units in 2004) under the plan, which includes the deferred share units related to the 2004 RSU grant as discussed herein. For the years ended December 31, 2005 and 2004, the Company recognized an expense of \$13 million and \$7 million, respectively, 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, 2005, 8.1 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, 2005 were 7.4 million, 0.5 million and 2.6 million, respectively.

12 Stock plans (continued)

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

	Number of options <i>In millions</i>	Weighted- average exercise price
<i>Outstanding at December 31, 2002</i> ⁽¹⁾	16.7	\$35.67
Granted	3.0	\$40.95
Canceled and expired	(0.6)	\$45.11
Exercised	<u>(2.9)</u>	\$26.60
<i>Outstanding at December 31, 2003</i> ⁽¹⁾	16.2	\$37.16
Granted	-	-
Canceled and expired	(0.2)	\$42.58
Exercised	<u>(2.9)</u>	\$28.70
<i>Outstanding at December 31, 2004</i> ⁽¹⁾	13.1	\$38.85
Granted	0.7	\$69.84
Canceled and expired	-	-
Exercised	<u>(3.3)</u>	\$35.14
<i>Outstanding at December 31, 2005</i> ⁽¹⁾	10.5	\$41.91

(1) Stock options with a U.S. dollar exercise price have been translated to Canadian dollars using the foreign exchange rate in effect at the balance sheet date.

Stock options outstanding and exercisable as at December 31, 2005 were as follows:

Range of exercise prices	Options outstanding			Options exercisable	
	Number of options <i>In millions</i>	Weighted- average years to expiration	Weighted- average exercise price	Number of options <i>In millions</i>	Weighted- average exercise price
\$12.35–\$23.34	1.0	3	\$21.43	1.0	\$21.43
\$23.69–\$29.51	0.7	3	\$26.05	0.7	\$26.05
\$30.23–\$39.67	1.9	5	\$33.17	1.9	\$33.17
\$40.54–\$49.21	2.7	7	\$41.00	1.8	\$41.03
\$51.05–\$56.41	3.5	6	\$51.19	2.4	\$51.20
\$67.88–\$94.25	<u>0.7</u>	9	\$69.83	-	-
<i>Balance at December 31, 2005</i> ⁽¹⁾	10.5	6	\$41.91	7.8	\$38.35

(1) Stock options with a U.S. dollar exercise price have been translated to Canadian dollars using the foreign exchange rate in effect at the balance sheet date.

At December 31, 2004 and 2003, the Company had 8.2 million and 7.5 million options exercisable at a weighted-average exercise price of \$35.55 and \$31.39, respectively.

Compensation cost for awards of employee stock options granted, modified or settled on or after January 1, 2003 was determined using the fair value based approach in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure," as explained in Note 2 – Accounting changes. Prior to 2003, compensation cost was recorded for the intrinsic value of the Company's performance-based stock option awards and no compensation cost was recognized for the Company's conventional

stock option awards, in accordance with APB 25, "Accounting for Stock Issued to Employees," and related interpretations. Compensation cost recognized for stock option awards was \$18 million, \$9 million and \$16 million in 2005, 2004 and 2003, respectively. Disclosures required under the fair value measurement and recognition method for awards under all plans, as prescribed by SFAS No. 123, "Accounting for Stock-Based Compensation," as well as the assumptions used to calculate compensation cost related to stock option awards are presented in Note 1 – Summary of significant accounting policies.

12 Stock plans (continued)

E. Vision 2008 Share Unit Plan

In the first quarter of 2005, the Board of Directors of the Company approved a special share unit plan with a four-year term to December 31, 2008, entitling designated senior management employees to receive cash payout in January 2009. The Company granted 0.4 million share units which vest conditionally upon the attainment of targets relating to the Company's share price during the six-month period ending December 31, 2008. Payout is conditional upon the attainment of targets relating to return on invested capital over the four-year period and to the Company's share price during the 20-day period ending on December 31, 2008. The award payout will be equal to the number of share units vested on December 31, 2008 multiplied by the Company's 20-day average share price ending on such date. Due to the nature of the vesting conditions, no compensation cost was recorded for the year ended December 31, 2005. As at December 31, 2005, 0.1 million share units remained authorized for future issuance under this plan.

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 Plan), unless otherwise specified.

Description of the Plan

The 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 Plan and the related legislation. The Company utilizes a measurement date of December 31 for the Plan.

Funding policy

Employee contributions to the 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 Plan was conducted as at December 31, 2004 and indicated a funding excess. Total contributions for all of the Company's pension plans are expected to be approximately \$100 million in each of 2006, 2007 and 2008 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 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 Plan have a fair market value of \$14,069 million as at December 31, 2005 (\$12,256 million at December 31, 2004). The Plan's target percentage allocation and weighted-average asset allocations as at December 31, 2005 and 2004, by asset category are as follows:

Plan assets by category	Target Allocation	December 31,	
		2005	2004
Equity securities	53%	56%	56%
Debt securities	40%	32%	34%
Real estate	4%	2%	3%
Other	3%	10%	7%
	100%	100%	100%

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 Plan does not invest in the securities of the Company or its subsidiaries.

13 Pensions (continued)**Weighted-average assumptions**

<i>December 31,</i>	2005	2004	2003
<i>To determine benefit obligation</i>			
Discount rate	5.00%	5.75%	6.00%
Rate of compensation increase	3.75%	3.75%	3.75%
<i>To determine net periodic benefit cost</i>			
Discount rate	5.75%	6.00%	6.50%
Rate of compensation increase	3.75%	3.75%	4.00%
Expected return on plan assets	8.00%	8.00%	8.00%

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**

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004
Benefit obligation at beginning of year	\$ 13,137	\$ 12,020	
Amendments	(3)	-	
Acquisition of GLT and BC Rail	-	684	
Interest cost	742	733	
Actuarial loss	1,234	349	
Service cost	138	124	
Plan participants' contributions	58	55	
Foreign currency changes	(11)	(23)	
Benefit payments and transfers	(949)	(805)	
<i>Benefit obligation at end of year</i>	\$ 14,346	\$ 13,137	

(b) Change in plan assets

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004
Fair value of plan assets at beginning of year	\$ 13,053	\$ 11,671	
Acquisition of GLT and BC Rail	-	611	
Employer contributions	127	165	
Plan participants' contributions	58	55	
Foreign currency changes	(8)	(15)	
Actual return on plan assets	2,593	1,371	
Benefit payments and transfers	(949)	(805)	
<i>Fair value of plan assets at end of year</i>	\$ 14,874	\$ 13,053	

(c) Funded status

<i>In millions</i>	<i>December 31,</i>	2005	2004
Excess (deficiency) of fair value of plan assets over benefit obligation at end of year ⁽¹⁾	\$ 528	\$ (84)	
Unrecognized net actuarial (gain) loss ⁽¹⁾	(111)	368	
Unrecognized prior service cost	54	75	
<i>Net amount recognized</i>	\$ 471	\$ 359	

⁽¹⁾ 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>	2005	2004
Prepaid benefit cost (Note 6)	\$ 621	\$ 515	
Accrued benefit cost (Note 9)	(150)	(156)	
Additional minimum pension liability (Note 9)	(18)	(22)	
Accumulated other comprehensive loss (Note 20)	18	22	
<i>Net amount recognized</i>	\$ 471	\$ 359	

(e) Additional information

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004	2003
Adjustment to minimum pension liability as a component of Other comprehensive income (loss)	\$ 4	\$ 8	\$ 7	

The accumulated benefit obligation for all defined benefit pension plans was \$13,584 million and \$12,450 million at December 31, 2005 and 2004, respectively. The projected benefit obligation, accumulated benefit obligation, and fair value of plan assets for the pension plan with an accumulated benefit obligation in excess of plan assets were \$104 million, \$96 million, and \$87 million, respectively, as at December 31, 2005, and \$98 million, \$93 million, and \$86 million, respectively, as at December 31, 2004.

(f) Components of net periodic benefit cost

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004	2003
Service cost	\$ 138	\$ 124	\$ 103	
Interest cost	742	733	720	
Amortization of net transition obligation	-	-	19	
Amortization of prior service cost	18	19	22	
Expected return on plan assets	(884)	(857)	(819)	
Recognized net actuarial loss	3	3	4	
<i>Net periodic benefit cost</i>	\$ 17	\$ 22	\$ 49	

13 Pensions (continued)

(g) 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>	
2006	\$ 821
2007	844
2008	868
2009	893
2010	916
Years 2011 to 2015	4,918

14 Other income (loss)

<i>In millions</i>	<i>Year ended December 31,</i>		
	2005	2004	2003
Gain on disposal of properties	\$ 26	\$ 32	\$ 56
Equity in earnings of English Welsh and Scottish Railway (Note 6)	4	(4)	17
Investment income	3	5	1
Foreign exchange gain (loss)	12	(2)	(3)
Net real estate costs	(12)	(18)	(19)
Other	(21)	(33)	(31)
	\$ 12	\$ (20)	\$ 21

15 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>		
	2005	2004	2003
Federal tax rate	22.1%	22.1%	24.1%
Income tax expense at the statutory Federal tax rate	\$ (516)	\$ (410)	\$ (358)
Income tax (expense) recovery resulting from:			
Provincial and other taxes	(331)	(263)	(199)
Deferred income tax adjustments due to rate enactments	(14)	5	(79)
Gain on disposals and dividends	5	10	11
Adjustments to prior years' income taxes ⁽¹⁾	16	11	44
Other	59	51	64
Income tax expense	\$ (781)	\$ (596)	\$ (517)
Cash payments for income taxes	\$ 186	\$ 92	\$ 86

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

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

<i>In millions</i>	<i>Year ended December 31,</i>		
	2005	2004	2003
Income before income taxes ⁽¹⁾			
Canada	\$ 1,769	\$ 1,501	\$ 1,322
U.S.	568	353	161
	\$ 2,337	\$ 1,854	\$ 1,483
Current income taxes			
Canada	\$ (95)	\$ (222)	\$ (94)
U.S.	(139)	(8)	(12)
	\$ (234)	\$ (230)	\$ (106)
Deferred income taxes			
Canada	\$ (488)	\$ (244)	\$ (377)
U.S.	(59)	(122)	(34)
	\$ (547)	\$ (366)	\$ (411)

⁽¹⁾ Before cumulative effect of change in accounting policy for 2003.

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

<i>In millions</i>	<i>December 31,</i>	
	2005	2004
Deferred income tax assets		
Workforce reduction provisions	\$ 51	\$ 86
Personal injury claims and other reserves	234	197
Post-retirement benefits	117	115
Losses and tax credit carryforwards	9	278
	411	676
Deferred income tax liabilities		
Net prepaid benefit cost for pensions	168	121
Properties and other	4,995	4,914
	5,163	5,035
Total net deferred income tax liability	\$ 4,752	\$ 4,359
Total net deferred income tax liability		
Canada	\$ 1,802	\$ 1,349
U.S.	2,950	3,010
	\$ 4,752	\$ 4,359
Total net deferred income tax liability	\$ 4,752	\$ 4,359
Net current deferred income tax asset	65	364
Long-term deferred income tax liability	\$ 4,817	\$ 4,723

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, 2005, the Company had no operating loss carryforwards available for future use (\$794 million of operating loss carryforwards at December 31, 2004).

The Company recognized tax credits of \$4 million in 2005 for eligible research and development expenditures (\$4 million in 2004 and \$15 million in 2003) not previously recognized, which reduced the cost of properties.

16 Segmented information

The Company manages its rail operations as one business segment over a single network that spans vast geographic distances and territories, with operations in Canada and the United States. Financial information reported at this level, such as revenues, operating income, operating ratio and cash flow from operations, is used by corporate management, including the Company's chief operating decision-maker, in evaluating financial and operational performance and allocating resources across CN's network.

The Company's strategic initiatives, which drive its operational direction, are developed and managed centrally by corporate management and are communicated to its regional activity centers (the Western Canada, Eastern Canada and U.S. regions). Corporate management is responsible for, among others, CN's marketing strategy, the management of large customer accounts, overall planning and control of infrastructure and rolling stock, the allocation of resources, and other functions such as financial planning, accounting and treasury.

The role of each region is to manage the day-to-day service requirements within its territory, service small customer accounts within its region, and control direct costs incurred locally. Such cost control is required to ensure that pre-established efficiency standards set at the corporate level are met. The regions execute the overall corporate strategy and operating plan established by corporate management, as their management of throughput and control of direct costs does not serve as the platform for the Company's decision-making process. Approximately 85% of the Company's freight revenues are from national accounts for which freight traffic spans North America and touches various commodity groups. As a result, the Company does not manage revenues on a regional basis since a large number of the movements originate in one region and pass through and/or terminate in another region.

The regions also demonstrate common characteristics in each of the following areas:

- (i) Each region's sole business activity is the transportation of freight over the Company's extensive rail network;
- (ii) The regions service national accounts that extend over the Company's various commodity groups and across its rail network;
- (iii) The services offered by the Company stem predominately from the transportation of freight by rail with the goal of optimizing the rail network as a whole;
- (iv) The Company and its subsidiaries, not its regions, are subject to one regulatory regime in both Canada and the U.S.

For the reasons mentioned herein, the Company reports as one operating segment.

The following tables provide information by geographic area:

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004	2003
Revenues				
Canada		\$ 4,660	\$ 4,126	\$ 3,707
U.S.		2,580	2,422	2,177
		<u>\$ 7,240</u>	<u>\$ 6,548</u>	<u>\$ 5,884</u>

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004	2003
Net income				
Canada		\$ 1,186	\$ 1,035	\$ 888
U.S.		370	223	126
		<u>\$ 1,556</u>	<u>\$ 1,258</u>	<u>\$ 1,014</u>

<i>In millions</i>	<i>December 31,</i>	2005	2004
Properties			
Canada		\$ 10,457	\$ 9,945
U.S.		9,621	9,770
		<u>\$ 20,078</u>	<u>\$ 19,715</u>

17 Earnings per share

	<i>Year ended December 31,</i>	2005	2004	2003
Basic earnings per share				
Income before cumulative effect of change in accounting policy		\$ 5.64	\$ 4.41	\$ 3.38
Cumulative effect of change in accounting policy		-	-	0.16
Net income		<u>\$ 5.64</u>	<u>\$ 4.41</u>	<u>\$ 3.54</u>
Diluted earnings per share				
Income before cumulative effect of change in accounting policy		\$ 5.54	\$ 4.34	\$ 3.33
Cumulative effect of change in accounting policy		-	-	0.16
Net income		<u>\$ 5.54</u>	<u>\$ 4.34</u>	<u>\$ 3.49</u>

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

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004	2003
Net income		\$ 1,556	\$ 1,258	\$ 1,014
Weighted-average shares outstanding		275.8	285.1	286.8
Effect of stock options		5.3	4.8	3.9
Weighted-average diluted shares outstanding		<u>281.1</u>	<u>289.9</u>	<u>290.7</u>

For the year ended December 31, 2003, 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 6.0 million.

18 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, 2005, the Company's commitments under operating and capital leases were \$1,058 million and \$1,231 million, respectively. Minimum lease payments in each of the next five years and thereafter are as follows:

<i>In millions</i>	Operating	Capital
2006	\$ 238	\$ 159
2007	196	154
2008	165	71
2009	136	113
2010	103	54
2011 and thereafter	220	680
	<u>\$ 1,058</u>	<u>1,231</u>
Less: imputed interest on capital leases at rates ranging from approximately 3.00% to 13.13%		<u>360</u>
Present value of minimum lease payments included in debt		<u>\$ 871</u>

Rent expense for operating leases was \$233 million, \$242 million and \$230 million for the years ended December 31, 2005, 2004 and 2003, respectively. Contingent rentals and sublease rentals were not significant.

B. Other commitments

As at December 31, 2005, the Company had commitments to acquire railroad ties, rail, freight cars, locomotives and other equipment at an aggregate cost of \$578 million. Furthermore, as at December 31, 2005, the Company had outstanding information technology service contracts of \$18 million and agreements with fuel suppliers to purchase approximately 57% of its anticipated 2006 volume and 12% 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.

At December 31, 2005, 2004 and 2003, the Company's provision for personal injury and other claims in Canada was as follows:

<i>In millions</i>	2005	2004	2003
Balance January 1,	\$ 204	\$ 169	\$ 183
Accruals and other	46	64	25
Payments	(45)	(29)	(39)
Balance December 31,	<u>\$ 205</u>	<u>\$ 204</u>	<u>\$ 169</u>

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 liability 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 and unasserted occupational disease claims, based on actuarial estimates of their ultimate cost. Prior to 2005, the Company's provisions for unasserted occupational disease claims constituted the minimum amount that could be reasonably estimated, reflecting a 25-year horizon as the Company expected that a large majority of the cases would be received over such period. In 2005, changes in the legislative and judicial environment, as well as in the methodology used by the courts and the Company to diagnose claims, enabled the Company to actuarially determine a best estimate for unasserted occupational disease claims, thereby increasing the expected number of claims to be received. These changes have also rendered the recent claim experience to be more representative of future anticipated settlements for asserted occupational disease claims, thereby reducing the average cost per claim. Accordingly, the Company recorded an increase in the provision for unasserted occupational disease claims, which was substantially offset by a reduction in the provision for asserted occupational disease claims.

Due to the inherent uncertainty involved in projecting future events related to occupational diseases, which include but are not limited to, the number of expected claims, the average cost per claim and the legislative and judicial environment, the Company's future obligations may differ from current amounts recorded.

18 Major commitments and contingencies (continued)

At December 31, 2005, 2004 and 2003, the Company's provision for U.S. personal injury and other claims was as follows:

<i>In millions</i>	2005	2004	2003
Balance January 1,	\$ 438	\$ 421	\$ 481
Accruals and other	61	94	27
Payments	(47)	(77)	(87)
Balance December 31,	\$ 452	\$ 438	\$ 421

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, 2005, 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 numerous federal, provincial, state, municipal and local environmental laws and regulations in Canada and the United States 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.

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 2005, the Company recorded a liability related to a derailment at Wabamun Lake, Alberta. The liability, which is mostly short-term, is based on current facts and circumstances and represents clean-up costs for the shoreline, fronting residences and First Nations Land. The Company's insurance policies are expected to cover substantially all expenses related to the derailment above the self-insured retention. Accordingly, the Company has recorded a receivable for estimated recoveries from the Company's insurance carriers. Third quarter expenses included approximately \$28 million, of which \$25 million was for environmental matters, related to this derailment, which represents the Company's retention under its insurance policies and other uninsured costs. The ultimate liability for clean-up costs could differ from the current amount recorded, but such a change is expected to be offset by a corresponding change in the insurance receivable. The Company expects its insurance coverage to be adequate to cover any additional clean-up costs related to the derailment above its self-insured retention.

In 2005, the Company's expenses relating to environmental matters, net of recoveries, were \$34 million (\$10 million in 2004 and \$6 million in 2003). Payments for such matters were \$24 million, net of potential insurance recoveries for 2005 (\$8 million in 2004 and \$12 million in 2003). As at December 31, 2005, the Company had aggregate accruals for environmental costs of \$124 million (\$113 million as at December 31, 2004). The Company anticipates that the majority of the liability at December 31, 2005 will be paid out over the next five years.

18 Major commitments and contingencies (continued)

In addition, related environmental capital expenditures were \$11 million in 2005, \$13 million in 2004 and \$23 million in 2003. The Company expects to incur capital expenditures relating to environmental matters of approximately \$18 million in 2006, \$13 million in 2007 and \$12 million in 2008.

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 and other 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 recognize a liability for the fair value of the 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 2006 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, 2005, the maximum exposure in respect of these guarantees was \$93 million, of which \$9 million has been recorded. Of that amount, \$7 million represents the expected cash outlay for such guarantees, while the remaining \$2 million represents the Company's obligation to stand ready and honor the guarantees that were entered into subsequent to January 1, 2003. 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 and other 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, 2005, the maximum potential liability under these guarantees was \$467 million of which \$375 million was for workers' compensation and other employee benefits and \$92 million was for equipment under leases and other. During 2005, the Company granted guarantees for which no liability has been recorded, as they relate to the Company's future performance.

As at December 31, 2005, 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 2006 and 2010.

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, 2005, 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 and other 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) pension transfer agreements, (j) master agreements with financial institutions governing derivative transactions; and (k) 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

18 Major commitments and contingencies (continued)

clauses, the maximum exposure for future payments may be material. However, such exposure cannot be determined with certainty.

The Company has 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 and accordingly, no liability was recorded. As at December 31, 2005, the carrying value for guarantees for which the Company was able to determine the fair value, was \$1 million. There are no recourse provisions to recover any amounts from third parties.

19 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, 2005. 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 hedging program which calls for 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, with an increased application of fuel surcharge on revenues, no additional swap positions were entered into since September 2004 and the Company has now suspended this program. At December 31, 2005, the Company's remaining hedge positions covered approximately 17% of the estimated 2006 fuel consumption, representing approximately 69 million U.S. gallons at an average price of U.S.\$0.89 per U.S. gallon.

The changes in the fair value of the swap positions are highly correlated to changes in the price of fuel and therefore, these fuel hedges are being accounted for as cash flow hedges, whereby the

effective portion of the cumulative change in the market value of the derivative instruments has been recorded in Accumulated other comprehensive loss. The amounts in Accumulated other comprehensive loss will be reclassified into income upon the ultimate consumption of the hedged fuel. To the extent that the cumulative change in the fair value of the swap positions does not offset the cumulative change in the price of fuel, the ineffective portion of the hedge will be recognized into income immediately. In the event that the fuel hedge is discontinued and the forecasted purchase of fuel is not expected to occur, the amount in Accumulated other comprehensive loss would be reclassified into income immediately.

Realized gains from the Company's fuel hedging activities, which are recorded in fuel expense, were \$177 million, \$112 million, and \$49 million for the years ended December 31, 2005, 2004 and 2003, respectively.

At December 31, 2005, Accumulated other comprehensive loss included unrealized gains of \$57 million, \$39 million after tax (\$92 million, \$62 million after tax at December 31, 2004), which relate to derivative instruments that will mature within the next year and are presented in Other current assets. The Company did not recognize any material gains or losses in 2005, 2004 and 2003 due to hedge ineffectiveness as the Company's derivative instruments have been highly effective in hedging the changes in cash flows associated with forecasted purchases of diesel fuel.

(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. 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. 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. The realized gain of \$12 million accumulated in other comprehensive income (loss) is being recorded into income, as a reduction of interest expense, over the term of the debt based on the interest payment schedule.

At December 31, 2005, Accumulated other comprehensive loss included an unamortized gain of \$12 million, \$8 million after tax (\$12 million, \$8 million after tax at December 31, 2004).

(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 is 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

19 Financial instruments (continued)

world marketplace and thereby further 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 Accumulated other comprehensive loss.

(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, 2005 and 2004 for which the carrying values on the Consolidated Balance Sheet are different from their fair values:

<i>In millions</i>	<i>December 31, 2005</i>		<i>December 31, 2004</i>	
	<i>Carrying amount</i>	<i>Fair value</i>	<i>Carrying amount</i>	<i>Fair value</i>
<i>Financial assets</i>				
Investments	\$ 132	\$ 185	\$ 166	\$ 220
<i>Financial liabilities</i>				
Long-term debt (including current portion)	\$ 5,085	\$ 5,751	\$ 5,164	\$ 5,857

20 Other comprehensive income (loss)

A. Components of Other comprehensive income (loss) and the related tax effects are as follows:

<i>In millions</i>	<i>Year ended December 31, 2005</i>		
	<i>Before tax amount</i>	<i>Income tax (expense) recovery</i>	<i>Net of tax amount</i>
Unrealized foreign exchange gain on translation of U.S. dollar-denominated long-term debt designated as a hedge of the net investment in U.S. subsidiaries	\$ 152	\$ (52)	\$ 100
Unrealized foreign exchange loss on translation of the net investment in foreign operations	(233)	79	(154)
Decrease in unrealized holding gains on fuel derivative instruments (Note 19)	(35)	12	(23)
Minimum pension liability adjustment (Note 13)	4	(1)	3
<i>Other comprehensive loss</i>	<i>\$ (112)</i>	<i>\$ 38</i>	<i>\$ (74)</i>

<i>In millions</i>	<i>Year ended December 31, 2004</i>		
	<i>Before tax amount</i>	<i>Income tax (expense) recovery</i>	<i>Net of tax amount</i>
Unrealized foreign exchange gain on translation of U.S. dollar-denominated long-term debt designated as a hedge of the net investment in U.S. subsidiaries	\$ 326	\$ (106)	\$ 220
Unrealized foreign exchange loss on translation of the net investment in foreign operations	(428)	140	(288)
Unrealized holding gains on fuel derivative instruments (Note 19)	54	(18)	36
Realized gain on settlement of interest rate swaps (Note 19)	12	(4)	8
Minimum pension liability adjustment (Note 13)	8	(3)	5
<i>Other comprehensive loss</i>	<i>\$ (28)</i>	<i>\$ 9</i>	<i>\$ (19)</i>

20 Other comprehensive income (loss) (continued)

<i>In millions</i>	<i>Year ended December 31, 2003</i>		
	Before tax amount	Income tax (expense) recovery	Net of tax amount
Unrealized foreign exchange gain on translation of U.S. dollar-denominated long-term debt designated as a hedge of the net investment in U.S. subsidiaries	\$ 754	\$ (245)	\$ 509
Unrealized foreign exchange loss on translation of the net investment in foreign operations	(1,101)	358	(743)
Unrealized holding gains on fuel derivative instruments (Note 19)	8	(2)	6
Minimum pension liability adjustment (Note 13)	7	(3)	4
Deferred income tax (DIT) rate enactment	-	(2)	(2)
Other comprehensive loss	\$ (332)	\$ 106	\$ (226)

B. Changes in the balances of each classification within Accumulated other comprehensive income (loss) are as follows:

<i>In millions</i>	Foreign exchange - U.S.\$ debt	Foreign Net investment in foreign operations	Increase (decrease) in unrealized holding gains on fuel derivative instruments	Realized gain on settlement of interest rate swaps	Minimum pension liability adjustment	DIT rate enactment	Accumulated other comprehensive income (loss)
Balance at December 31, 2002	\$ (187)	\$ 320	\$ 20	\$ -	\$ (24)	\$ (32)	\$ 97
Period change	509	(743)	6	-	4	(2)	(226)
Balance at December 31, 2003	322	(423)	26	-	(20)	(34)	(129)
Period change	220	(288)	36	8	5	-	(19)
Balance at December 31, 2004	542	(711)	62	8	(15)	(34)	(148)
Period change	100	(154)	(23)	-	3	-	(74)
Balance at December 31, 2005	\$ 642	\$ (865)	\$ 39	\$ 8	\$ (12)	\$ (34)	\$ (222)

21 Reconciliation of United States and Canadian generally accepted accounting principles

The Consolidated financial statements of the Company prepared in accordance with Canadian GAAP are provided below along with a tabular reconciliation and discussion of the significant differences between U.S. and Canadian GAAP.

A. Canadian GAAP financial statements**CONSOLIDATED STATEMENT OF INCOME**

<i>In millions, except per share data</i>	<i>Year ended December 31,</i>		
	2005	2004	2003
Revenues	\$ 7,240	\$ 6,548	\$ 5,884
Operating expenses			
Labor and fringe benefits	1,873	1,838	1,929
Purchased services and material	814	746	879
Depreciation and amortization	510	517	472
Fuel	725	528	471
Equipment rents	192	244	299
Casualty and other	417	445	466
Total operating expenses	4,531	4,318	4,516
Operating income	2,709	2,230	1,368
Interest expense	(299)	(282)	(317)
Other income (loss)	12	(20)	21
Income before income taxes	2,422	1,928	1,072
Income tax expense	(819)	(631)	(338)
Net income	\$ 1,603	\$ 1,297	\$ 734
Earnings per share			
Basic	\$ 5.81	\$ 4.55	\$ 2.56
Diluted	\$ 5.71	\$ 4.48	\$ 2.52
Weighted-average number of shares			
Basic	275.8	285.1	286.8
Diluted	280.9	289.6	290.7

21 Reconciliation of United States and Canadian generally accepted accounting principles *(continued)*A. Canadian GAAP financial statements *(continued)***CONSOLIDATED BALANCE SHEET**

<i>In millions</i>	<i>December 31,</i>	2005	2004
Assets			
Current assets:			
Cash and cash equivalents	\$	62	\$ 147
Accounts receivable		623	793
Material and supplies		151	127
Deferred income taxes		85	393
Other		188	194
		1,109	1,654
Properties		17,187	16,688
Intangible and other assets		961	929
Total assets	\$	19,257	\$ 19,271
Liabilities and shareholders' equity			
Current liabilities:			
Accounts payable and accrued charges	\$	1,478	\$ 1,605
Current portion of long-term debt		408	578
Other		72	76
		1,958	2,259
Deferred income taxes		3,731	3,591
Other liabilities and deferred credits		1,466	1,488
Long-term debt		4,677	4,586
Shareholders' equity:			
Common shares		3,562	3,587
Contributed surplus		154	164
Currency translation		(120)	(80)
Retained earnings		3,829	3,676
		7,425	7,347
Total liabilities and shareholders' equity	\$	19,257	\$ 19,271

21 Reconciliation of United States and Canadian generally accepted accounting principles (*continued*)A. Canadian GAAP financial statements (*continued*)**CONSOLIDATED STATEMENT OF CASH FLOWS**

<i>In millions</i>	<i>Year ended December 31,</i>		
	2005	2004	2003
Operating activities			
Net income	\$ 1,603	\$ 1,297	\$ 734
Adjustments to reconcile net income to net cash provided from operating activities:			
Depreciation and amortization	513	521	478
Deferred income taxes	585	401	232
Equity in earnings of English Welsh and Scottish Railway	(4)	4	(17)
Other changes in:			
Accounts receivable	142	(233)	153
Material and supplies	(25)	10	(3)
Accounts payable and accrued charges	(156)	5	(96)
Other net current assets and liabilities	8	21	(27)
Other	39	113	46
Cash provided from operating activities	2,705	2,139	1,500
Investing activities			
Net additions to properties	(1,180)	(1,072)	(583)
Acquisition of BC Rail	-	(984)	-
Acquisition of GLT	-	(547)	-
Other, net	105	192	(16)
Cash used by investing activities	(1,075)	(2,411)	(599)
Dividends paid	(275)	(222)	(191)
Financing activities			
Issuance of long-term debt	2,728	8,277	4,109
Reduction of long-term debt	(2,865)	(7,579)	(4,141)
Issuance of common shares	115	86	83
Repurchase of common shares	(1,418)	(273)	(656)
Cash provided from (used by) financing activities	(1,440)	511	(605)
Net increase (decrease) in cash and cash equivalents	(85)	17	105
Cash and cash equivalents, beginning of year	147	130	25
Cash and cash equivalents, end of year	\$ 62	\$ 147	\$ 130

21 Reconciliation of United States and Canadian generally accepted accounting principles (*continued*)**B. Reconciliation and discussion of significant differences between U.S. and Canadian GAAP***(i) Reconciliation of net income*

The application of Canadian GAAP would have the following effects on the net income as reported:

<i>In millions</i>	<i>Year ended December 31,</i>	2005	2004	2003
Net income – U.S. GAAP		\$ 1,556	\$ 1,258	\$ 1,014
Adjustments in respect of:				
Depreciation and amortization on difference in properties		117	81	(384)
Stock-based compensation cost		(32)	(19)	(27)
Interest expense		-	12	-
Income tax rate enactments		2	(3)	46
Income tax (expense) recovery on current year Canadian GAAP adjustments		(40)	(32)	133
Income before cumulative effect of change in accounting policy		1,603	1,297	782
Cumulative effect of change in accounting policy (net of applicable taxes)		-	-	(48)
Net income – Canadian GAAP		\$ 1,603	\$ 1,297	\$ 734

(ii) Reconciliation of significant balance sheet items

The application of Canadian GAAP would have the following effects on the balance sheet as reported:

<i>In millions</i>	<i>December 31,</i>	2005	2004
Current assets - U.S. GAAP		\$ 1,149	\$ 1,710
Derivative instruments		(57)	(81)
Deferred income taxes related to derivative instruments		18	29
Other		(1)	(4)
Current assets - Canadian GAAP		\$ 1,109	\$ 1,654
Properties - U.S. GAAP		\$ 20,078	\$ 19,715
Property capitalization, net of depreciation		(2,816)	(2,952)
Cumulative effect of change in accounting policy		(75)	(75)
Properties - Canadian GAAP		\$ 17,187	\$ 16,688
Intangible and other assets - U.S. GAAP		\$ 961	\$ 940
Derivative instruments		-	(11)
Intangible and other assets - Canadian GAAP		\$ 961	\$ 929
Deferred income tax liability - U.S. GAAP		\$ 4,817	\$ 4,723
Cumulative effect of prior years' adjustments to income		(1,172)	(1,204)
Income taxes on current year Canadian GAAP adjustments to income		40	32
Income taxes on cumulative effect of change in accounting policy		(27)	(27)
Income taxes on translation of U.S. to Canadian GAAP adjustments		33	28
Income taxes on minimum pension liability adjustment		6	7
Income taxes on derivative instruments		-	(1)
Income taxes on settlement of interest rate swaps recorded in Other comprehensive loss		(4)	(4)
Income tax rate enactments		39	41
Other		(1)	(4)
Deferred income tax liability - Canadian GAAP		\$ 3,731	\$ 3,591

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

(ii) Reconciliation of significant balance sheet items (continued)

<i>In millions</i>	<i>December 31,</i>	
	2005	2004
Other liabilities and deferred credits - U.S. GAAP	\$ 1,487	\$ 1,513
Minimum pension liability	(18)	(22)
Other	(3)	(3)
Other liabilities and deferred credits - Canadian GAAP	\$ 1,466	\$ 1,488
Common shares - U.S. GAAP	\$ 4,580	\$ 4,706
Capital reorganization	(1,300)	(1,300)
Stock-based compensation	14	(18)
Foreign exchange loss on convertible preferred securities	(12)	(12)
Costs related to the sale of shares	33	33
Share repurchase programs	247	178
Common shares - Canadian GAAP	\$ 3,562	\$ 3,587
Contributed surplus - U.S. GAAP	\$ -	\$ -
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 programs	(36)	(26)
Capital reorganization	489	489
Contributed surplus - Canadian GAAP	\$ 154	\$ 164
Accumulated other comprehensive loss - U.S. GAAP	\$ (222)	\$ (148)
Unrealized foreign exchange loss on translation of U.S. to Canadian GAAP adjustments, net of applicable taxes	103	89
Derivative instruments, net of applicable taxes	(39)	(62)
Unamortized gain on settlement of interest rate swaps, net of applicable taxes	(8)	(8)
Income tax rate enactments	34	34
Minimum pension liability adjustment, net of applicable taxes	12	15
Currency translation - Canadian GAAP	\$ (120)	\$ (80)
Retained earnings - U.S. GAAP	\$ 4,891	\$ 4,726
Cumulative effect of prior years' adjustments to income	(1,889)	(1,928)
Cumulative effect of change in accounting policy	(48)	(48)
Current year adjustments to net income	47	39
Share repurchase programs	(211)	(152)
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
Retained earnings - Canadian GAAP	\$ 3,829	\$ 3,676

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

(iii) Reconciliation of cash flow items

For the years ended December 31, 2005 and 2004, cash provided from (used by) operating, investing and financing activities presented under U.S. and Canadian GAAP were the same.

For the year ended December 31, 2003, cash provided from operating activities and cash used by investing activities under Canadian GAAP, would decrease by the same amount, \$476 million, when compared to U.S. GAAP, due to the difference in the Company's property capitalization policies that existed prior to January 1, 2004 as discussed herein. Cash used by financing activities presented under U.S. and Canadian GAAP were the same.

(iv) Discussion of the significant differences between U.S. and Canadian GAAP

Property capitalization

Effective January 1, 2004, the Company changed its capitalization policy under Canadian GAAP, on a prospective basis, to conform to 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.

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 amounts capitalized under Canadian and U.S. GAAP as at January 1, 2004.

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.

Income taxes

The provincial, federal and state 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 2005, under U.S. GAAP, the Company recorded an increase to its net deferred income tax liability of \$14 million resulting from the net impact of higher enacted corporate tax rates in certain Canadian provinces, with the corresponding increase of \$12 million under Canadian GAAP. 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.

Stock-based compensation cost

As explained in Note 2, effective January 1, 2003, the Company voluntarily adopted the recommendations of 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.

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

Under Canadian GAAP, 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, modified or settled on or after January 1, 2002. Compensation cost attributable to employee stock options granted prior to January 1, 2003 continues to be a reconciling difference.

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. Effective for the Company's fiscal year beginning after October 1, 2006, Canadian GAAP will conform to the U.S. GAAP standard.

Minimum pension liability adjustment

Under U.S. GAAP 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, this would give rise to an additional minimum pension liability. As a result, an intangible asset is recognized to the extent 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.

Convertible preferred securities

In July 2002, the Convertible preferred securities (Securities) of the Company were converted into common shares. 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. Also, the interest on the Securities until July 2002 was treated as a dividend for Canadian GAAP but as interest expense for U.S. GAAP.

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

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

Under U.S. GAAP, the cost resulting from the repurchase of shares have been allocated to Common shares followed by Retained earnings. Under Canadian GAAP, the cost was allocated first to Common shares, then to Contributed surplus and finally to 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 U.S. GAAP, 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." For Canadian GAAP purposes, the resulting net unrealized foreign exchange loss from the date of designation, has been included in Currency translation. Effective for the Company's fiscal year beginning after October 1, 2006, Canadian GAAP will conform to the U.S. GAAP standard.

Cumulative effect of change in accounting policy

As explained in Note 2, 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 the CICA Handbook Section 3110, "Asset Retirement Obligations," which are similar to those under SFAS No. 143, 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.

22 Subsequent event

Common stock split

On January 24, 2006, the Board of Directors of the Company approved a two-for-one common stock split which is to be effected in the form of a stock dividend of one additional common share of CN for each share outstanding, payable on February 28, 2006, to shareholders of record on February 22, 2006. All equity-based benefit plans and the current share repurchase program will be adjusted to reflect the issuance of additional shares or options due to the declaration of the stock split. All share and per share data for future periods will reflect the stock split.

23 Comparative figures

Certain figures, previously reported for 2004 and 2003, have been reclassified to conform with the basis of presentation adopted in the current year.