Management Report

Year ended December 31,1998

Management of the Corporation is responsible for the preparation and integrity of the financial statements contained in the Annual Report. These statements have been prepared in accordance with generally accepted accounting principles and necessarily include some amounts that are based on management's best estimates and judgement. Financial information used elsewhere in the Annual Report is consistent with that in the financial statements. Management considers that the statements present fairly the financial position of the Corporation, the results of its operations and its cash flows.

To fulfill its responsibility, the Corporation maintains systems of internal accounting controls, policies and procedures to ensure the reliability of financial information and the safeguarding of assets. The internal control systems are subject to periodic reviews by Samson Bélair/Deloitte & Touche, general partnership, as internal auditors. The external auditors, the Auditor General of Canada and Raymond Chabot Grant Thornton, general partnership, have audited the Corporation's financial statements and their report indicates the scope of their audit and their opinion on the financial statements.

The Audit Committee of the Board of Directors, consisting solely of outside Directors, meets periodically with the internal and external auditors and with management, to review the scope of their audits and to assess reports on audit work performed. The financial statements have been reviewed and approved by the Board of Directors on the recommendation of the Audit Committee.

Rod Morrison

Rod Morrison
President and
Chief Executive Officer

J. R. Paquette

J. R. Paquette
Vice-President,
Planning and Finance,
and Treasurer

Montreal, Canada
February 12, 1999

Auditors' Report

TO THE MINISTER OF TRANSPORT

We have audited the balance sheet of VIA Rail Canada Inc. as at December 31, 1998 and the statements of operations and retained earnings (deficit) and cash flows for the year then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. 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 financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 1998 and the results of its operations and its cash flows for the year then ended in accordance with generally accepted accounting principles. As required by the *Financial Administration Act*, we report that, in our opinion, these principles have been applied, after giving retroactive effect to the change in the method of accounting for Government funding for depreciable properties as explained in note 3 to the financial statements, on a basis consistent with that of the preceding year.

Further, in our opinion, the transactions of the Corporation that have come to our notice during our audit of the financial statements have, in all significant respects, been in accordance with Part X of the *Financial Administration Act* and the regulations, the *Canada Business Corporations Act* and the by-laws of the Corporation.

Raymond Chabot Grant Thornton

RAYMOND CHABOT GRANT THORNTON
General partnership
Chartered Accountants

Montreal, Canada
February 12, 1999

L. Denis Desautels

L. DENIS DESAUTELS, FCA
Auditor General of Canada

Ottawa, Canada
February 12, 1999

Financial Statements

As at December 31

BALANCE SHEET

(in thousands)

	Notes	1998	1997
Current assets			
Cash and term deposits		$ 12,733	$ 21,477
Accounts receivable		7,813	7,303
Receivable from the Government of Canada		23,678	57,265
Temporary investments	6	33,563	–
Materials		16,111	16,884
		93,898	**102,929**
Long-term assets			
Properties	5	520,255	544,484
Asset renewal fund	6	9,682	37,513
Deferred pension		–	3,173
		529,937	**585,170**
		$ 623,835	**$ 688,099**
Current liabilities			
Accounts payable and accrued liabilities		$ 75,717	$ 84,108
Deferred revenue		4,805	4,768
		80,522	**88,876**
Long-term liabilities			
Network restructuring and reorganization charges	9	16,029	29,088
Deferred pension	13	40,072	–
Other		5,989	7,174
		62,090	**36,262**
Deferred capital funding	3 and 8	**499,211**	**540,672**
Shareholder's equity (deficiency)			
Share capital	10	9,300	9,300
Contributed surplus	11	3,812	3,812
Retained earnings (deficit)		(31,100)	9,177
		(17,988)	**22,289**
		$ 623,835	**$ 688,099**

See accompanying notes to financial statements

Signed on behalf of the Board,

ANTHONY FRIEND, Q.C.
Director and Chairman of the Audit Committee

MARC LEFRANÇOIS
Director and Chairman of the Board

Financial Statements

Year ended December 31

STATEMENT OF OPERATIONS AND RETAINED EARNINGS (DEFICIT)

(in thousands)

	Notes	1998	1997
Revenue			
Passenger		$ 185,861	$ 178,917
Other		14,297	11,642
		200,158	**190,559**
Expenses			
Customer services		228,020	231,704
Equipment maintenance		75,840	82,055
Marketing and sales		28,928	27,531
Support services		35,196	30,243
General and administrative		16,101	12,079
Pension	13	43,244	(3,558)
Amortization		39,683	48,404
Reorganization charges	9	(5,538)	15,550
		461,474	**444,008**
Net operating loss before funding from the Government of Canada		**261,316**	**253,449**
Funding from the Government of Canada			
Operating funding from the Government of Canada		178,413	212,295
Amortization of deferred capital funding	3 and 8	41,461	50,111
Net results of operations before taxes		**(41,442)**	**8,957**
Income and federal large corporation taxes		(1,165)	3,356
Net results of operations for the year		**(40,277)**	**5,601**
Retained earnings, beginning of year	3	9,177	3,576
Retained earnings (deficit), end of year		**$ (31,100)**	**$ 9,177**

See accompanying notes to financial statements

STATEMENT OF CASH FLOWS

(in thousands)

	1998	1997
Operating activities		
Net results of operations for the year	$ (40,277)	$ 5,601
Non-cash charges (credits) to operations:		
Amortization of properties	40,988	42,084
Losses (gains) on write-off, retirement and disposal of properties	(952)	437
Amortization of investment tax credits	(353)	(475)
Write-down of properties	–	6,358
Amortization of deferred capital funding	(41,461)	(50,111)
Changes in non-cash working capital	22,802	10,205
Change in deferred pension	43,245	(3,173)
Change in network restructuring and reorganization charges	(13,059)	928
Change in other long-term liabilities	(832)	(894)
	10,101	**10,960**
Financing activities		
Capital funding from the Government of Canada	–	16,443
Receivable from the Government of Canada	2,944	(5,943)
	2,944	**10,500**
Investment activities		
Change in asset renewal fund	27,831	(2,455)
Temporary investments	(33,563)	–
Acquisition of properties	(18,332)	(16,443)
Change in advances on contracts	–	1,208
Proceeds from sale of properties	2,525	1,232
Change in accounts payable and accrued liabilities related to properties	(250)	(389)
	(21,789)	**(16,847)**
Cash and term deposits		
Increase (decrease) during the year	**(8,744)**	**4,613**
Balance, beginning of year	21,477	16,864
Balance, end of year	**$ 12,733**	**$ 21,477**
Represented by:		
Cash	$ 1,174	$ 1,324
Term deposits, 5.1%, maturing in January, 1999 (1997: 4.3%)	11,559	20,153
	$ 12,733	**$ 21,477**

See accompanying notes to financial statements

Notes to Financial Statements

as at December 31, 1998

1. AUTHORITY AND OBJECTIVES

VIA Rail Canada Inc. is a Crown corporation named in Part I of Schedule III to the Financial Administration Act. It was incorporated in 1977, under the Canada Business Corporations Act. The Corporation's vision is to be the best passenger transportation company in Canada with a mission to provide high-quality, low-cost passenger service. The Corporation uses the roadway infrastructure of other railway companies and relies on them to control train operations.

The Corporation is not an agent of Her Majesty and is subject to the Income Tax Act (Canada) and those of certain provinces.

2. ACCOUNTING POLICIES

These financial statements have been prepared by management in accordance with generally accepted accounting principles. The significant accounting policies followed by the Corporation are summarized as follows:

a) Funding from the Government of Canada

Operating funding, which pertains to services, activities and other undertakings of the Corporation for the management and operation of railway passenger services in Canada, is recorded in the Statement of operations and retained earnings (deficit). The amounts are determined on the basis of operating costs less commercial revenues excluding non-cash transactions relating to properties, certain network restructuring and reorganization charges, and are based on the operating budget approved by the Government of Canada for each year.

Funding for depreciable properties is recorded on an accrual basis as deferred capital funding on the Balance sheet and amortized on the same basis and over the same periods as the related capital assets. Upon disposition of the funded depreciable properties, the Corporation recognizes into income all remaining deferred capital funding related to these properties. Funding for non-depreciable capital assets is recorded as contributed surplus.

b) Materials

Materials are valued at weighted average cost.

c) Properties

Properties acquired from Canadian National Railway and Canadian Pacific Limited at the start of operations in 1978 were recorded at the net transfer values while subsequent additions, including those acquired under capital leases, are recorded at cost.

The costs of refurbishing and rebuilding rolling stock and costs associated with other property upgrading are capitalized if they are incurred to improve the service value or extend the useful lives of the properties concerned; otherwise, costs are expensed as incurred.

Retired assets are written down to their net realizable value.

d) Amortization of properties

Amortization of properties is calculated on a straight-line basis at rates sufficient to write off the cost of properties, less their residual value, over their estimated useful lives, as follows:

Rolling stock	12 to 29 years
Maintenance buildings	25 years
Stations and Facilities	20 years
Infrastructure improvements	5 to 38 years
Leasehold improvements	5 to 20 years
Machinery and Equipment	4 to 15 years
Information systems	3 years
Other assets	7 to 10 years

No amortization is provided for projects in progress and retired assets.

e) Leases

Properties recorded under capital leases are amortized on a straight-line basis over 20 years, which is representative of their useful lives.

Rental payments under operating leases are expensed as incurred.

f) Deferred credits

Investment tax credits are amortized over the estimated useful lives of the related properties. The amortization of deferred investment tax credits is recorded as a reduction of the amortization of properties. These credits are included in other long-term liabilities.

g) Pension plans

The Corporation has defined benefit pension plans, based on retirement age, compensation and length of service, covering all its permanent employees.

The cost to the Corporation is determined by actuarial valuations which allocate to each year, the accrued portion of the benefits based on projections of employees' compensation levels to the time of their retirement, prorated on employees' years of service.

Pension expense (Note 13) includes the cost of benefits attributable to services rendered during the current year, the amortization of past service costs, the amortization of experience gains and losses as well as the amortization of plan amendments. Amortization is calculated on a straight-line basis over the expected average remaining service lives of the active employee groups.

The difference between the accumulated pension expense and the employer's contributions to the pension funds is reflected in the balance sheet as a long-term asset or liability.

h) Employee termination and special benefits

Employee termination and special benefits provided for under labour agreements and special programmes relate to the restructuring and reorganization of the operations. These benefits are recognized when a decision has been approved by management and an estimate of future costs can be reasonably calculated.

Management recognizes changes in the liability from the original estimates based on the results of actual experiences.

i) VIA Préférence program

The incremental costs of providing travel awards under the Corporation's *VIA Préférence* frequent traveller reward program are accrued as the entitlements to such awards are earned and are included in accounts payable and accrued liabilities. The revenues from the sale of point credits to participating partners are recorded as revenue in the year in which the credits are sold.

j) Financial instruments

The estimated fair value of financial instruments, except for the asset renewal fund, approximates their carrying value due to their current nature.

k) Income taxes

The Corporation follows the future income tax method of accounting for income taxes.

l) Measurement uncertainty

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Network restructuring and reorganization charges, amortization of properties, pension charges and contingencies are the most significant items where estimates are used. Actual results could differ from those estimates.

3. ADOPTION OF NEW ACCOUNTING STANDARD—DEFERRED CAPITAL FUNDING

Effective January 1, 1998 the Corporation adopted the recommendation of the Public Sector Accounting and Auditing Board of the Canadian Institute of Chartered Accountants with respect to funding received from the Government of Canada for depreciable properties. The Corporation is recording the funding as a deferred credit instead of a credit to contributed surplus on the balance sheet and is amortizing this credit on the same basis as the amortization of the related properties.

This change has been applied retroactively resulting in a reduction of contributed surplus and an equivalent increase in deferred capital funding on the balance sheet of $499.2 million (1997: $540.6 million), an increase in the net results of operations of $41.4 million (1997: $50.1 million) and a decrease in the opening contributed surplus of $623.2 million and in the opening deficit of $48.8 million in 1997.

This accounting change does not have any impact upon the Corporation's operating surplus or deficit on a government funding basis.

4. RECONCILIATION OF NET RESULTS OF OPERATIONS TO GOVERNMENT FUNDING BASIS

The Corporation receives its funding from the Government of Canada based primarily on cash flow requirements. Items recognized in the Statement of operations and retained earnings (deficit) in one year may be funded by the Government of Canada in different years. Accordingly, the Corporation has different net results of operations for the year on a government funding basis than on a generally accepted accounting principles basis. These differences are outlined below:

(in millions of dollars)

	1998	1997
Net results of operations for the year	(40.3)	5.6
Items not requiring (not providing) operating funds:		
Amortization and gains and losses on properties	40.0	48.9
Amortization of deferred capital funding	(41.4)	(50.1)
Reorganization charges to be funded in subsequent years	(8.8)	9.2
Payment of prior years' reorganization charges	(8.0)	(10.0)
Pension	43.3	(3.6)
Operating funding deficit for the year (see note 6)	**(15.2)**	**–**

5. PROPERTIES

(in millions of dollars)

	1998			1997		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Land	3.8	–	3.8	3.8	–	3.8
Rolling stock	512.9	246.8	266.1	509.9	227.2	282.7
Maintenance buildings	159.5	79.9	79.6	159.1	72.7	86.4
Stations and Facilities	35.1	13.1	22.0	33.1	11.5	21.6
Infrastructure improvements	92.9	29.2	63.7	92.7	26.7	66.0
Leasehold improvements	89.4	55.5	33.9	85.6	52.9	32.7
Machinery and Equipment	28.2	19.9	8.3	27.9	18.5	9.4
Information systems	50.7	42.1	8.6	54.4	53.1	1.3
Other assets	20.9	20.4	0.5	20.9	19.9	1.0
	993.4	506.9	486.5	987.4	482.5	504.9
Projects in progress			12.1			17.8
Retired assets (at net realizable value)			21.6			21.8
			520.2			544.5

On December 31, 1998, the gross value of assets under capital leases included above was $3.5 million (1997: $5.7 million) and related accumulated amortization thereon amounted to $2.3 million (1997: $4.2 million).

Projects in progress primarily consist of station improvements and information systems.

6. ASSET RENEWAL FUND

The Corporation has been authorized by the Treasury Board of the Government of Canada to segregate proceeds from the sale or lease of surplus assets as well as the operating savings resulting from the rationalization of its maintenance activities, in a manner which ensures that these funds are retained for future capital projects.

During the year the Corporation received Treasury Board approval to drawdown from the Asset renewal fund $38.2 million. In 1998, $15.2 million was required for operating expenditures and $18.3 million was required for capital expenditures. These funds are presented in Current Assets as Temporary investments.

The Asset renewal fund investment decisions are made consistent with the Minister of Finance of Canada Financial Risk Management Guidelines for Crown Corporations.

The Asset renewal fund includes the following investment instruments:

(in millions of dollars)

	1998		1997	
	Cost	Market value	Cost	Market value
Canadian bonds and discount notes	20.8	22.5	18.8	19.7
Pooled equity unit trust	22.3	22.7	18.6	19.7
Cash and short-term investments	0.1	0.1	0.1	0.1
	43.2	**45.3**	**37.5**	**39.5**
Less: transfer to Temporary investments	33.5	35.2	–	–
	9.7	**10.1**	**37.5**	**39.5**

Canadian bonds and discount notes bear interest at rates varying between 4.25% and 11.25% (1997: 3.82% and 11.25%) and mature between September 1999 and December 2026.

The fair value of Canadian bonds, discount notes and pooled equity unit trust is equivalent to the market value based on the current bid price at the balance sheet date.

The Corporation is not encountering any significant market, cashflow or interest rate risk related to these investments.

The temporary investments are carried at the lower of cost and market.

7. INCOME AND FEDERAL LARGE CORPORATION TAXES

The Corporation has net timing differences of $70.5 million (1997: $40.3 million) resulting from items not deducted for income tax purposes, the benefit of which has not yet been recognized in the financial statements. These timing differences generally result from the accrual of pension costs and network restructuring and reorganization charges. The corporation has unused tax losses in the amount of $11.9 million which will expire in the year 2005.

8. DEFERRED CAPITAL FUNDING

(in millions of dollars)

	1998	1997
Balance, beginning of year	540.6	574.4
Government Funding for depreciable capital assets	–	16.3
Amortization	(41.4)	(50.1)
Balance, end of year	**499.2**	**540.6**

9. NETWORK RESTRUCTURING AND REORGANIZATION CHARGES

The Corporation has incurred expenses related to approved plans for the restructuring of its transportation network on October 4, 1989 as well as subsequent reorganizations.

The present value of the projected cost is recorded as a liability. As at December 31, 1998 a provision of $25.2 million (1997: $42.1 million), of which $16.0 million (1997: $29.1 million) is reflected as a long-term liability, has been recorded to provide for the on-going costs of severance payments and employment security benefits governed by labour agreements, special programmes and arbitration decisions which may extend over several years. The provision was adjusted to reflect the effects of the new collective agreements that were signed in 1998.

10. SHARE CAPITAL

The authorized share capital of the Corporation is comprised of an unlimited number of common shares of no par value. As at December 31, 1998 and 1997, 93,000 shares at $100 per share are issued and fully paid.

11. CONTRIBUTED SURPLUS

Contributed Surplus represents the Capital Funding from the Government of Canada of $3.8 million (1997: $3.8 million) for investments in land.

12. COMMITMENTS

a) The future minimum payments relating to operating leases mainly for real estate and computer equipment are as follows:

(in millions of dollars)	
1999	9.1
2000	11.1
2001	5.1
2002	5.1
2003	4.6
Subsequent years up to 2047	23.7
	58.7

b) Effective January 1, 1989 as well as in 1997 and 1998, the Corporation entered into a train service agreement and other agreements for the use of tracks and control of train operations. These agreements expire up to December 31, 2008.

c) The Corporation has issued letters of credit totalling approximately $8.2 million (1997: $7.6 million) to various provincial government workmen's compensation boards as security for future payment streams. These financial instruments can only be exercised upon an unlikely default of payment event.

13. PENSION PLANS

The latest actuarial valuations of the pension plans were carried out as at December 31, 1997 by external actuaries who are members of the Canadian Institute of Actuaries. Based on these valuations and actuarial projections for 1998, the accumulated plan benefits as at December 31, 1998 are $961.2 million (1997: $825.4 million). The net assets available to provide for these benefits at actuarial adjusted market values as at that date amount to $1,027.5 million (1997: $1,003.0 million).

(in millions of dollars)

	1998	1997
Pension Expense:		
Current service cost	9.0	5.2
Past service amortization	9.9	9.8
Amortization of 1998 plan amendments	14.1	–
Amortization of experience gains	(30.5)	(18.6)
Plan amendment for early retirement program	39.4	–
Interest charges on accrued liabilities	1.3	–
	43.2	(3.6)
Deferred pension:		
Balance, beginning of year	(3.2)	0.4
Pension expense	43.2	(3.6)
Balance, end of year	40.0	(3.2)

14. RELATED PARTY TRANSACTIONS

The Corporation is related in terms of common ownership to all Government of Canada created departments and agencies, and enters into transactions with these entities in the normal course of business on trade terms applicable to all individuals and enterprises and are recorded at exchange value.

15. CONTINGENCY

Under the terms of an ancillary agreement to the collective labour agreements between VIA Rail, Canadian National Railway and their respective unions, certain employees of VIA Rail have elected to transfer back to Canadian National Railway because they are unable to hold a regular road assignment at VIA Rail.

Canadian National Railway is contesting the right of these employees to exercise their flow back rights under this Agreement which has been in place since 1987.

In the opinion of management, the employees concerned have the right to flow back to Canadian National Railway. Since 1987, Canadian National Railway has never claimed from VIA Rail for any employee that has exercised flow back rights under this agreement.

At this time, no reasonable estimate as to the existence of a liability can be made.

16. UNCERTAINTY DUE TO THE YEAR 2000 ISSUE

The Year 2000 issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the year 2000 issue may be experienced before, on or after January 1, 2000 and if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect the Corporation's ability to conduct normal business operations.

The Corporation has undertaken an enterprise-wide initiative to address the Year 2000 issue and is implementing a comprehensive plan to prepare date-sensitive systems to recognize the change. However, it is not possible to be certain that all aspects of the Year 2000 issue affecting the Corporation, including those related to the efforts of customers, suppliers or other third parties, will be fully resolved.