CANADIAN NATIONAL RAILWAY CO
Form 6-K
November 01, 2004

FORM 6-K
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Report of Foreign Issuer

Pursuant to Rule 13a-16 or 15d-16
of the Securities Exchange Act of 1934

For the month of November, 2004

Commission File Number: 001-02413

Canadian National Railway Company

(Translation of registrant s name into English)

935 de la Gauchetiere Street West
Montreal, Quebec
Canada H3B 2M9
(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F:

Form 20-F ___ Form 40-F _X_

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1):

Yes ___ No _X_

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7):

Yes ___ No _X_

Indicate by check mark whether by furnishing the information contained in this Form, the Registrant is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934:

Yes ___ No _X_

If Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): N/A

Canadian National Railway Company

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Item 1

News

North America□s Railroad

FOR IMMEDIATE RELEASE

Stock symbols: TSX: CNR / NYSE: CNI

www.cn.ca

CN reports record results, strong core business growth

MONTREAL, Oct. 27, 2004 □ CN today reported its financial results for the third quarter and nine-month period ended Sept. 30, 2004.

Third-quarter 2004 highlights

- Net income of $346 million, an 18 per cent increase from 2003;
- Diluted earnings per share of $1.19, a 17 per cent improvement over third-quarter 2003 results;

- Operating income of $591 million, up 30 per cent year-over-year;
- Operating ratio of 65.4 per cent, 2.5 percentage points better than the prior year's quarterly performance;
- Nine-month 2004 free cash flow of $754 million, compared with $455 million for the same period of 2003. (1)

E. Hunter Harrison, president and chief executive officer of CN, said: "These results demonstrate the power of CN's business model, franchise and people. Our success is built on solid railroading execution, a strong merchandise traffic base, productivity and pricing discipline, and a proven ability to leverage new acquisitions for the benefit of customers and shareholders.

"Third-quarter revenues grew 21 per cent, reflecting core business growth in a strong North American economy and the acquisitions of BC Rail and the railroad and related holdings of Great Lakes Transportation (GLT). The integration of these carriers into our network continues in seamless fashion, and we believe anticipated merger benefits will outpace our original expectations.

"I am particularly proud of our nine-month 2004 free cash flow of $754 million. This cash generation ability is one of CN's key strengths, giving it the financial flexibility to reward shareholders now and in the future."

Revenues for the latest quarter increased to a record $1,709 million despite a stronger Canadian dollar. Factors driving the improved performance were increased merchandise traffic revenues, the inclusion of $148 million of GLT and BC Rail revenues, a solid intermodal performance, and an improved Canadian grain crop. CN began to record the operations of GLT as of May 10, 2004, and BC Rail as of July 14, 2004.

All seven CN business units registered revenue gains: metals and minerals (56 per cent); forest products (25 per cent); coal (25 per cent); petroleum and chemicals (17 per cent); automotive (nine per cent); intermodal (eight per cent); and grain and fertilizers (five per cent).

Operating expenses for the most recent quarter increased by 17 per cent to $1,118 million. The rise reflected the inclusion of $93 million of GLT and BC Rail expenses, increased fuel costs, and higher expenses for personal injuries, labor and fringe benefits, and purchased services.

The stronger Canadian dollar affected the conversion of CN's U.S. dollar denominated revenues and expenses, and accordingly, reduced the company's third-quarter revenues, operating income and net income by approximately $45 million, $15 million and $7 million, respectively.

Nine-month 2004 financial results

Net income for the first nine months of 2004 was $882 million, or $3.05 per diluted share, compared with net income of $790 million, or $2.71 per diluted share, for the same period of 2003.

Nine-month 2003 net income included a cumulative benefit of $48 million after tax, resulting from a change in the accounting for removal costs for certain track structure assets. Excluding the effect of this change, net income for the first nine months of 2004 increased 19 per cent, with diluted earnings per share rising 20 per cent.

Operating income for the first nine months of this year increased 23 per cent to $1,561 million. Revenues rose by 10 per cent to $4,812 million, while operating expenses increased by five per cent to $3,251 million.

CNs operating ratio for the first nine months of 2004 was 67.6 per cent, a 3.5-percentage point improvement over the year-earlier performance.

The translation impact of the stronger Canadian dollar reduced nine-month 2004 revenues, operating income and net income by approximately $195 million, $70 million and $37 million, respectively.

The financial results in this press release are reported in Canadian dollars and were determined on the basis of U.S. generally accepted accounting principles (U.S. GAAP).

(1) Please see discussion and reconciliation of this non-GAAP adjusted performance measure in the attached supplementary schedule, Non-GAAP Measures.

This news release contains forward-looking statements. CN cautions that, by their nature, forward-looking statements involve risk and uncertainties and that its results could differ materially from those expressed or implied in such statements. Reference should be made to CNs most recent Form 40-F filed with the United States Securities and Exchange Commission, and the Annual Information Form filed with the Canadian securities regulators, for a summary of major risks.

Canadian National Railway Company 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, Ala., and the key cities of Toronto, Buffalo, Chicago, Detroit, Duluth, Minn./Superior, Wis., Green Bay, Wis., Minneapolis/St. Paul, Memphis, St. Louis, and Jackson, Miss., with connections to all points in North America.

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CANADIAN NATIONAL RAILWAY COMPANY

CONSOLIDATED STATEMENT OF INCOME *(U.S. GAAP)*

(In millions, except per share data)

	Three months ended September 30		Nine months ended September 30	
	2004(1)	2003	**2004(1)**	2003
	(Unaudited)			
Revenues	**$ 1,709**	$ 1,413	**$ 4,812**	$ 4,372
Operating expenses	**1,118**	959	**3,251**	3,107
Operating income	**591**	454	**1,561**	1,265
Interest expense	**(79)**	(76)	**(219)**	(244)
Other income (loss)	**(9)**	13	**(45)**	13
Income before income taxes and cumulative effect of change in accounting policy	**503**	391	**1,297**	1,034
Income tax expense	**(157)**	(97)	**(415)**	(292)
Income before cumulative effect of change in accounting policy	**346**	294	**882**	742
Cumulative effect of change in accounting policy (net of applicable taxes)	-	-	-	48
Net income	**$ 346**	$ 294	**$ 882**	$ 790
Earnings per share *(Notes 9, 10)*				
Basic earnings per share				
Income before cumulative effect of change in accounting policy	**$ 1.21**	$ 1.04	**$ 3.09**	$ 2.59
Net income	**$ 1.21**	$ 1.04	**$ 3.09**	$ 2.75
Diluted earnings per share				
Income before cumulative effect of change in accounting policy	**$ 1.19**	$ 1.02	**$ 3.05**	$ 2.55
Net income	**$ 1.19**	$ 1.02	**$ 3.05**	$ 2.71
Weighted-average number of shares				

Basic	**285.9**	283.9	**285.1**	287.7
Diluted	**290.8**	288.1	**289.6**	291.8

See accompanying notes to consolidated financial statements.

(1) Includes BC Rail and GLT from dates of acquisition. (See Note 2 - Acquisitions)

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CANADIAN NATIONAL RAILWAY COMPANY

CONSOLIDATED STATEMENT OF OPERATING INCOME *(U.S. GAAP)*

(In millions)

	Three months ended September 30			Nine months ended September 30		
	2004(1)	2003	Variance Fav (Unfav)	**2004(1)**	2003	Variance Fav (Unfav)
			(Unaudited)			
Revenues						
Petroleum and chemicals	**$ 299**	$ 255	17%	**$ 840**	$ 798	5%
Metals and minerals	**203**	130	56%	**521**	387	35%
Forest products	**402**	322	25%	**1,065**	966	10%
Coal	**71**	57	25%	**212**	201	5%
Grain and fertilizers	**231**	220	5%	**756**	655	15%
Intermodal	**303**	280	8%	**817**	834	(2%)
Automotive	**112**	103	9%	**385**	389	(1%)
Other items	**88**	46	91%	**216**	142	52%
	1,709	1,413	21%	**4,812**	4,372	10%
Operating expenses						
Labor and fringe benefits	**465**	414	(12%)	**1,350**	1,283	(5%)
Purchased services and material	**190**	151	(26%)	**561**	529	(6%)
Depreciation and amortization	**153**	136	(13%)	**445**	418	(6%)
Fuel	**132**	100	(32%)	**377**	352	(7%)
Equipment rents	**64**	69	7%	**195**	228	14%
Casualty and other	**114**	89	(28%)	**323**	297	(9%)

	1,118	959	(17%)	**3,251**	3,107	(5%)
Operating income	**$ 591**	$ 454	30%	**$ 1,561**	$ 1,265	23%
Operating ratio	**65.4%**	67.9%	2.5	**67.6%**	71.1%	3.5

See accompanying notes to consolidated financial statements.

(1) Includes BC Rail and GLT from dates of acquisition. (See Note 2 - Acquisitions)

CANADIAN NATIONAL RAILWAY COMPANY

CONSOLIDATED BALANCE SHEET *(U.S. GAAP)*

(In millions)

	September 30 2004	December 31 2003	September 30 2003
	(Unaudited)		*(Unaudited)*
Assets			
Current assets:			
Cash and cash equivalents	**$ 132**	$ 130	$ 122
Accounts receivable *(Note 4)*	**743**	529	567
Material and supplies	**155**	120	145
Deferred income taxes	**106**	125	123
Other	**279**	223	174
	1,415	1,127	1,131
Properties	**20,022**	18,305	18,478
Other assets and deferred charges *(Note 3)*	**947**	905	844
Total assets	**$ 22,384**	$ 20,337	$ 20,453
Liabilities and shareholders' equity			
Current liabilities:			
Accounts payable and accrued charges	**$ 1,276**	$ 1,366	$ 1,394

Current portion of long-term debt *(Note 4)*	**257**	483	537
Other	**69**	73	62
	1,602	1,922	1,993
Deferred income taxes	**4,673**	4,550	4,489
Other liabilities and deferred credits	**1,671**	1,258	1,252
Long-term debt *(Note 4)*	**5,141**	4,175	4,473
Shareholders' equity:			
Common shares	**4,742**	4,664	4,642
Accumulated other comprehensive loss	**(57)**	(129)	(116)
Retained earnings	**4,612**	3,897	3,720
	9,297	8,432	8,246
Total liabilities and shareholders' equity	**$ 22,384**	$ 20,337	$ 20,453

See accompanying notes to consolidated financial statements.

CANADIAN NATIONAL RAILWAY COMPANY

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY *(U.S. GAAP)*

(In millions)

	Three months ended September 30		Nine months ended September 30	
	2004(1)	2003	**2004(1)**	2003
		(Unaudited)		
Common shares (2)				
Balance, beginning of period	**$ 4,704**	$ 4,631	**$ 4,664**	$ 4,785
Stock options exercised and other	**38**	40	**78**	100
Share repurchase program	-	(29)	-	(243)
Balance, end of period	**$ 4,742**	$ 4,642	**$ 4,742**	$ 4,642

Accumulated other comprehensive loss

Balance, beginning of period	**$ (35)**	$ (119)	**$ (129)**	$ 97
Other comprehensive income (loss):				
Unrealized foreign exchange gain (loss) on translation of U.S. dollar denominated long-term debt designated as a hedge of the net investment in U.S. subsidiaries	**238**	(17)	**109**	589
Unrealized foreign exchange gain (loss) on translation of the net investment in foreign operations	**(333)**	27	**(126)**	(898)
Unrealized holding gain (loss) on fuel derivative instruments (Note 6)	**69**	(5)	**112**	(6)
Realized gain (loss) on settlement of interest rate swaps (Note 6)	**(6)**	-	**12**	-
Other comprehensive income (loss) before income taxes	**(32)**	5	**107**	(315)
Income tax recovery (expense)	**10**	(2)	**(35)**	102
Other comprehensive income (loss)	**(22)**	3	**72**	(213)
Balance, end of period	**$ (57)**	$ (116)	**$ (57)**	$ (116)
Retained earnings				
Balance, beginning of period	**$ 4,322**	$ 3,532	**$ 3,897**	$ 3,487
Net income	**346**	294	**882**	790
Share repurchase program	**-**	(58)	**-**	(413)
Dividends	**(56)**	(48)	**(167)**	(144)
Balance, end of period	**$ 4,612**	$ 3,720	**$ 4,612**	$ 3,720

See accompanying notes to consolidated financial statements.

(1) Includes BC Rail and GLT from dates of acquisition. (See Note 2 - Acquisitions)
(2) During the three and nine months ended September 30, 2004, the Company issued 1.1 million and 2.2 million common shares, respectively, as a result of stock options exercised. At September 30, 2004, the Company had 286.4 million common shares outstanding. (Note 9)

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CANADIAN NATIONAL RAILWAY COMPANY

CONSOLIDATED STATEMENT OF CASH FLOWS *(U.S. GAAP)*

(In millions)

	Three months ended September 30		Nine months ended September 30	
	2004(1)	2003	**2004(1)**	2003
		(Unaudited)		
Operating activities				
Net income	**$ 346**	$ 294	**$ 882**	$ 790
Adjustments to reconcile net income to net cash provided from operating activities:				
Depreciation and amortization	**153**	137	**448**	422
Deferred income taxes	**158**	65	**300**	222
Equity in earnings of English Welsh and Scottish Railway	**(1)**	(2)	**7**	(20)
Cumulative effect of change in accounting policy	**-**	-	**-**	(48)
Other changes in:				
Accounts receivable	**(80)**	39	**(140)**	119
Material and supplies	**30**	7	**(8)**	(27)
Accounts payable and accrued charges	**(81)**	(30)	**(110)**	(105)
Other net current assets and liabilities	**26**	3	**45**	(2)
Other	**5**	13	**27**	37
Cash provided from operating activities	**556**	526	**1,451**	1,388
Investing activities				
Net additions to properties	**(323)**	(309)	**(707)**	(696)
Acquisition of BC Rail *(Note 2)*	**(984)**	-	**(984)**	-
Acquisition of GLT *(Note 2)*	**6**	-	**(547)**	-
Other, net *(Note 3)*	**(3)**	2	**169**	(5)
Cash used by investing activities	**(1,304)**	(307)	**(2,069)**	(701)
Dividends paid	**(56)**	(48)	**(167)**	(144)
Financing activities				
Issuance of long-term debt *(Note 4)*	**2,903**	705	**6,924**	2,729
Reduction of long-term debt *(Note 4)*	**(2,132)**	(825)	**(6,198)**	(2,588)
Issuance of common shares	**30**	28	**61**	69
Repurchase of common shares	**-**	(87)	**-**	(656)
Cash provided from (used by) financing activities	**801**	(179)	**787**	(446)
Net increase (decrease) in cash and cash equivalents	**(3)**	(8)	**2**	97
Cash and cash equivalents, beginning of period	**135**	130	**130**	25

Cash and cash equivalents, end of period	**$ 132**	$ 122	**$ 132**	$ 122
Supplemental cash flow information				
Net cash receipts from customers and other	**$ 1,738**	$ 1,602	**$ 4,761**	$ 4,647
Net cash payments for:				
Employee services, suppliers and other expenses	**(980)**	(891)	**(2,754)**	(2,691)
Interest	**(71)**	(80)	**(199)**	(243)
Workforce reductions	**(25)**	(32)	**(81)**	(121)
Personal injury and other claims	**(23)**	(36)	**(78)**	(91)
Pensions	**(55)**	(21)	**(119)**	(43)
Income taxes	**(28)**	(16)	**(79)**	(70)
Cash provided from operating activities	**$ 556**	$ 526	**$ 1,451**	$ 1,388

See accompanying notes to consolidated financial statements.

(1) Includes BC Rail and GLT from dates of acquisition. (See Note 2 - Acquisitions)

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CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(U.S. GAAP)*

Note 1 Basis of presentation

In management's opinion, the accompanying unaudited interim consolidated financial statements, expressed in Canadian dollars, and prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP), contain all adjustments (consisting of normal recurring accruals) necessary to present fairly Canadian National Railway Company's (the Company) financial position as at September 30, 2004 and December 31 and September 30, 2003, its results of operations, changes in shareholders' equity and cash flows for the three and nine months ended September 30, 2004 and 2003.

These interim consolidated financial statements and notes have been prepared using accounting policies consistent with those used in preparing the Company's 2003 Annual Consolidated Financial Statements. While management believes that the disclosures presented are adequate to make the information not misleading, these interim consolidated financial statements and notes should be read in conjunction with the Company's 2004 interim and 2003 annual Management's Discussion and Analysis and Annual Consolidated Financial Statements and notes thereto.

Note 2 Acquisitions

BC Rail

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

On July 2, 2004, the Company reached a consent agreement with Canadas 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 the Financial Accounting Standards Boards (FASB) Statement of Financial Accounting Standards (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 Companys cost to acquire BC Rail of $1,004 million includes purchase price adjustments and transaction costs. The following table reflects the preliminary purchase price allocation, based on the fair value of BC Rails assets, owned and leased, and liabilities acquired at acquisition, which is subject to a final valuation, the impact of which, and any changes in accounting practices, are not expected to have a material effect on the results of operations.

In millions		July 14, 2004
Current assets (1)	$	226
Properties		620
Deferred income taxes		400
Total assets acquired		1,246
Current liabilities		74
Other liabilities and deferred credits		155
Long-term debt (2)		13
Total liabilities assumed		242
Net assets acquired	$	1,004

(1) Includes cash on hand of $20 million.
(2) Net of unamortized discount.

Great Lakes Transportation LLCs Railroads and Related Holdings

In October 2003, the Company, through an indirect wholly owned subsidiary, entered into an agreement for the acquisition of Great Lakes Transportation LLCs railroads and related holdings (GLT) for a purchase price of U.S.$380 million.

In 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

CANADIAN NATIONAL RAILWAY COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(U.S. GAAP)*

the assets, liabilities and results of operations of GLT as of May 10, 2004, the date of acquisition. The Company's cost to acquire GLT of U.S.$395 million (Cdn$547 million) includes purchase price adjustments and transaction costs. The following table reflects the preliminary purchase price allocation, based on the fair value of GLT's assets and liabilities acquired at acquisition, which is subject to a final valuation, the impact of which, and any changes in accounting practices, are not expected to have a material effect on the results of operations.

In millions		May 10, 2004
Current assets	$	67
Properties		1,018
Intangible and other assets		90
Total assets acquired		1,175
Current liabilities		64
Deferred income taxes		290
Other liabilities and deferred credits		274
Total liabilities assumed		628
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 preliminary estimates of 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 three and nine months ended September 30, 2004 and 2003 would have been as follows:

	Three months ended September 30		**Nine months ended September 30**	
In millions, except per share data	2004	2003	2004	2003
Revenues	$ 1,719	$ 1,561	$ 5,037	$ 4,781
Income before cumulative effect of change in accounting policy	$ 347	$ 318	$ 895	$ 786
Net income	$ 347	$ 318	$ 895	$ 837

Basic earnings per share				
Income before cumulative effect of change in accounting policy	$ 1.21	$ 1.12	$ 3.14	$ 2.73
Net income	$ 1.21	$ 1.12	$ 3.14	$ 2.91
Diluted earnings per share				
Income before cumulative effect of change in accounting policy	$ 1.19	$ 1.10	$ 3.09	$ 2.69
Net income	$ 1.19	$ 1.10	$ 3.09	$ 2.87

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.

Note 3 Investment in English Welsh and Scottish Railway (EWS) Capital reorganization

On January 6, 2004, EWS shareholders approved a plan to reduce the EWS share capital to enable cash to be returned to the shareholders by offering them the ability to cancel a portion of their EWS shares. For each share cancelled, EWS shareholders would receive cash and 8% notes due in 2009, redeemable in whole or in part at any time by EWS, at their principal amount together with accrued but unpaid interest up to the date of repayment.

The Company elected to have the maximum allowable number of shares cancelled under the plan, thereby reducing its ownership interest of 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 £81.6 million (Cdn$199 million) from EWS, of which £23.9 million (Cdn$58 million) was in the form of EWS notes.

Note 4 Financing activities

On July 9, 2004, the Company issued U.S.$300 million (Cdn$395 million) of 4.25% Notes due 2009 and U.S.$500 million (Cdn$658 million) of 6.25% Debentures due 2034. The debt offering was made under the Companys shelf prospectus and registration statement filed in October 2003. Accordingly, the amount available under the shelf prospectus and registration statement has been reduced to U.S.$200 million. The Company used the net proceeds of U.S.$790 million to finance a portion of the acquisition costs of BC Rail and GLT.

In the first quarter of 2004, the Company repaid its borrowings under the revolving credit facility of U.S.$180 million (Cdn$233 million) outstanding at December 31, 2003. As at September 30, 2004, letters of credit under the revolving credit facility amounted to $344 million.

In March 2004, the Company repaid U.S.$266 million (Cdn$355 million) of 7.00% 10-year Notes, with cash on hand and the proceeds received from the issuance of commercial paper under its commercial paper program.

CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(U.S. GAAP)*

At September 30, 2004, the Company had outstanding borrowings of U.S.$266 million (Cdn$337 million) under the commercial paper program.

The Company has an accounts receivable securitization program, expiring in June 2006, under which it may sell, on a revolving basis, a maximum of $450 million of eligible freight trade and other receivables outstanding at any point in time, to an unrelated trust. The Company has a contingent residual interest of approximately 10% of receivables sold, which is recorded in Other current assets. At September 30, 2004, pursuant to the agreement, $436 million had been sold compared to $448 million at December 31, 2003.

Note 5 Stock plans

For the three and nine months ended September 30, 2004, the Company recorded total compensation cost for awards under all plans of $12 million and $37 million, respectively, and $1 million and $10 million, respectively, for the same periods in 2003.

(a) Mid-term incentive share unit plan

On June 30, 2004, upon partially attaining targets relating to its mid-term incentive share unit plan, the Company recorded additional compensation cost of $13 million based on the number of share units vested multiplied by the Companys share price on such date.

(b) Restricted share units (RSUs)

In 2004, the Company granted approximately 1.2 million RSUs to designated management employees entitling them to receive payout in cash based on the Companys 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 and to the Companys share price during the three-month period ending December 31, 2006. For the three and nine months ended September 30, 2004, the Company recorded compensation cost of $8 million and $15 million, respectively.

The Company accounts for stock -based compensation using the fair value based approach. The Company prospectively applied this method of accounting to all awards granted, modified or settled on or after January 1, 2003. If compensation cost had been determined based upon fair values at the date of grant for awards under all plans, the Companys pro forma net income and earnings per share would have been as follows:

	Three months ended September 30		**Nine months ended September 30**	
In millions, except per share data	**2004**	2003	**2004**	2003
Net income, as reported	**$ 346**	$ 294	**$ 882**	$ 790
Add (deduct) compensation cost, net of applicable taxes, determined under:				
Fair value method for awards granted after Jan 1, 2003 (SFAS No. 123)	**9**	1	**19**	4
Intrinsic value method for performance-based awards granted prior to 2003 (APB 25)	**-**	-	**9**	6
Fair value method for all awards (SFAS No. 123)	**(17)**	(10)	**(51)**	(32)
Pro forma net income	**$ 338**	$ 285	**$ 859**	$ 768

Basic earnings per share, as reported	**$ 1.21**	$ 1.04	**$ 3.09**	$ 2.75
Basic earnings per share, pro forma	**$ 1.18**	$ 1.00	**$ 3.01**	$ 2.67
Diluted earnings per share, as reported	**$ 1.19**	$ 1.02	**$ 3.05**	$ 2.71
Diluted earnings per share, pro forma	**$ 1.16**	$ 0.99	**$ 2.97**	$ 2.63

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CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(U.S. GAAP)*

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

	Three months ended September 30		**Nine months ended September 30**	
	2004(1)	2003**(2)**	**2004(1)**	2003**(2)**
Expected option life (years)	-	5.0	-	5.0
Risk-free interest rate	-	4.01%	-	4.12%
Expected stock price volatility	-	30%	-	30%
Average dividend per share	-	$ 0.67	-	$ 0.67
Weighted average fair value of options granted	**$** -	$ 14.32	**$** -	$ 11.87

(1) The Company did not grant any stock option awards in 2004.
(2) 2003 data has been adjusted for the three-for-two stock split.

Note 6 Derivative instruments

Fuel

At September 30, 2004, the Company had hedged approximately 56% of the estimated remaining 2004 fuel consumption, representing approximately 56 million U.S. gallons at an average price of U.S.$0.67 per U.S. gallon, 51% of the estimated 2005 fuel consumption, representing approximately 203 million U.S. gallons at an average price of U.S.$0.74 per U.S. gallon, and 17% of the estimated 2006 fuel consumption, representing 69 million U.S. gallons at an average price of U.S.$0.89 per U.S. gallon. These derivative instruments are carried at market value on the balance sheet and are 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 Other comprehensive income. At September 30, 2004, Accumulated other comprehensive income included an unrealized gain of $150 million, $102 million after tax, ($38 million unrealized gain, $26 million after tax at December 31, 2003) related to fuel hedge derivative instruments of which $123 million will mature within the next twelve months.

Interest rate

In the first quarter of 2004, in anticipation of future debt issuances, the Company had entered into treasury lock transactions for a notional amount of U.S.$380 million to fix the treasury component on these future debt issuances. Upon expiration in June 2004, these treasury rate locks were rolled into new contracts expiring in September 2004, at an average locked-in rate of 5.106%. The Company settled these treasury locks at a gain of U.S.$9 million (Cdn$12 million) upon the pricing of the U.S.$500 million 6.25% Debentures due 2034, subsequently issued on July 9, 2004. 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 income. Beginning July 9, 2004, upon the issuance of debt, the realized gain of $12 million accumulated in other comprehensive income will be recorded into income, as a reduction of interest expense, over the term of the debt based on the interest payment schedule. At September 30, 2004, Accumulated other comprehensive income included an unamortized gain of $12 million, $8 million after tax.

Note 7 Pensions and other post-retirement benefits

For the three and nine months ended September 30, 2004 and 2003, the components of net periodic benefit cost for pensions and other post-retirement benefits were as follows:

***(a)* Components of net periodic benefit cost for pensions**

	Three months ended September 30		**Nine months ended September 30**	
In millions	**2004**	2003	**2004**	2003
Service cost	**$ 30**	$ 24	**$ 82**	$ 71
Interest cost	**186**	178	**539**	535
Amortization of net transition obligation	**-**	5	**-**	15
Amortization of prior service cost	**5**	5	**15**	15
Expected return on plan assets	**(219)**	(205)	**(635)**	(615)
Recognized net actuarial loss	**1**	1	**2**	2
Net periodic benefit cost	**$ 3**	$ 8	**$ 3**	$ 23

***(b)* Components of net periodic benefit cost for post-retirement benefits**

	Three months ended	**Nine months ended**

In millions	**September 30 2004**	September 30 2003	**September 30 2004**	September 30 2003
Service cost	**$ 2**	$ 3	**$ 12**	$ 9
Interest cost	**5**	6	**22**	18
Amortization of prior service cost	**1**	1	**3**	3
Recognized net actuarial (gain) loss	**(4)**	1	**(3)**	3
Net periodic benefit cost	**$ 4**	$ 11	**$ 34**	$ 33

For 2004, the Company expects to make total contributions of $150 million for all its defined benefit plans of which $119 million have been made at September 30, 2004. The total expected contributions take into account the defined benefit plans assumed as part of the BC Rail and GLT acquisitions.

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 (APBO at December 31, 2003 was $454 million). Net periodic benefit cost for the nine months ended September 30, 2004 was reduced by $5 million due to the effects of the Act. The Company has not restated prior periods, as the effect of the Act on net periodic benefit cost for prior quarters was not significant.

CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS *(U.S. GAAP)*

Note 8 Major commitments and contingencies

A. Commitments

As at September 30, 2004, the Company had commitments to acquire railroad ties, rail, freight cars, locomotives and other equipment at an aggregate cost of $175 million ($211 million at December 31, 2003). The Company also had outstanding information technology service contracts of $24 million and agreements with fuel suppliers to purchase approximately 73% of the estimated remaining 2004 volume, 56% of its anticipated 2005 volume, and 19% of its anticipated 2006 volume at market prices prevailing on the date of purchase.

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

In the United States, employee work-related injuries, including occupational disease claims, are compensated according to the provisions of the Federal Employers Liability Act (FELA), which requires either the finding of fault through the U.S. jury system or individual settlements. The Company accrues the expected cost for personal injury and property damage claims and existing occupational disease claims, based on actuarial estimates of their ultimate cost. The Company is unable to estimate the total cost for unasserted occupational disease claims. However, a liability for unasserted occupational disease claims is accrued to the extent they are probable and can be reasonably estimated. An actuarial study is conducted on an annual basis by an independent actuarial firm. On an ongoing basis, management reviews and compares the assumptions inherent in the latest actuarial study with the current claim experience and, if required, adjustments to the liability are recorded.

As at September 30, 2004, the Company had aggregate reserves for personal injury and other claims of $649 million ($590 million at December 31, 2003). Although the Company considers such provisions to be adequate for all its outstanding and pending claims, the final outcome with respect to actions outstanding or pending at September 30, 2004, or with respect to future claims, cannot be predicted with certainty, and therefore there can be no assurance that their resolution will not have a material adverse effect on the Companys financial position or results of operations in a particular quarter or fiscal year or that the Companys liquidity will not be adversely impacted.

C. Environmental matters

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

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 Companys 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.

As at September 30, 2004, the Company had aggregate accruals for environmental costs of $117 million ($83 million as at December 31, 2003).

D. Guarantees and indemnifications

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

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. Where the Company expects to make a payment in respect of a guarantee, a liability will be recognized to the extent that one has not yet been recognized.

Guarantee of residual values of operating leases

The Company has guaranteed a portion of the residual values of certain of its assets under operating leases with expiry dates between 2005 and 2012, for the benefit of the lessor. If the fair value of the assets, at the end of their respective lease term, is less than the fair value, as estimated at the inception of the lease, then the Company must, under certain conditions, compensate the lessor for the shortfall. At September 30, 2004, the maximum exposure in respect of these guarantees was $98 million, of which $6 million has been recorded.

At September 30, 2004, the carrying value for guarantees for which the Company was required to recognize a liability for the fair value of the obligation was $2 million. There are no recourse provisions to recover any amounts from third parties.

Other guarantees

The Company, including certain of its subsidiaries, has granted irrevocable standby letters of credit and surety bonds, issued by highly rated financial institutions, to third parties to indemnify them in the event the Company does not perform its contractual obligations. As at September 30, 2004, the maximum potential liability under these guarantees was $444 million of which $361 million was for workers' compensation and other employee benefits and $83 million was for equipment under leases and other. During 2004, the Company granted guarantees for which no liability has been recorded, as they relate to the Company's future performance.

As at September 30, 2004, the Company had not recorded any additional liability with respect to these guarantees, as the Company does not expect to make any additional payments associated with these guarantees. The guarantee instruments mature at various dates between 2004 and 2007.

CN Pension Plan and CN 1935 Pension Plan

The Company has indemnified and held harmless the current trustee and the former trustee of the Canadian National Railways Pension Trust Funds, 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 September 30, 2004, the Company had not recorded a liability associated with these indemnifications, as the Company does not expect to make any payments pertaining to these indemnifications.

General indemnifications

In the normal course of business, the Company has provided indemnifications, customary for the type of transaction or for the railway business, in various agreements with third parties, including indemnification provisions where the Company would be required to indemnify third parties and others. Indemnifications are found in various types of contracts with third parties which include, but are not limited to, (a) contracts granting the Company the right to use or enter upon property owned by third parties such as leases, easements, trackage rights and sidetrack agreements; (b) contracts granting rights to others to use the Companys 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 Companys securities; (h) trust agreements relating to pension plans and other plans, including those establishing trust funds to secure payment to certain officers and senior employees of special retirement compensation arrangements; (i) master agreements with financial institutions governing derivative transactions; and (j) settlement agreements with insurance companies or other third parties whereby such insurer or third party has been indemnified for any present or future claims relating to insurance policies, incidents or events covered by the settlement agreements. To the extent of any actual claims under these agreements, the Company maintains provisions for such items, which it considers to be adequate. Due to the nature of the indemnification clauses, the maximum exposure for future payments may be material. However, such exposure cannot be determined with certainty.

In 2004, the Company entered into various indemnification contracts with third parties for which the maximum exposure for future payments cannot be determined with certainty. As a result, the Company was unable to determine the fair value of these guarantees and accordingly, no liability was recorded. As at September 30, 2004, 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.

Note 9 Common stock

Share repurchase program

On October 26, 2004, the Board of Directors of the Company approved a share repurchase program which allows for the repurchase of up to 14 million common shares between November 1, 2004 and October 31, 2005 pursuant to a normal course issuer bid, at prevailing market prices.

Common stock split

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

CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. GAAP)

Note 10 Earnings per share

	Three months ended September 30		Nine months ended September 30	
	2004	2003	**2004**	2003
		(Unaudited)		
Basic earnings per share				
Income before cumulative effect of change in accounting policy	**$ 1.21**	$ 1.04	**$ 3.09**	$ 2.59
Cumulative effect of change in accounting policy	**-**	-	**-**	0.16
Net income	**$ 1.21**	$ 1.04	**$ 3.09**	$ 2.75
Diluted earnings per share				
Income before cumulative effect of change in accounting policy	**$ 1.19**	$ 1.02	**$ 3.05**	$ 2.55
Cumulative effect of change in accounting policy	**-**	-	**-**	0.16
Net income	**$ 1.19**	$ 1.02	**$ 3.05**	$ 2.71

The following table provides a reconciliation between basic and diluted weighted average shares outstanding:

	Three months ended September 30		Nine months ended September 30	
In millions	**2004**	2003	**2004**	2003
		(Unaudited)		
Weighted-average shares outstanding	**285.9**	283.9	**285.1**	287.7
Dilutive effect of stock options	**4.9**	4.2	**4.5**	4.1

Weighted-average diluted shares outstanding	**290.8**	288.1	**289.6**	291.8

CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. GAAP)

Note 11 Reconciliation of United States and Canadian GAAP

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

A. Canadian GAAP financial statements

CONSOLIDATED STATEMENT OF INCOME

(In millions, except per share data)	**Three months ended September 30**		**Nine months ended September 30**	
	2004	2003	**2004**	2003
		(Unaudited)		
Revenues	**$ 1,709**	$ 1,413	**$ 4,812**	$ 4,372
Operating expenses				
Labor and fringe benefits	**471**	484	**1,365**	1,440
Purchased services and material	**190**	202	**561**	631
Depreciation and amortization	**129**	114	**381**	360
Fuel	**132**	100	**377**	353
Equipment rents	**64**	71	**195**	232
Casualty and other	**114**	113	**323**	351
Total expenses	**1,100**	1,084	**3,202**	3,367
Operating income	**609**	329	**1,610**	1,005
Interest expense	**(67)**	(78)	**(207)**	(246)
Other income (loss)	**(9)**	13	**(45)**	13

Income before income taxes	**533**	264	**1,358**	772
Income tax expense	**(166)**	(56)	**(434)**	(207)
Net income	**$ 367**	$ 208	**$ 924**	$ 565
Earnings per share				
Basic	**$ 1.28**	$ 0.73	**$ 3.24**	$ 1.96
Diluted	**$ 1.26**	$ 0.72	**$ 3.19**	$ 1.94
Weighted-average number of shares				
Basic	**285.9**	283.9	**285.1**	287.7
Diluted	**290.3**	288.1	**289.3**	291.8

CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. GAAP)

A. Canadian GAAP financial statements (continued)

CONSOLIDATED BALANCE SHEET

(In millions)	**September 30 2004**	December 31 2003	September 30 2003
	(Unaudited)		*(Unaudited)*
Assets			
Current assets:			
Cash and cash equivalents	**$ 132**	$ 130	$ 122
Accounts receivable	**743**	529	567
Material and supplies	**155**	120	145
Deferred income taxes	**106**	125	123
Other	**154**	188	153

		1,290		1,092		1,110
Properties		**16,943**		15,158		15,442
Other assets and deferred charges		**919**		900		840
Total assets	**$**	**19,152**	$	17,150	$	17,392
Liabilities and shareholders' equity						
Current liabilities:						
Accounts payable and accrued charges	**$**	**1,276**	$	1,366	$	1,394
Current portion of long-term debt		**257**		483		537
Other		**69**		73		62
		1,602		1,922		1,993
Deferred income taxes		**3,466**		3,365		3,401
Other liabilities and deferred credits		**1,621**		1,208		1,194
Long-term debt		**5,141**		4,175		4,473
Shareholders' equity:						
Common shares		**3,620**		3,530		3,490
Contributed surplus		**166**		166		166
Currency translation		**(43)**		(38)		(25)
Retained earnings		**3,579**		2,822		2,700
		7,322		6,480		6,331
Total liabilities and shareholders' equity	**$**	**19,152**	$	17,150	$	17,392

CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. GAAP)

A. Canadian GAAP financial statements (continued)

CONSOLIDATED STATEMENT OF CASH FLOWS

(In millions)

	Three months ended September 30		Nine months ended September 30	
	2004	2003	**2004**	2003
		(Unaudited)		
Operating activities				
Net income	**$ 367**	$ 208	**$ 924**	$ 565
Adjustments to reconcile net income to net cash provided from operating activities:				
Depreciation and amortization	**129**	114	**384**	364
Deferred income taxes	**167**	24	**319**	137
Equity in earnings of English Welsh and Scottish Railway	**(1)**	(2)	**7**	(20)
Other changes in:				
Accounts receivable	**(80)**	39	**(140)**	119
Material and supplies	**30**	7	**(8)**	(27)
Accounts payable and accrued charges	**(81)**	(30)	**(110)**	(105)
Other net current assets and liabilities	**26**	3	**45**	(2)
Other	**(1)**	24	**30**	42
Cash provided from operating activities	**556**	387	**1,451**	1,073
Investing activities				
Net additions to properties	**(323)**	(165)	**(707)**	(392)
Acquisition of BC Rail	**(984)**	-	**(984)**	-
Acquisition of GLT	**6**	-	**(547)**	-
Other, net	**(3)**	(3)	**169**	6
Cash used by investing activities	**(1,304)**	(168)	**(2,069)**	(386)
Dividends paid	**(56)**	(48)	**(167)**	(144)
Financing activities				
Issuance of long-term debt	**2,903**	705	**6,924**	2,729
Reduction of long-term debt	**(2,132)**	(825)	**(6,198)**	(2,588)
Issuance of common shares	**30**	28	**61**	69
Repurchase of common shares	-	(87)	-	(656)
Cash provided from (used by) financing activities	**801**	(179)	**787**	(446)
Net increase (decrease) in cash and cash equivalents	**(3)**	(8)	**2**	97
Cash and cash equivalents, beginning of period	**135**	130	**130**	25
Cash and cash equivalents, end of period	**$ 132**	$ 122	**$ 132**	$ 122

CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. GAAP)

B. Reconciliation and discussion of significant differences between U.S. and Canadian GAAP

(i) Reconciliation of net income

	Three months ended September 30		Nine months ended September 30	
In millions	**2004**	2003	**2004**	2003
Net income U.S. GAAP	**$ 346**	$ 294	**$ 882**	$ 790
Adjustments in respect of:				
Property capitalization, net of depreciation	**24**	(121)	**64**	(253)
Stock-based compensation cost	**(6)**	(6)	**(15)**	(9)
Interest expense	**12**	-	**12**	-
Income tax recovery (expense) on current period adjustments	**(9)**	41	**(19)**	85
Income before cumulative effect of change in accounting policy	**367**	208	**924**	613
Cumulative effect of change in accounting policy (net of applicable taxes)	**-**	-	**-**	(48)
Net income Canadian GAAP	**$ 367**	$ 208	**$ 924**	$ 565

Property capitalization

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

The Company s accounting for Properties under Canadian GAAP had been based on the rules and regulations of the Canadian Transportation Agency s (CTA) Uniform Classification of Accounts, which for railways in Canada, were considered Canadian GAAP prior to the issuance of Section 1100. Under the CTA rules, the Company capitalized only the material component of track replacement costs, to the extent it met the Company s minimum threshold for capitalization. In accordance with the CICA Handbook Section 3061 Properties, Plant and Equipment, the Company now capitalizes the cost of labor, material and related overheads 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 policies. However, since the change was applied prospectively, there continues to be a difference in depreciation and amortization expense between Canadian and U.S. GAAP relating to the difference in the amounts previously capitalized under Canadian and U.S. GAAP as at January 1, 2004.

Stock-based compensation

Effective January 1, 2003, the Company adopted the fair value based approach of the CICA 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. Under U.S. GAAP, 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. Compensation cost attributable to employee stock options granted prior to January 1, 2003 continues to be a reconciling difference.

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 income. 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 income 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.

Cumulative effect of change in accounting policy

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

(ii) Reconciliation of significant balance sheet items

(In millions)	**September 30**	December 31	September 30

		2004		2003		2003
Current assets - U.S. GAAP	**$**	**1,415**	$	1,127	$	1,131
Derivative instruments		**(123)**		(33)		(21)
Other		**(2)**		(2)		-
Current assets - Canadian GAAP	**$**	**1,290**	$	1,092	$	1,110
Properties - U.S. GAAP	**$**	**20,022**	$	18,305	$	18,478
Property capitalization, net of depreciation		**(3,004)**		(3,072)		(2,961)
Cumulative effect of change in accounting policy		**(75)**		(75)		(75)
Properties - Canadian GAAP	**$**	**16,943**	$	15,158	$	15,442
Other assets and deferred charges - U.S. GAAP	**$**	**947**	$	905	$	844
Derivative instruments		**(27)**		(5)		(3)
Other		**(1)**		-		(1)
Other assets and deferred charges - Canadian GAAP	**$**	**919**	$	900	$	840
Deferred income tax liability - U.S. GAAP	**$**	**4,673**	$	4,550	$	4,489
Cumulative effect of prior years adjustments to income		**(1,204)**		(1,071)		(1,071)
Income taxes on current period Canadian GAAP adjustments to income		**19**		(133)		(85)
Cumulative effect of change in accounting policy		**(27)**		(27)		(27)
Income taxes on translation of U.S. to Canadian GAAP adjustments		**17**		15		8
Income taxes on minimum pension liability adjustment		**10**		10		13
Income taxes on derivative instruments		**(48)**		(12)		(8)
Income taxes on settlement of interest rate swap recorded in other comprehensive income		**(4)**		-		-
Income tax rate enactments		**38**		38		86
Other		**(8)**		(5)		(4)
Deferred income tax liability - Canadian GAAP	**$**	**3,466**	$	3,365	$	3,401

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CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. GAAP)

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

(In millions)		**September 30 2004**		December 31 2003		September 30 2003
Other liabilities and deferred credits - U.S. GAAP	**$**	**1,671**	$	1,258	$	1,252
Stock-based compensation		**(17)**		(20)		(20)
Minimum pension liability		**(30)**		(30)		(38)
Other		**(3)**		-		-
Other liabilities and deferred credits - Canadian GAAP	**$**	**1,621**	$	1,208	$	1,194
Capital stock - U.S. GAAP	**$**	**4,742**	$	4,664	$	4,642
Capital reorganization		**(1,300)**		(1,300)		(1,300)
Stock-based compensation		**(5)**		(17)		(35)
Foreign exchange loss on convertible preferred securities		**(12)**		(12)		(12)
Costs related to the sale of shares		**33**		33		33
Share repurchase program		**162**		162		162
Capital stock - Canadian GAAP	**$**	**3,620**	$	3,530	$	3,490
Contributed surplus - U.S. GAAP	**$**	**-**	$	-	$	-
Dividend in kind with respect to land transfers		**(248)**		(248)		(248)
Costs related to the sale of shares		**(33)**		(33)		(33)
Other transactions and related income tax effect		**(18)**		(18)		(18)
Share repurchase program		**(24)**		(24)		(24)
Capital reorganization		**489**		489		489
Contributed surplus - Canadian GAAP	**$**	**166**	$	166	$	166
Accumulated other comprehensive loss - U.S. GAAP	**$**	**(57)**	$	(129)	$	(116)
Unrealized foreign exchange loss on translation of U.S. to Canadian GAAP adjustments, net of applicable taxes		**66**		63		51
Derivative instruments, net of applicable taxes		**(102)**		(26)		(16)
Unamortized gain on settlement of interest rate swap, net of applicable taxes		**(8)**		-		-
Income tax rate enactments		**34**		34		32
Minimum pension liability, net of applicable taxes		**20**		20		24
Other		**4**		-		-
Currency translation - Canadian GAAP	**$**	**(43)**	$	(38)	$	(25)
Retained earnings - U.S. GAAP	**$**	**4,612**	$	3,897	$	3,720
Cumulative effect of prior years adjustments to income		**(1,928)**		(1,696)		(1,696)
Cumulative effect of change in accounting policy		**(48)**		(48)		(48)

Current period adjustments to net income		**42**		(232)		(177)
Share repurchase program		**(138)**		(138)		(138)
Cumulative dividend on convertible preferred securities		**(38)**		(38)		(38)
Capital reorganization		**811**		811		811
Dividend in kind with respect to land transfers		**248**		248		248
Other transactions and related income tax effect		**18**		18		18
Retained earnings - Canadian GAAP	**$**	**3,579**	$	2,822	$	2,700

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CANADIAN NATIONAL RAILWAY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. GAAP)

Income taxes

In the fourth quarter of 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 the Consolidated Statement of Income and Other comprehensive income, respectively. For Canadian GAAP, the corresponding increase to the net deferred income tax liability was $33 million. The difference in the expense recorded reflects a larger net deferred tax liability position under U.S. GAAP.

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 income, a separate component of Shareholders equity. There are no similar requirements under Canadian GAAP.

Minimum pension liability

Under U.S. GAAP, one of the Company s pension plan had an accumulated benefit obligation in excess of the fair value of the plan assets. Under U.S. GAAP, this gave rise to an additional minimum pension liability and as a result, an intangible asset was recognized up to the amount of the unrecognized prior service cost and the difference has been recorded in Accumulated other comprehensive income, 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.

Shareholders equity

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

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

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

Under Canadian GAAP, the excess in cost over the stated value resulting from the repurchase of shares was allocated first to Capital stock, then to Contributed surplus and finally to Retained earnings. Under U.S. GAAP, the excess has been allocated to Capital stock followed by Retained earnings.

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

(iii) Consolidated statement of cash flows

For the three and nine months ended September 30, 2004, cash provided from (used by) operating, investing and financing activities presented under U.S. and Canadian GAAP were the same.

For the three and nine months ended September 30, 2003, cash provided from operating activities and cash used by investing activities under Canadian GAAP, would increase by the same amount, $139 million and $315 million, respectively, due to the difference in the Company s property capitalization policies that existed prior to January 1, 2004 as discussed herein.

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CANADIAN NATIONAL RAILWAY COMPANY

SELECTED RAILROAD STATISTICS *(U.S. GAAP)*

	Three months ended September 30		**Nine months ended September 30**	
	2004 (1)	2003	**2004** (1)	2003
		(Unaudited)		
Statistical operating data				
Freight revenues ($ millions)	**1,621**	1,367	**4,596**	4,230
Gross ton miles (GTM) (millions)	**83,039**	76,169	**244,171**	229,993
Revenue ton miles (RTM) (millions)	**44,266**	39,936	**129,768**	119,678
Carloads (thousands)	**1,226**	1,031	**3,394**	3,113
Route miles (includes Canada and the U.S.)	**19,303**	17,539	**19,303**	17,539

Employees (end of period)	**23,466**	22,293	**23,466**	22,293
Employees (average during period)	**23,332**	22,357	**22,283**	22,040
Productivity				
Operating ratio (%)	**65.4**	67.9	**67.6**	71.1
Freight revenue per RTM (cents)	**3.66**	3.42	**3.54**	3.53
Freight revenue per carload ($)	**1,322**	1,326	**1,354**	1,359
Operating expenses per GTM (cents)	**1.35**	1.26	**1.33**	1.35
Labor and fringe benefits expense per GTM (cents)	**0.56**	0.54	**0.55**	0.56
GTMs per average number of employees (thousands)	**3,559**	3,407	**10,958**	10,435
Diesel fuel consumed (U.S. gallons in millions)	**95**	88	**288**	275
Average fuel price ($/U.S. gallon)	**1.31**	1.13	**1.26**	1.23
GTMs per U.S. gallon of fuel consumed	**874**	866	**848**	836
Safety indicators				
Injury frequency rate per 200,000 person hours	**2.8**	3.5	**2.7**	3.0
Accident rate per million train miles	**2.0**	1.9	**1.5**	2.0
Financial ratios				
Debt to total capitalization ratio (% at end of period)	**36.7**	37.8	**36.7**	37.8

(1) Includes BC Rail and GLT from dates of acquisition.

Certain of the comparative statistical data and related productivity measures have been restated to reflect changes to estimated statistical data previously reported.

CANADIAN NATIONAL RAILWAY COMPANY

SUPPLEMENTARY INFORMATION *(U.S. GAAP)*

	Three months ended September 30			Nine months ended September 30		
	2004(1)	2003	Variance Fav (Unfav)	**2004**(1)	2003	Variance Fav (Unfav)
			(Unaudited)			
Revenue ton miles (millions)						

Petroleum and chemicals	**8,373**	7,515	11%	**24,274**	22,933	6%
Metals and minerals	**4,345**	3,421	27%	**12,332**	10,084	22%
Forest products	**10,480**	8,811	19%	**28,465**	25,706	11%
Coal	**3,451**	3,495	(1%)	**10,708**	11,022	(3%)
Grain and fertilizers	**8,787**	8,272	6%	**28,693**	24,217	18%
Intermodal	**8,090**	7,802	4%	**22,817**	23,336	(2%)
Automotive	**740**	620	19%	**2,479**	2,380	4%
	44,266	39,936	11%	**129,768**	119,678	8%
Freight revenue / RTM (cents)						
Total freight revenue per RTM	**3.66**	3.42	7%	**3.54**	3.53	-
Business units:						
Petroleum and chemicals	**3.57**	3.39	5%	**3.46**	3.48	(1%)
Metals and minerals	**4.67**	3.80	23%	**4.22**	3.84	10%
Forest products	**3.84**	3.65	5%	**3.74**	3.76	(1%)
Coal	**2.06**	1.63	26%	**1.98**	1.82	9%
Grain and fertilizers	**2.63**	2.66	(1%)	**2.63**	2.70	(3%)
Intermodal	**3.75**	3.59	4%	**3.58**	3.57	-
Automotive	**15.14**	16.61	(9%)	**15.53**	16.34	(5%)
Carloads (thousands)						
Petroleum and chemicals	**162**	149	9%	**476**	449	6%
Metals and minerals	**256**	105	144%	**552**	297	86%
Forest products	**177**	148	20%	**478**	446	7%
Coal	**121**	112	8%	**364**	360	1%
Grain and fertilizers	**132**	134	(1%)	**416**	389	7%
Intermodal	**314**	323	(3%)	**888**	963	(8%)
Automotive	**64**	60	7%	**220**	209	5%
	1,226	1,031	19%	**3,394**	3,113	9%
Freight revenue / carload (dollars)						
Total freight revenue per carload	**1,322**	1,326	-	**1,354**	1,359	-
Business units:						
Petroleum and chemicals	**1,846**	1,711	8%	**1,765**	1,777	(1%)
Metals and minerals	**793**	1,238	(36%)	**944**	1,303	(28%)
Forest products	**2,271**	2,176	4%	**2,228**	2,166	3%
Coal	**587**	509	15%	**582**	558	4%
Grain and fertilizers	**1,750**	1,642	7%	**1,817**	1,684	8%
Intermodal	**965**	867	11%	**920**	866	6%
Automotive	**1,750**	1,717	2%	**1,750**	1,861	(6%)

(1) Includes BC Rail and GLT from dates of acquisition.

Certain of the comparative statistical data and related productivity measures have been restated to reflect changes to estimated statistical data previously reported.

CANADIAN NATIONAL RAILWAY COMPANY

NON-GAAP MEASURES *(U.S. GAAP)*

Free cash flow

The Company believes that free cash flow is a useful measure of performance as it demonstrates the Company s ability to generate cash after the payment of capital expenditures and dividends. Free cash flow does not have any standardized meaning prescribed by GAAP and may, therefore, not be comparable to similar measures presented by other companies. The Company defines free cash flow as cash provided from operating activities, excluding changes in the level of accounts receivable sold under the securitization program, less investing activities and dividends paid, and adjusted for significant acquisitions as they are not indicative of normal day-to-day investments in the Company s asset base, calculated as follows:

	Three months ended September 30		**Nine months ended September 30**	
In millions	**2004**	2003	**2004**	2003
Cash provided from operating activities	**$ 556**	$ 526	**$ 1,451**	$ 1,388
Less:				
Investing activities	**(1,304)**	(307)	**(2,069)**	(701)
Dividends paid	**(56)**	(48)	**(167)**	(144)
Cash provided (used) before financing activities	**(804)**	171	**(785)**	543
Adjustments:				
Change in accounts receivable sold	**(7)**	(66)	**8**	(88)
Acquisition of BC Rail	**984**	-	**984**	-
Acquisition of GLT	**(6)**	-	**547**	-
Free cash flow	**$ 167**	$ 105	**$ 754**	$ 455

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Item 2

CANADIAN NATIONAL RAILWAY COMPANY

MANAGEMENTS DISCUSSION AND ANALYSIS *(U.S. GAAP)*

Managements discussion and analysis (MD&A) relates to the financial condition and results of operations of Canadian National Railway Company (CN) together with its wholly owned subsidiaries, including the railroads and related holdings of Great Lakes Transportation LLC (GLT) as of May 10, 2004 and BC Rail as of July 14, 2004. As used herein, the word Company means, as the context requires, CN and its subsidiaries. CNs common shares are listed on the Toronto and New York stock exchanges. Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars and determined on the basis of United States generally accepted accounting principles (U.S. GAAP). The Companys objective is to provide meaningful and relevant information reflecting the Companys financial condition and results of operations. The reader is advised to read all information provided in the MD&A in conjunction with the Companys 2003 Annual MD&A and 2004 Interim and 2003 Annual Consolidated Financial Statements and notes thereto.

BUSINESS PROFILE

CN, directly and through its subsidiaries, is engaged in the rail and related transportation business. CNs network of approximately 19,300 route miles of track spans Canada and mid-America, connecting three coasts: the Atlantic, the Pacific and the Gulf of Mexico. CNs revenues are derived from seven business units consisting of the movement of a diversified and balanced portfolio of goods which positions it well to face economic fluctuations and enhances its potential to grow revenues. In 2003, no individual business unit accounted for more than 22% of revenues. The sources of revenue also reflect a balanced mix of destinations. In 2003, 22% of revenues came from U.S. domestic traffic, 34% from transborder traffic, 25% from Canadian domestic traffic and 19% from overseas traffic. CN originates approximately 84% of traffic moving along its network. This allows the Company to both capitalize on service advantages and build on opportunities to efficiently use assets.

STRATEGY

CN is committed to creating value for both its customers and shareholders. By providing quality and cost-effective service, CN seeks to create value for its customers, which solidifies existing customer relationships, while enabling it to pursue new ones. Sustainable financial performance is a critical element of shareholder value, which CN strives to achieve by pursuing revenue growth, steadily increasing profitability, a solid free cash flow and an adequate return on investment. CNs business strategy is, and will continue to be, guided by its five core values: providing good service, controlling costs, focusing on asset utilization, commitment to safety, and developing and recognizing employees.

FINANCIAL RESULTS

Third quarter and first nine months of 2004 compared to corresponding periods in 2003

The Company recorded consolidated net income of $346 million ($1.21 per basic share or $1.19 per diluted share) for the quarter ended September 30, 2004 compared to $294 million ($1.04 per basic share or $1.02 per diluted share) in the third quarter of 2003, an increase of $52 million ($0.17 per basic and diluted share). Consolidated net income for the nine months ended September 30, 2004 was $882 million ($3.09 per basic share or $3.05 per diluted share) compared to $790 million ($2.75 per basic share or $2.71 per diluted share) in the same period of 2003, an increase of $92 million ($0.34 per basic and diluted share). The results for the third quarter and first nine months of 2004 include the results of operations of GLT as of May 10, 2004 and BC Rail as of July 14, 2004.

Operating income was $591 million for the third quarter of 2004 compared to $454 million in the same quarter of 2003, an increase of $137 million, or 30%. For the first nine months of 2004, operating income was $1,561 million compared to $1,265 million in the same period of 2003, an increase of $296 million, or 23%.

The operating ratio, defined as operating expenses as a percentage of revenues, was 65.4% in the third quarter of 2004 compared to 67.9% in the same quarter of 2003, a 2.5-point betterment. The nine-month operating ratio decreased to 67.6% in 2004 from 71.1% in the same period of 2003, a 3.5-point betterment.

The Companys results in the first nine months of 2003 included a cumulative benefit of $75 million, or $48 million after tax, resulting from a change in the accounting for removal costs for certain track structure

CANADIAN NATIONAL RAILWAY COMPANY
MANAGEMENTS DISCUSSION AND ANALYSIS *(U.S. GAAP)*

assets pursuant to the requirements of Statement of Financial Accounting Standards (SFAS) No. 143, Accounting for Asset Retirement Obligations.

Excluding the 2003 cumulative effect of change in accounting policy, consolidated net income for the first nine months of 2004 increased by $140 million, or 19%.

The first nine months of 2004 was affected by the significant year-over-year appreciation in the Canadian dollar relative to the U.S. dollar. The stronger Canadian dollar impacted the conversion of the Company's U.S. dollar denominated revenues and expenses, and accordingly, reduced revenues, operating income and net income by approximately $45 million, $15 million and $7 million, respectively, for the third quarter, and approximately $195 million, $70 million and $37 million, respectively, for the first nine months of 2004. Also impacting the results for the nine-month period ended September 30, 2004 was a strike by the Companys employees represented by the Canadian Auto Workers (CAW) union (the CAW strike) in February/March 2004. The strike, which lasted one month, negatively impacted operating income and net income for the nine-month period by approximately $35 million and $24 million, respectively.

Revenues

	Three months ended September 30			Nine months ended September 30		
	2004	2003	% Δ	**2004**	2003	% Δ
Total revenues (*$M)*	**1,709**	1,413	21%	**4,812**	4,372	10%
Rail freight:						
Revenues *($M)*	**1,621**	1,367	19%	**4,596**	4,230	9%
RTMs *(M)*	**44,266**	39,936	11%	**129,768**	119,678	8%
Revenue/RTM *(¢)*	**3.66**	3.42	7%	**3.54**	3.53	-

Revenues in the third quarter of 2004 totaled $1,709 million compared to $1,413 million during the same period in 2003, an increase of $296 million, or 21%. Revenues for the first nine months of 2004 were $4,812 million, an increase of $440 million, or 10%, from the same period last year. The increase in the third quarter and nine-month period was due to strong merchandise revenue, the inclusion of GLT and BC Rail revenues, $148 million for the quarter and $206 million for the nine-month period, and an improved Canadian grain crop. Strong intermodal revenues also affected the increase in the third quarter. Partially offsetting these gains was the translation impact of the stronger Canadian dollar on U.S dollar denominated revenues.

Revenue ton miles, measuring the volume of rail freight transported by the Company, increased by 11% in the third quarter and 8% in the first nine months of 2004 when compared to the same periods in 2003. Freight revenue per revenue ton mile, a measurement of yield defined as revenue earned on the movement of a ton of freight over one mile, increased by 7% in the third quarter and was flat for the first nine months of 2004 when compared to the same periods last year. In both the third quarter and the first nine months of 2004, freight revenue per revenue ton mile was positively affected by an overall decrease in the average length of haul and was negatively affected by the translation impact of the stronger Canadian dollar.

Petroleum and chemicals

	Three months ended September 30			Nine months ended September 30		
	2004	2003	% Δ	**2004**	2003	% Δ
Revenues (*$M)*	**299**	255	17%	**840**	798	5%
RTMs *(M)*	**8,373**	7,515	11%	**24,274**	22,933	6%
Revenue/RTM (¢)	**3.57**	3.39	5%	**3.46**	3.48	(1%)

Petroleum and chemicals comprise a wide range of commodities, including chemicals, sulfur, plastics, petroleum and gas products. Most of the Company's petroleum and chemicals shipments originate in the Gulf of Mexico, Alberta and eastern Canada, and are destined for customers in Canada, the United States and overseas. The performance of this business unit is closely correlated with the North American economy. Revenues for this business unit increased by $44 million, or 17%, for the third quarter and $42 million or 5%, for the first nine months of 2004 when compared to the same periods in 2003. The increase was due to freight rate improvements in several key segments, particularly in the first half of the year, the inclusion of $13 million of BC Rail revenues (primarily sulfur), higher offshore demand for Canadian sulfur, and a shift from offshore to Canadian suppliers for petroleum gas. These gains were partially offset by the translation impact of the stronger Canadian dollar. Revenue per revenue ton mile increased by 5% in the third quarter and declined by 1% for the first nine months of 2004 as the benefits of freight rate improvements were partially offset in the third quarter,

and more than offset in the first nine months of 2004, by the translation impact of the stronger Canadian dollar.

Metals and minerals

	Three months ended September 30			Nine months ended September 30		
	2004	2003	% Δ	**2004**	2003	% Δ
Revenues (*$M)*	**203**	130	56%	**521**	387	35%
RTMs *(M)*	**4,345**	3,421	27%	**12,332**	10,084	22%
Revenue/RTM (¢)	**4.67**	3.80	23%	**4.22**	3.84	10%

The metals and minerals business unit consists of nonferrous base metals, iron ore, steel, equipment and parts and construction materials. The Company's superior rail access to major mines and smelters throughout North America has made the Company a transportation leader of copper, lead, zinc concentrates, iron ore, refined metals and aluminum. Construction materials are mainly aggregates (stone and sand) and cement. The Company has access to major cement producers and aggregate mines in Canada as well as in the U.S. Metals and minerals traffic is sensitive to fluctuations in the economy. Revenues for this business unit increased by $73 million, or 56%, for the third quarter and $134 million, or 35%, for the first nine months of 2004 when compared to the same periods in 2003. The increase is mainly due to the inclusion of GLT revenues, $50 million for the quarter and $82 million for the nine-month period, higher volumes of iron ore, largely from new business, increased shipments of raw materials and metal bars, and freight rate improvements. Partially offsetting these gains was the translation impact of the stronger Canadian dollar. Revenue per revenue ton mile increased by 23% in the current quarter, and 10% in the first nine months of 2004, mainly due to GLT shorter-haul traffic which was partly offset by the translation impact of the stronger Canadian dollar.

Forest products

	Three months ended September 30			Nine months ended September 30		
	2004	2003	% Δ	**2004**	2003	% Δ
Revenues (*$M)*	**402**	322	25%	**1,065**	966	10%
RTMs *(M)*	**10,480**	8,811	19%	**28,465**	25,706	11%
Revenue/RTM (¢)	**3.84**	3.65	5%	**3.74**	3.76	(1%)

The forest products business unit includes various types of lumber, panels, wood chips, woodpulp, printing paper, linerboard and newsprint. The Company has superior rail access to the western and eastern Canadian fiber-producing regions, which are among the largest fiber source areas in North America. In the United States, the Company is strategically located to serve both the midwest and southern U.S. corridors with interline capabilities to other Class 1 railroads. The key drivers for the various commodities are: for newsprint, advertising lineage and overall economic conditions in the United States; for fibers (mainly wood pulp), the consumption of paper worldwide; and for lumber and panels traffic, housing starts and renovation activities in the United States. Although demand for forest products can be cyclical, the Company's geographical advantages and product diversity tend to reduce the impact of market fluctuations. Revenues for this business unit increased by $80 million, or 25%, for the third quarter and $99 million, or 10%, for the first nine months of 2004 when compared to the same periods in 2003. The increase in both the current quarter and first nine months of 2004 was largely due to the inclusion of $40 million of BC Rail revenues (mainly lumber and panels), continued solid demand for lumber, freight rate improvements and solid western Canadian woodpulp shipments. The translation impact of the stronger Canadian dollar partially offset these gains. Revenue per revenue ton mile increased by 5% in the current quarter and decreased by 1% in the first nine months of 2004 as the benefit of freight rate improvements and a positive change in traffic mix were partially offset in the third quarter, and more than offset in the nine-month period, by the translation impact of the stronger Canadian dollar.

Coal

	Three months ended September 30			Nine months ended September 30		
	2004	2003	% Δ	**2004**	2003	% Δ
Revenues (*$M)*	**71**	57	25%	**212**	201	5%

RTMs *(M)*	**3,451**	3,495	(1%)	**10,708**	11,022	(3%)
Revenue/RTM (¢)	**2.06**	1.63	26%	**1.98**	1.82	9%

The coal business consists primarily of thermal grades of bituminous coal. Canadian thermal coal is delivered to power utilities primarily in eastern Canada, while in the United States, thermal coal is transported from mines served in southern Illinois, or from western U.S. mines via interchange with other railroads, to major utilities in the Midwest and southeast United States. The coal business also includes the transport of metallurgical coal, which is largely exported to steel markets in Japan and other Asian markets. Revenues for this business unit increased by $14 million, or 25%, for the third quarter and $11 million, or 5%, for the first nine months of 2004 when compared to the same periods in 2003. Revenues in the third quarter and first nine months of 2004 benefited from higher coal shipments to U.S. utilities and the inclusion of GLT and BC Rail revenues, $7 million for the quarter and $12 million for the nine-month period, and were negatively impacted by metallurgical mine closures in western Canada and the translation impact of the stronger Canadian dollar. The revenue per revenue ton mile increase of 26% in the current quarter and 9% in the nine-month period was mainly due to a decrease in the average length of haul and a positive change in traffic mix that were partly offset by the translation impact of the stronger Canadian dollar.

Grain and fertilizers

	Three months ended September 30			Nine months ended September 30		
	2004	2003	% Δ	**2004**	2003	% Δ
Revenues *($M)*	**231**	220	5%	**756**	655	15%
RTMs *(M)*	**8,787**	8,272	6%	**28,693**	24,217	18%
Revenue/RTM *(¢)*	**2.63**	2.66	(1%)	**2.63**	2.70	(3%)

The grain and fertilizer business unit depends primarily on crops grown and fertilizers processed in western Canada and the U.S. Midwest. The grain segment consists of three primary commodities: food grains, mainly wheat; oilseeds and oilseed products, primarily canola seed, oil and meal; and feed grains, including feed barley, feed wheat, and corn. Production of grain varies considerably from year to year, affected primarily by weather conditions. Grain exports are volatile, reflecting the size of the crop produced, international market conditions and foreign government policy. In the U.S., grain grown in Illinois and Iowa is exported, as well as transported to domestic processing facilities and feed markets. The Company also serves producers of potash, ammonium nitrate, urea and other fertilizers. Revenues for this business unit increased by $11 million, or 5%, for the third quarter and $101 million, or 15%, for the first nine months of 2004 when compared to the same periods in 2003.The increase in both the quarter and the nine-month period reflects higher Canadian wheat and barley exports. Partially offsetting the increase in the current quarter was the translation impact of the stronger Canadian dollar and a late harvest for the Canadian grain crop. The increase in the first nine months of 2004 was partially offset by weak shipments of U.S. soybeans due to tight supply, a shift in exports from the Gulf to the Pacific Northwest and the translation impact of the stronger Canadian dollar. Revenue per revenue ton mile decreased by 1% in the current quarter and 3% in the nine-month period due to an increase in the average length of haul and the translation impact of the stronger Canadian dollar.

Intermodal

	Three months ended September 30			Nine months ended September 30		
	2004	2003	% Δ	**2004**	2003	% Δ
Revenues (*$M)*	**303**	280	8%	**817**	834	(2%)
RTMs *(M)*	**8,090**	7,802	4%	**22,817**	23,336	(2%)

Revenue/RTM (¢)	**3.75**	3.59	4%	**3.58**	3.57	-

The intermodal business unit is comprised of two segments: domestic and international. The domestic segment is responsible for consumer products and manufactured goods, operating through both retail and wholesale channels while the international segment handles import and export container traffic, serving the ports of Vancouver, Montreal, Halifax and New Orleans. The domestic segment is driven by consumer markets, with growth generally tied to the economy. The international segment is driven mainly by North American economic and trade conditions. Revenues for this business unit increased by $23 million, or 8%, for the third quarter and decreased by $17 million, or 2%, for the first nine months of 2004 when compared to the same periods in 2003. Both the third quarter and nine-month period benefited from heavy import volumes through the Port of Vancouver and price improvements, and were negatively affected by the de-marketing of marginal traffic, including the closure of the Company□s smaller terminal facilities in the U.S, and the translation impact of the stronger Canadian dollar. Revenues in the first nine months of 2004 were also negatively impacted by the first-quarter CAW strike. Revenue per revenue ton mile increased by 4% in the third quarter and was flat in the first nine months of 2004. Improvements in traffic mix were partially offset in the third quarter, and were entirely offset in the nine-month period, by an increase in the average length of haul and the translation impact of the stronger Canadian dollar.

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CANADIAN NATIONAL RAILWAY COMPANY

MANAGEMENT□S DISCUSSION AND ANALYSIS *(U.S. GAAP)*

Automotive

	Three months ended September 30			Nine months ended September 30		
	2004	2003	% Δ	**2004**	2003	% Δ
Revenues (*$M)*	**112**	103	9%	**385**	389	(1%)
RTMs *(M)*	**740**	620	19%	**2,479**	2,380	4%
Revenue/RTM (¢)	**15.14**	16.61	(9%)	**15.53**	16.34	(5%)

The automotive business unit moves both finished vehicles and parts, originating in southwestern Ontario, Michigan and Mississippi, destined for the United States, Canada and Mexico. The Company□s broad coverage, including its access to all of the Canadian assembly plants, enables it to consolidate full trainloads of automotive traffic for delivery to connecting railroads at key interchange points. The Company also serves shippers of import vehicles via the ports of Halifax and Vancouver, and through interchange with other railroads. The Company□s automotive revenues are closely correlated to automotive production and sales in North America. Revenues for this business unit increased by $9 million, or 9%, in the third quarter and decreased by $4 million, or 1%, in the first nine months of 2004 when compared to the same periods in 2003. The benefit of new finished vehicle traffic that began in late 2003 was partially offset in the third quarter, and more than offset in the nine-month period, by the translation impact of the stronger Canadian dollar. Revenue per revenue ton mile decreased by 9% in the current quarter and 5% in the first nine months of 2004, due to the translation impact of the stronger Canadian dollar. The third quarter was also negatively impacted by an increase in the average length of haul.

Other

In the third quarter and first nine months of 2004, other revenues increased by $42 million and $74 million, respectively, when compared to the same periods last year, mainly due to revenues from GLT□s maritime division of $38 million and $59 million, respectively.

CANADIAN NATIONAL RAILWAY COMPANY

MANAGEMENT'S DISCUSSION AND ANALYSIS *(U.S. GAAP)*

Operating expenses

In the third quarter of 2004, operating expenses amounted to $1,118 million compared to $959 million in the same quarter of 2003. Operating expenses for the first nine months of 2004 were $3,251 million compared to $3,107 million in the same period of 2003. The increase of $159 million, or 17%, in the third quarter was mainly due to the inclusion of $93 million of GLT and BC Rail expenses, increased fuel costs, and higher expenses for personal injuries, labor and fringe benefits and purchased services. Partly offsetting the increase was the translation impact of the stronger Canadian dollar on U.S. dollar denominated expenses. The increase of $144 million, or 5%, in the first nine months of 2004 was mainly due to the inclusion of $136 million of GLT and BC Rail expenses, higher expenses for labor and fringe benefits, increased fuel costs, and higher casualty and other and depreciation expense. Partly offsetting the increase was the translation impact of the stronger Canadian dollar on U.S. dollar denominated expenses and lower equipment rents. The month-long CAW strike had a minimal impact on overall operating expenses during the nine-month period ended September 30, 2004 as the benefit from lower labor and fringe benefit expenses was mostly offset by increases in other expense categories.

	Three months ended September 30				**Nine months ended September 30**			
In millions	**2004**		2003		**2004**		2003	
	Amount	**% of revenue**	Amount	% of revenue	**Amount**	**% of revenue**	Amount	% of revenue
Labor and fringe benefits	**$ 465**	**27.2%**	$ 414	29.3%	**$ 1,350**	**28.1%**	$ 1,283	29.3%
Purchased services and material	**190**	**11.1%**	151	10.7%	**561**	**11.7%**	529	12.1%
Depreciation and amortization	**153**	**9.0%**	136	9.6%	**445**	**9.2%**	418	9.6%
Fuel	**132**	**7.7%**	100	7.1%	**377**	**7.8%**	352	8.1%
Equipment rents	**64**	**3.7%**	69	4.9%	**195**	**4.1%**	228	5.2%
Casualty and other	**114**	**6.7%**	89	6.3%	**323**	**6.7%**	297	6.8%
Total	**$ 1,118**	**65.4%**	$ 959	67.9%	**$ 3,251**	**67.6%**	$ 3,107	71.1%

Labor and fringe benefits: Labor and fringe benefits includes wages, payroll taxes, and employee benefits such as incentive compensation, stock-based compensation, health and welfare, pensions and other post-employment benefits. These expenses increased by $51 million, or 12%, for the third quarter and $67 million, or 5%, for the first nine months of 2004 when compared to the same periods in 2003. The increase was attributable to the inclusion of GLT and BC Rail labor expense, $40 million for the quarter and $55 million for the nine-month period, higher wages and employee benefits, including increased costs for stock-based compensation, and charges and adjustments relating to the workforce reduction provision. Partly offsetting these factors were the translation impact of the stronger Canadian dollar, particularly in the first quarter of 2004, lower expenses for pensions and other post-retirement benefits and the effects of a reduced workforce. The first nine months of the year also benefited from wage and benefits savings during the CAW strike.

Purchased services and material: Purchased services and material primarily includes the costs of services purchased from outside contractors, materials used in the maintenance of the Company's track, facilities and equipment, transportation and lodging for train crew employees, utility costs and the net costs of operating facilities jointly used by the Company and other railroads. These costs increased by $39 million, or 26%, for the third quarter and $32 million, or 6%, for the first nine months of 2004 when compared to the same periods in 2003. The increase in the third quarter was mainly due to the inclusion of $29 million of GLT and BC Rail expenses, higher repair and maintenance expenses, and increased training costs, that were partly offset by the translation impact of the stronger Canadian dollar. The increase in the nine-month period was due to the inclusion of $46 million of GLT and BC Rail expenses, higher repair and maintenance expenses, partly related to the CAW strike, and other strike-related costs. Partly offsetting the increase was the translation impact of the stronger Canadian dollar and lower expenses for operating joint facilities.

Depreciation and amortization: Depreciation and amortization relates solely to the Company's rail operations. These expenses increased by $17 million,

or 13%, for the third quarter and $27 million, or 6%, for the first nine months of 2004 when compared to the same periods in 2003. The increase was mainly due to the inclusion of GLT and BC Rail expenses, $12 million for the quarter and $18 million for the nine-month period, and the impact of net capital additions, partially offset by the translation impact of the stronger Canadian dollar.

Fuel: Fuel expense includes the cost of fuel consumed by locomotives, intermodal equipment and other vehicles. These expenses increased by $32 million, or 32%, for the third quarter and $25 million, or 7%, for the first nine months of 2004 when compared to the same periods in 2003. The increase was mainly due to a higher average price per gallon, net of the impact of the hedging program, higher volumes, and the inclusion of GLT and BC Rail expenses, $8 million for the quarter and $10 million for the nine-month period. The increase was partly offset by the translation impact of the stronger Canadian dollar and, a fuel excise tax refund in the second quarter.

Equipment rents: Equipment rents include rental expenses for the use of freight cars owned by other railroads or private companies and for the short or long-term lease of freight cars, locomotives and intermodal equipment, net of rental income from other railroads for the use of the Company's cars and locomotives. These expenses decreased by $5 million, or 7%, for the third quarter and $33 million, or 14%, for the first nine months of 2004 when compared to the same periods in 2003. The decrease was mainly due to higher car hire income, including that of BC Rail, the translation impact of the stronger Canadian dollar and a reduction in car hire expenses that were partly offset by higher lease expense for freight cars.

Casualty and other: Casualty and other includes expenses for personal injuries, environmental, freight and property damage, insurance, bad debt and operating taxes as well as travel and travel-related expenses. These expenses increased by $25 million, or 28%, for the third quarter and $26 million, or 9%, for the first nine months of 2004 when compared to the same periods in 2003. The increase in the third quarter was mainly due to higher expenses for personal injuries and the inclusion of GLT and BC Rail expenses. The increase in the first nine months of 2004 was due to higher expenses for personal injuries, the inclusion of GLT and BC Rail expenses, increased environmental expenses, favorable adjustments to U.S. property taxes in 2003, and strike-related travel expenses. Partially offsetting the increase was the translation impact of the stronger Canadian dollar.

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MANAGEMENTS DISCUSSION AND ANALYSIS *(U.S. GAAP)*

Other

Interest expense: Interest expense for the third quarter of 2004 increased by $3 million, or 4%, from the comparable 2003 quarter and decreased by $25 million, or 10%, for the first nine months of 2004 versus the same 2003 period. Interest expense related to the issuance of new debt was partly offset in the third quarter, and more than offset in the nine-month period, by the benefit of lower interest rates on new debt to replace matured debt and the translation impact of the stronger Canadian dollar.

Other income (loss): In the third quarter and first nine months of 2004, the Company recorded a loss of $9 million and $45 million, respectively, compared to income of $13 million, respectively, in the same periods last year. The decrease in other income (loss) in both the quarter and nine-month period was due to lower gains on disposal of surplus properties. Lower equity income from the Companys investment in English Welsh and Scottish Railway (EWS) as a result of restructured operations also affected the decrease in the nine-month period ended 2004.

Income tax expense: The Company recorded income tax expense of $157 million for the third quarter of 2004 compared to $97 million in the corresponding 2003 period. For the nine-month period ended September 30, 2004, income tax expense was $415 million compared to $292 million for the same period in 2003. The effective tax rate for the third quarter and first nine months of 2004 was 31.2% and 32.0%, respectively. The effective tax rate for the third quarter and first nine months of 2003 was 24.8% and 28.2%, respectively. The increase in the effective tax rates in 2004 was mainly due to net favorable adjustments relating to the resolution of matters pertaining to prior years income taxes.

Summary of quarterly results - unaudited

In millions, except per share data

	2004			2003				2002
	Third	**Second**	**First**	**Fourth**	**Third**	**Second**	**First**	**Fourth** (1)
Revenues	$ 1,709	$ 1,665	$ 1,438	$ 1,512	$ 1,413	$ 1,463	$ 1,496	$ 1,547
Operating income	$ 591	$ 575	$ 395	$ 512	$ 454	$ 437	$ 374	$ 89
Net income	$ 346	$ 326	$ 210	$ 224	$ 294	$ 244	$ 252	$ 22
Basic earnings per share	$ 1.21	$ 1.14	$ 0.74	$ 0.79	$ 1.04	$ 0.85	$ 0.86	$ 0.07
Diluted earnings per share	$ 1.19	$ 1.13	$ 0.73	$ 0.78	$ 1.02	$ 0.84	$ 0.85	$ 0.07
Dividend declared per share	$ 0.195	$ 0.195	$ 0.195	$ 0.167	$ 0.167	$ 0.167	$ 0.167	$ 0.143

(1) In the fourth quarter of 2002, the Company recorded a charge of $281 million ($173 million after tax) to increase its liability for U.S. personal injury and other claims and a charge for workforce reductions of $120 million ($79 million after tax).

Liquidity and capital resources

The Companys principal source of liquidity is cash generated from operations. The Company also has the ability to fund liquidity requirements through its revolving credit facility, the issuance of debt and/or equity, and the sale of a portion of its accounts receivable through a securitization program. In addition, from time to time, the Companys liquidity requirements can be supplemented by the disposal of surplus properties and the monetization of assets.

Operating activities: Cash provided from operating activities for the three and nine months ended September 30, 2004 was $556 million and $1,451 million, respectively, compared to $526 million and $1,388 million, respectively, for the same periods in 2003. Net cash receipts from customers and others were $4,761 million for the nine months ended September 30, 2004

compared to $4,647 million in the same period of 2003. Payments for employee services, suppliers and other expenses were $2,754 million for the nine months ended September 30, 2004, an increase of $63 million from the comparative 2003 period. Also consuming cash in the first nine months of 2004, were payments for interest, workforce reductions and personal injury and other claims of $199 million, $81 million and $78 million, respectively, compared to $243 million, $121 million and $91 million, respectively in 2003. In 2004, pension contributions and payments for income taxes were $119 million and $79 million, respectively, compared to $43 million and $70 million, respectively in 2003.

As at September 30, 2004, the Company had outstanding information technology service contracts of $24 million.

Investing activities: Cash used by investing activities in the quarter and nine months ended September 30, 2004 amounted to $1,304 million and $2,069 million, respectively, compared to $307 million and $701 million for the comparable periods in 2003. The Companys investing activities in the first nine months of 2004 included $984 million related to the acquisition of BC Rail and $547 million related to the acquisition of GLT, net proceeds of $141 million from the EWS capital reorganization and $35 million from the sale of its Canac Inc. subsidiary. Net capital expenditures amounted to $323 million and $707 million in the three and nine months ended September 30, 2004, respectively, an increase of $14 million and $11 million from the same 2003 periods. The following table details capital expenditures for the third quarter and first nine months of 2004 and 2003.

	Three months ended September 30		Nine months ended September 30	
In millions	**2004**	2003	**2004**	2003
Rail infrastructure	**$ 220**	$ 223	**$ 526**	$ 497
Rolling stock	**80**	31	**164**	102
Information technology and other	**85**	56	**130**	124
	385	310	**820**	723
Less: capital leases	**62**	1	**113**	27

Net capital expenditures	**$**	**323**	$	309	**$**	**707**	$	696

The Company expects that its capital expenditures will be approximately $1,250 million in 2004, an increase from 2003, due to capital programs related to recent acquisitions and an increase to the locomotive fleet. Capital expenditures include funds required for ongoing renewal of the basic plant and other acquisitions and investments required to improve the Companys operating efficiency and customer service.

As at September 30, 2004, the Company had commitments to acquire railroad ties, rail, freight cars, locomotives and other equipment at an aggregate cost of $175 million ($211 million at December 31, 2003).

Dividends: The Company paid a quarterly dividend of $0.195 per share amounting to $56 million for the third quarter and $167 million for the first nine months of 2004 compared to $48 million and $144 million, respectively, at the rate of $0.167 per share, for the same periods in 2003.

Free cash flow

The Company generated $167 million and $754 million of free cash flow for the three and nine months ended September 30, 2004, compared to $105 million and $455 million for the same 2003 periods. Free cash flow does not have any standardized meaning prescribed by GAAP and may, therefore not be comparable to similar measures presented by other companies. The Company believes that free cash flow is a useful measure of performance as it demonstrates the Companys ability to generate cash after the payment of capital expenditures and dividends. The Company defines free cash flow as cash provided from operating activities, excluding changes in the level of accounts receivable sold under the securitization program, less investing activities and dividends paid, and adjusted for significant acquisitions as they are not indicative of normal day-to-day investments in the Companys asset base, calculated as follows:

	Three months ended September 30		Nine months ended September 30	
In millions	**2004**	2003	**2004**	2003
Cash provided from operating activities	**$ 556**	$ 526	**$ 1,451**	$ 1,388
Less:				
Investing activities	**(1,304)**	(307)	**(2,069)**	(701)
Dividends paid	**(56)**	(48)	**(167)**	(144)
Cash provided (used)				

before financing activities	**(804)**	171	**(785)**	543
Adjustments:				
Change in accounts receivable sold	**(7)**	(66)	**8**	(88)
Acquisitions of BC Rail & GLT	**978**	-	**1,531**	-
Free cash flow	**$ 167**	$ 105	**$ 754**	$ 455

Financing activities: Cash provided from financing activities totaled $801 million for the third quarter and $787 million for the nine months ended September 30, 2004 compared to cash used by financing activities of $179 million and $446 million, respectively, for the same periods in 2003. In July 2004, the Company issued U.S.$300 million (Cdn$395 million) of 4.25% Notes due 2009 and U.S.$500 million (Cdn$658 million) of 6.25% Debentures due 2034. In March 2004, the Company had repaid U.S.$266 million (Cdn$355 million) of 7.00% 10-year Notes with cash on hand and the proceeds received from the issuance of commercial paper. In May 2003, the Company had repaid U.S.$150 million (Cdn$207 million) of 6.625% 10-year Notes and U.S.$100 million (Cdn$138 million) of 6.75% 10-year Notes with the proceeds received in March 2003 from the issuance of U.S.$400 million (Cdn$586 million) 4.40% Notes due 2013. In the third quarter and first nine months of 2004 and 2003, issuances and repayments of long-term debt related principally to the Company's commercial paper and revolving credit facility.

In 2003, the Company used $656 million to repurchase the remaining 10.0 million common shares under its 13.0 million share repurchase program. The total cost of the program was $859 million.

During the third quarter and first nine months of 2004, the Company recorded $62 million and $113 million, respectively, in capital lease obligations ($1 million and $27 million, respectively, for the comparable 2003 periods) related to new equipment and the exercise of purchase options on existing equipment.

The Company has access to various financing arrangements:

Revolving credit facility

The Company has a U.S.$1,000 million three-year revolving credit facility expiring in December 2005. The credit facility provides for borrowings at various interest rates, plus applicable margins, and contains customary financial covenants with which the Company has been in full compliance. The Company's borrowings of U.S.$180 million (Cdn$233 million) outstanding at December 31, 2003 were entirely repaid in the first quarter of 2004. As at September 30, 2004, letters of credit under the revolving credit facility amounted to $344 million.

Commercial paper

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 long-term revolving credit facility. As at September 30, 2004, the Company had outstanding borrowings of U.S.$266 million (Cdn$337 million) under the commercial paper program.

Shelf registration statement

On July 9, 2004, the Company issued U.S.$300 million (Cdn$395 million) of 4.25% Notes due 2009 and U.S.$500 million (Cdn$658 million) of 6.25% Debentures due 2034. The debt offering was made under the Company's shelf prospectus and registration statement filed in October 2003. Accordingly, the amount available under the shelf prospectus and registration statement has been reduced to U.S.$200 million. The Company used the net proceeds of U.S.$790 million to finance a portion of the acquisition costs of BC Rail and GLT.

The Company□s access to current and alternate sources of financing at competitive costs is dependent on its credit rating. The Company is not currently aware of any adverse trend, event or condition that would affect the Company□s credit rating.

Contractual obligations

In the normal course of business, the Company incurs contractual obligations. The following table sets forth the Company□s contractual obligations for the following items as at September 30, 2004:

In millions	**Total**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009 & thereafter**
Long-term debt obligations (a)	**$ 4,609**	$ 12	$ 481	$ 324	$ 63	$ 219	$ 3,510
Capital lease obligations (b)	**1,157**	47	120	87	125	48	730
Operating lease obligations	**1,037**	59	210	196	143	113	316
Purchase obligations (c)	**199**	127	62	8	2	-	-
Total obligations	**$ 7,002**	**$ 245**	**$ 873**	**$ 615**	**$ 333**	**$ 380**	**$ 4,556**

(a) Presented net of unamortized discounts, of which $819 million relates to a non-interest bearing Note due in 2094 assumed as part of the BC Rail acquisition and excludes capital lease obligations of $789 million which are included in □Capital lease obligations.□

(b) Includes $368 million of imputed interest on capital leases at rates ranging from approximately 2.23% to 13.13%.

(c) Includes commitments for railroad ties, rail, freight cars, locomotives and other equipment and outstanding information technology service contracts.

For 2004 and the foreseeable future, the Company expects cash flow from operations and from its various sources of financing to be sufficient to meet its debt repayments and future obligations, and to fund anticipated capital expenditures.

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MANAGEMENTS DISCUSSION AND ANALYSIS *(U.S. GAAP)*

Acquisitions

BC Rail

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

On July 2, 2004, the Company reached a consent agreement with Canadas 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 the Financial Accounting Standards Boards (FASB) SFAS No.141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. As such, the consolidated financial statements of the Company include the assets, liabilities and results of operations of BC Rail as of July 14, 2004, the date of acquisition. The Companys cost to acquire BC Rail of $1,004 million includes purchase price adjustments and transaction costs. The preliminary purchase price allocation, based on the fair value of BC Rails assets, owned and leased, and liabilities acquired at acquisition, as presented in Note 2 Acquisitions, of the Companys interim consolidated financial statements, is subject to a final valuation, the impact of which, and any changes in accounting practices, are not expected to have a material effect on the results of operations.

Great Lakes Transportation LLCs Railroads and Related Holdings

In October 2003, the Company, through an indirect wholly owned subsidiary, entered into an agreement for the acquisition of Great Lakes Transportation LLCs railroads and related holdings (GLT) for a purchase price of U.S.$380 million.

In 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 consolidated financial statements of the Company include the assets, liabilities and results of operations of GLT as of May 10, 2004, the date of acquisition. The Companys cost to acquire GLT of U.S.$395 million (Cdn$547 million) includes purchase price adjustments and transaction costs. The preliminary purchase price allocation, based on the fair value of GLTs assets and liabilities acquired at acquisition, as presented in Note 2 Acquisitions, of the Companys interim consolidated financial statements, is subject to a final valuation, the impact of which, and any changes in accounting practices, are not expected to have a material effect on the results of operations.

These acquisitions involve the integration of two previously independent businesses to provide shippers enhanced rail services over a coordinated network. There can be no assurance that CN will be able to integrate its business with that of either BC Rail or GLT without encountering operational difficulties or experiencing the loss of key employees or customers, or that the rail service levels and other efficiencies or synergies expected from these acquisitions will be attained.

Investment in English Welsh and Scottish Railway (EWS) Capital reorganization

On January 6, 2004, EWS shareholders approved a plan to reduce the EWS share capital to enable cash to be returned to the shareholders by offering them the ability to cancel a portion of their EWS shares. For each share cancelled, EWS shareholders would receive cash and 8% notes due in 2009, redeemable in whole or in part at any time by EWS, at their principal amount together with accrued but unpaid interest up to the date of repayment.

The Company elected to have the maximum allowable number of shares cancelled under the plan, thereby reducing its ownership interest of EWS to approximately 31% on a fully diluted basis (13.7 million shares) compared to approximately 37% on a fully diluted basis

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(43.7 million shares) prior to the capital reorganization. In the first quarter of 2004, the Company received £81.6 million (Cdn$199 million) from EWS, of which £23.9 million (Cdn$58 million) was in the form of EWS notes.

Off balance sheet arrangements

Accounts receivable securitization program

The Company has an accounts receivable securitization program, expiring in June 2006, under which it may sell, on a revolving basis, a maximum of $450 million of eligible freight trade and other receivables outstanding at any point in time, to an unrelated trust. The Company has a contingent residual interest of approximately 10% of receivables sold, which is recorded in Other current assets.

The Company is subject to customary reporting requirements for which failure to perform could result in termination of the program. In addition, the trust is subject to customary credit rating requirements, which if not met could also result in termination of the program. The Company is not currently aware of any trend, event or condition that would cause such termination.

The accounts receivable securitization program provides the Company with readily available short-term financing for general corporate uses. In the event the program is terminated before its scheduled maturity, the Company expects to meet its future payment obligations through its various sources of financing, including its revolving credit facility and commercial paper program, and/or access to capital markets.

At September 30, 2004, pursuant to the agreement, $436 million had been sold compared to $448 million at December 31, 2003.

Guarantees and indemnifications

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

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. 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.

The nature of these guarantees or indemnifications, the maximum potential amount of future payments, the carrying amount of the liability, if any, and the nature of any recourse provisions are disclosed in Note 8 Major commitments and contingencies of the Companys interim Consolidated Financial Statements.

Financial instruments

The Company has limited involvement with derivative financial instruments and does not use them for trading purposes. Collateral or other security to support financial instruments subject to credit risk is usually not obtained. While the Company is exposed to counterparty credit risk in the event of non-performance, the credit standing of counterparties or their guarantors is regularly monitored, and losses due to counterparty non-performance are not anticipated.

Fuel

To mitigate the effects of fuel price changes on its operating margins and overall profitability, the Company has a systematic hedging program which calls for regularly entering into swap positions on crude and heating oil to cover a target percentage of future fuel consumption up to two years in advance. At September 30, 2004, the Company had hedged approximately 56% of the estimated remaining 2004 fuel consumption, representing approximately 56 million U.S. gallons at an average price of U.S.$0.67 per U.S. gallon, 51% of the estimated 2005 fuel consumption, representing approximately 203 million U.S. gallons at an average price of U.S.$0.74 per U.S. gallon, and 17% of the estimated 2006 fuel consumption, representing 69 million U.S. gallons at an average price of U.S.$0.89 per U.S. gallon.

For the three months ended September 30, 2004, the Company realized a $32 million gain from its fuel hedging activities compared to a $10 million gain in the comparative quarter of 2003. For the first nine months of 2004, the Company's hedging activities resulted in a realized gain of $73 million compared to $37 million in the same period of 2003.

Other comprehensive income for the quarters ended September 30, 2004 and 2003 included an unrealized gain of $69 million, $47 million after tax, and an

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unrealized loss of $5 million, $3 million after tax, respectively. For the first nine months of 2004 and 2003, other comprehensive income included an unrealized gain of $112 million, $76 million after tax, and an unrealized loss of $6 million, $4 million after tax, respectively.

At September 30, 2004, Accumulated other comprehensive income included an unrealized gain of $150 million, $102 million after tax ($38 million unrealized gain, $26 million after tax at December 31, 2003), of which $123 million relates to derivative instruments that will mature within the next twelve months.

Interest rate

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

At September 30, 2004, Accumulated other comprehensive income included an unamortized gain of $12 million, $8 million after tax.

Common stock

Share repurchase program

On October 26, 2004, the Board of Directors of the Company approved a share repurchase program which allows for the repurchase of up to 14 million common shares between November 1, 2004 and October 31, 2005 pursuant to a normal course issuer bid, at prevailing market prices.

Common stock split

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

Outstanding share data

As at October 25, 2004, the Company had 286.5 million common shares outstanding.

Critical accounting policies

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 based upon currently available information. Actual results could differ from these estimates. The Company□s policies for personal injury and other claims, environmental matters, depreciation lives, pensions and other post-retirement benefits, and income taxes, require management□s more significant judgments and estimates in the preparation of the Company□s consolidated financial statements and as such, are considered to be critical. The discussion on the methodology and assumptions underlying these critical accounting estimates, their effect on the Company□s results of operations and financial position for the three years ended December 31, 2003, as well as the effect of changes to these estimates, can be found on pages 42 to 45 of the Company□s 2003 Annual Report and has not changed materially since December 31, 2003. As at September 30, 2004 and December 31 and September 30, 2003, the Company had the following amounts outstanding:

In millions	**Sept. 30 2004**	December 31 2003	Sept. 30 2003
	(unaudited)		(unaudited)
Prepaid benefit cost for pensions	**$ 491**	$ 411	$ 373
Accrued benefit cost for pensions	**38**	-	-
Provision for personal injury and other claims	**649**	590	613
Provision for environmental costs	**117**	83	86
Net deferred income tax provision	**4,567**	4,425	4,366
Accrued benefit cost for post-retirement benefits other than pensions	**444**	290	289
Properties	**20,022**	18,305	18,478

Management has discussed the development and selection of the Company□s critical accounting estimates with the Audit, Finance and Risk Committee of the Company□s Board of Directors and the Audit, Finance and Risk Committee has reviewed the Company□s related disclosures.

Business risks

Certain information included in this report may be □forward-looking statements□ within the meaning of the United States Private Securities Litigation Reform Act of 1995. Such forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors which may cause the outlook, the actual results or performance of the Company or the rail industry to be materially different from any future results or performance implied by such statements. Such factors include those set forth below as well as other risks detailed from time to time in reports filed by the Company with securities regulators in Canada and the United States.

Competition

The Company faces significant competition from a variety of carriers, including Canadian Pacific Railway Company (CP) which operates the other major rail system in Canada, serving most of the same industrial and population centers as the Company, long distance trucking companies and, in many markets, major U.S. railroads and other Canadian and U.S. railroads. Competition is generally based on the quality and reliability of services provided, price, and the condition and suitability of carriers equipment. Competition is particularly intense in eastern Canada where an extensive highway network and population centers, located relatively close to one another, have encouraged significant competition from trucking companies. In addition, much of the freight carried by the Company consists of commodity goods that are available from other sources in competitive markets. Factors affecting the competitive position of suppliers of these commodities, including exchange rates, could materially adversely affect the demand for goods supplied by the sources served by the Company and, therefore, the Companys volumes, revenues and profit margins.

In addition to trucking competition, and to a greater degree than other rail carriers, the Companys subsidiary, Illinois Central Railroad Company (ICRR), is vulnerable to barge competition because its main routes are parallel to the Mississippi River system. The use of barges for some commodities, particularly coal and grain, often represents a lower cost mode of transportation. Barge competition and barge rates are affected by navigational interruptions from ice, floods and droughts, which can cause widely fluctuating barge rates. The ability of ICRR to maintain its market share of the available freight has traditionally been affected by the navigational conditions on the river.

The significant consolidation of rail systems in the United States has resulted in larger rail systems that are able to offer seamless services in larger market areas and, accordingly, compete effectively with the Company in certain markets. This requires the Company to consider transactions that would similarly enhance its own service, such as its acquisitions of BC Rail and the GLT carriers. There can be no assurance that the Company will be able to compete effectively against current and future competitors in the railroad industry and that further consolidation within the railroad industry will not adversely affect the Companys competitive position. No

assurance can be given that competitive pressures will not lead to reduced revenues, profit margins or both.

Environmental matters

The Companys 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 for environmental matters in the next several years, based on known information, the Companys 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.

In railroad and related transportation operations, it is possible that derailments, explosions or other accidents may occur that could cause harm to human health or to the environment. As a result, the Company may incur costs in the future, which may be material, to address any such harm, including costs relating to the performance of clean-ups, natural resource damages and compensatory or punitive damages relating to harm to individuals or property.

The ultimate cost of known contaminated sites cannot be definitely established, and the estimated environmental liability for any given site may vary depending on the nature and extent of the contamination, the available clean-up technique, the Company's share of the costs and evolving regulatory standards governing environmental liability. Also, additional contaminated sites yet unknown may be discovered or future operations may result in accidental releases. For these reasons, there can 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 affected by such environmental liabilities or costs.

Personal injury and other claims

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. The Company maintains provisions for such items, which it considers to be adequate for all of its outstanding or pending claims. The final outcome with respect to actions outstanding or pending at September 30, 2004, or with respect to future claims, cannot be predicted with certainty, and therefore there can be no assurance that their resolution will not have a material adverse effect on the Company's financial position or results of operations in a particular quarter or fiscal year.

Labor negotiations

Canadian workforce

Labor agreements covering approximately 97% of the Company's Canadian unionized workforce expired on December 31, 2003. As of October 2004, the Company has successfully negotiated four collective agreements with the CAW, retroactive to January 1, 2004, covering the Company's shopcraft forces, clerical workers, intermodal yard employees and owner operators. Agreements were also reached with CN's Rail Traffic Controllers, Toronto Terminal employees and the Canadian Railway Police Association. The United Transportation Union (UTU), representing 20% of the unionized workforce in Canada, have filed for conciliation and the Minister of Labour appointed a conciliator on October 15, 2004. The role of the conciliator is to assist the parties in negotiating a new collective agreement. The conciliation process may take up to 60 days, although the parties may mutually agree to extend this time period. The parties do not acquire the right to strike or lockout, at the earliest, until 21 days after completing the conciliation process, and they must fulfill a number of legal requirements before exercising these rights, including giving at least 72 hours' notice of an impending strike or lockout. The Company is currently undergoing discussions with all its remaining trade unions, representing 40% of the unionized workforce in

Canada, whose agreements also expired on December 31, 2003.

In the third quarter of 2004, the Company acquired BC Rail. The Canada Labour Code now governs this former provincial entity. Labor contracts remain in effect until either, the parties negotiate new collective agreements or, the parties agree to integrate the BC Rail employees into the Company's current bargaining structure. The Company is currently undergoing discussions with BC Rail Unions. In the absence of negotiated agreements, the Canadian Industrial Relations Board (CIRB) can determine whether the employees should be integrated into CN's bargaining structure.

In the first quarter of 2004, the Company's shopcraft forces, clerical workers and intermodal yard employees, represented by the CAW had rejected three tentative agreements signed by the CAW and the Company on January 23, 2004. The strike that ensued lasted one month and disrupted the Company's operations and affected operating income by approximately $35 million in the first quarter of 2004. There can be no assurance that the Company will be able to have all its collective agreements renewed and ratified without any other strikes or lockouts, or that such strikes or lockouts or the resolution of these collective bargaining negotiations will not have a material adverse effect on the Company's financial position or results of operations.

U.S. workforce

The general approach to labor negotiations by U.S. Class 1 railroads is to bargain on a collective national basis. Grand Trunk Western (GTW), Duluth, Winnipeg and Pacific (DWP), ICRR, CCP Holdings, Inc. (CCP) and Wisconsin Central Transportation Corporation (WC), have bargained on a local basis rather than holding national, industry wide negotiations because it results in agreements that better address both the employees' concerns and preferences, and the railways' actual operating environment. However, local negotiations may not generate federal intervention in a strike or lockout situation, since a dispute may be localized. The Company believes the potential mutual benefits of local bargaining outweigh the risks.

As of October 2004, the Company had in place agreements with bargaining units representing the entire unionized workforce at ICRR, GTW, DWP, CCP and GLT, and 93% of the unionized workforce at WC. Agreements in place have various moratorium provisions, ranging from the end of 2001 to the end of 2005, which preserve the status quo in respect of given areas during the terms of such moratoriums. Several of these agreements are currently under renegotiation and several will open for negotiation by the end of 2004.

Negotiations are ongoing with the bargaining units with which the Company does not have agreements or settlements. Until new agreements are reached or the processes of the Railway Labor Act have been exhausted, the terms and conditions of existing agreements or policies continue to apply. Although the Company does not anticipate work action related to these negotiations while they are ongoing, there can be no assurance that there will not be any such work action and that the resolution of these negotiations will not have a material adverse effect on the Company's financial position or results of operations.

Regulation

The Company's rail operations in Canada are subject to regulation as to (i) rate setting and network rationalization by the Canadian Transportation Agency (the Agency) under the Canada Transportation Act (Canada) (the CTA), and (ii) safety by the federal Minister of Transport under the Railway Safety Act (Canada) and certain other statutes. The Company's U.S. rail operations are subject to regulation as to (i) economic regulation by the Surface Transportation Board (STB) (the successor to the Interstate Commerce Commission) and (ii) safety by the Federal Railroad Administration. As such, various Company business transactions must gain prior regulatory approval, with attendant risks and uncertainties. The Company is also subject to a variety of health, safety, security, labor, environmental and other regulations, all of which can affect its competitive position and profitability.

The CTA Review Panel, which was appointed by the federal government to carry out a comprehensive review of the Canadian transportation legislation, issued its report to the Minister of Transport at the end of June 2001. The report was released to the public on July 18, 2001 and contains numerous recommendations for legislative changes affecting all modes of transportation, including rail. On February 25, 2003, the Canadian Minister of Transport released its policy document *Straight Ahead A Vision for Transportation in Canada* and tabled in the House of Commons Bill C-26 entitled *An Act to Amend the Canada Transportation Act and the Railway Safety Act, to enact the VIA Rail Canada Act and to make consequential amendments to other Acts*. Bill C-26 died on the Order Paper (was terminated) when Parliament

was prorogued on November 12, 2003. No assurance can be given that any future legislative action by the federal government pursuant to the report's recommendations and the policy document, or other future governmental initiatives will not materially adversely affect the Company's financial position or results of operations.

The U.S. Congress has had under consideration for several years various pieces of legislation that would increase federal economic regulation of the railroad industry. In addition, the STB is authorized by statute to commence regulatory proceedings if it deems them to be appropriate. No assurance can be given that any future regulatory initiatives by the U.S. federal government will not materially adversely affect the Company's operations, or its competitive and financial position.

The Company is subject to new statutory and regulatory directives in the United States addressing homeland security concerns. These include new border security arrangements, pursuant to an agreement the Company and CP entered into with U.S. Customs and Border Protection (CBP) and the Canada Border Services Agency (CBSA). New requirements include advance electronic transmission of cargo information for U.S.-bound traffic and cargo screening (including gamma ray and radiation screening), as well as U.S. government imposed restrictions on the transportation into the United States of certain commodities. In the fourth quarter of 2003, the CBP issued regulations to extend advance notification requirements to all modes of transportation and the U.S. Food and Drug Administration promulgated interim final rules requiring advance notification by all modes for certain food imports into the United States. The Company has also worked with the Association of American Railroads to develop and put in place an extensive industry-wide security plan. While the Company will continue to work closely with the CBSA, CBP, and other Canadian and U.S. agencies, as above, no assurance can be given that future decisions by the U.S. and/or Canadian governments on homeland security matters, or joint decisions by the industry in response to threats to the North American rail network, will not materially adversely affect the Company's operations, or its competitive and financial position.

In October 2002, the Company became the first North American railroad to gain membership in the U.S. Customs Service's Customs-Trade Partnership Against Terrorism (C-TPAT). C-TPAT is a joint government-business initiative designed to build cooperative relationships that strengthen overall supply chain and border security on goods exported to the U.S. The Company is also designated as a low-risk carrier under the Customs Self-Assessment (CSA) program, a CBSA program designed to expedite the cross-border movement of goods of CSA-accredited importing companies for goods imported into Canada.

The Company's ownership of the former Great Lakes Transportation vessels is subject to regulation by the U.S. Coast Guard and the Department of Transportation, Maritime Administration, which regulate the ownership and operation of vessels operating on the Great Lakes and in U.S. coastal waters. On February 4, 2004, the Maritime Administration and the U.S. Coast Guard issued a Joint Notice of Proposed Rulemaking, proposing modifications to the regulations governing vessel documentation for lease financing for vessels engaged in the coastwise trade. In addition, the U.S. Congress has from time to time considered modifications to the legislation governing the United States coastwise trade. As a result of maritime legislation enacted earlier this year, the regulations governing the Company's acquisition of these vessels should not be affected. No assurance can be given that any future legislative or regulatory initiatives by the U.S. federal government will not materially adversely affect the Company's operations, or its competitive and financial position.

Business prospects and other risks

In any given year, the Company, like other railroads, is susceptible to changes in the economic conditions of the industries and geographic areas that produce and consume the freight it transports or the supplies it requires to operate. In addition, many of the goods and commodities carried by the Company experience cyclicality in demand. Many of the bulk commodities the Company transports move offshore and are affected more by global rather than North American economic conditions. The Company's results of operations can be expected to reflect these conditions because of the significant fixed costs inherent in railroad operations.

Global, as well as North American trade conditions, including trade barriers on certain commodities, may interfere with the free circulation of goods across Canada and the United States.

Potential terrorist actions can have a direct or indirect impact on the transportation infrastructure, including railway infrastructure in North America, and interfere with the free flow of goods. International conflicts can also have an impact on the Company's markets.

CANADIAN NATIONAL RAILWAY COMPANY
MANAGEMENTS DISCUSSION AND ANALYSIS *(U.S. GAAP)*

Although the Company conducts its business and receives revenues primarily in Canadian dollars, a growing portion of its revenues, expenses, assets and debt are denominated in U.S. dollars. Thus, the Companys results are affected by fluctuations in the exchange rate between these currencies. Based on the Companys current operations, the estimated annual impact on net income of a year-over-year one-cent change in the Canadian dollar relative to the U.S. dollar is approximately $8 million. Changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby affect the Companys revenues and expenses.

Should a major economic slowdown or recession occur in North America or other key markets, or should major industrial restructuring take place, the volume of rail shipments carried by the Company is likely to be adversely affected.

In addition to the inherent risks of the business cycle, the Companys operations are occasionally susceptible to severe weather conditions, which can disrupt operations and service for the railroad as well as for the Companys customers. Recent severe drought conditions in western Canada, for instance, significantly reduced bulk commodity revenues, principally grain.

Generally accepted accounting principles require the use of historical cost as the basis of reporting in financial statements. As a result, the cumulative effect of inflation, which has significantly increased asset replacement costs for capital-intensive companies such as CN, is not reflected in operating expenses. Depreciation charges on an inflation-adjusted basis, assuming that all operating assets are replaced at current price levels, would be substantially greater than historically reported amounts.

Controls and procedures

The Companys Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Companys disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of September 30, 2004, have concluded that the Companys disclosure controls and procedures were adequate and effective and designed to ensure that material information relating to the Company and its consolidated subsidiaries would have been made known to them. During the third quarter ending September 30, 2004, there was no change in the Companys internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Companys internal control over financial reporting.

Additional information, including the Companys Annual Information Form and Form 40-F, may be found on SEDAR at www.sedar.com and on EDGAR at www.sec.gov/edgar.shtml, respectively.

Montreal, Canada
October 25, 2004

Item 3

Investor Services
Computershare Trust Company of Canada

1500 University Street
Suite 700
Montreal Quebec H3A 3S8
Telephone 1-800-332-0095
Facsimile 514-982-7580
Email: service@computershare.com
www.computershare.com

Canada
Australia
Channel Islands
Hong Kong
Ireland
New Zealand
Philippines
South Africa
United Kingdom
USA

Sean Finn
Senior Vice-President Public Affairs, Chief Legal Officer and Corporate Secretary
Canadian National Railway Company
935 de La Gauchetière Street West, 16th Floor
Montreal, Quebec
H3B 2M9

Re: Canadian National Railway Company - Common Shares
3rd Quarter 2004 Report - Quarterly Review

Dear Mr. Finn,

This letter will serve to confirm that on November 1, 2004 the following material was sent by prepaid mail to each registered shareholder of the above Corporation who requested to receive reports:

- 2004 3rd Quarter Report- Quarterly Review (English or French)

In addition, copies of the above-mentioned material were sent by prepaid mail on November 1, 2004, to beneficial shareholders that requested material in accordance with National Instrument 54-101.

Please do not hesitate to contact me if you have any questions or require additional information.

Yours truly,

COMPUTERSHARE TRUST COMPANY OF CANADA

Signed "Mark Thompson"

Mark Thompson
Relationship Manager
Stock Transfer Services

Item 4

Statement of CEO Regarding Facts and Circumstances Relating to Exchange Act Filings

I, E. Hunter Harrison, certify that:

(1) I have reviewed this report on Form 6-K of Canadian National Railway Company;

(2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

(3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

(4) The registrant□s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) [Paragraph omitted pursuant to SEC Release Nos.33-8238 and 34-47986];

(c) Evaluated the effectiveness of the registrant□s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant□s internal control over financial reporting that occurred during the registrant□s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant□s internal control over financial reporting; and

(5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 31, 2004

(s) E. Hunter Harrison

E. Hunter Harrison
President and Chief Executive Officer

Item 5

Statement of CFO Regarding Facts and Circumstances Relating to Exchange Act Filings

I, Claude Mongeau, certify that:

(1) I have reviewed this report on Form 6-K of Canadian National Railway Company;

(2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

(3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

(4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) [Paragraph omitted pursuant to SEC Release Nos.33-8238 and 34-47986];

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

(5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 31, 2004

(s) Claude Mongeau

Claude Mongeau
Executive Vice-President and Chief
Financial Officer

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Canadian National Railway Company

Date: November 1, 2004

By: /s/ Sean Finn

Name: Sean Finn
Title: Senior Vice President Public Affairs, Chief Legal Officer and Corporate Secretary

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740,090

2,222,714

240,066

6,505,788

Impaired loans

Nonaccrual loans(2)

Substandard-nonaccrual

5,819

9,344

7,607

1,591

4,902

29,263

Doubtful-nonaccrual

2

2

-

92

-

96

Total nonaccrual loans

5,821

9,346

7,607

1,683

4,902

29,359

Troubled debt restructurings[3]

Pass

223

409

-

553

28

1,213

Special Mention

-

422

-

-

-

422

Substandard

-

2,861

-

3,592

-

6,453

Total troubled debt restructurings

223

3,692

-

4,145

28

8,088

Total impaired loans

6,044

13,038

7,607

5,828

4,930

37,447

Total loans

$

2,275,483

$
1,046,517

$
747,697

$
2,228,542

$
244,996

$
6,543,235

(1) Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by Pinnacle Bank's primary regulators for loans classified as substandard, excluding the impact of nonaccrual loans and troubled debt restructurings. Potential problem loans, which are not included in nonaccrual loans, amounted to approximately $98.1 million at June 30, 2016, compared to $105.0 million at December 31, 2015.

(2) Included in nonaccrual loans at June 30, 2016 and December 31, 2015 are $9.8 million and $12.1 million, respectively, in purchase credit impaired loans acquired with deteriorated credit quality.

(3) Troubled debt restructurings are presented as an impaired loan; however, they continue to accrue interest at contractual rates.

At June 30, 2016 and December 31, 2015, all loans classified as nonaccrual were deemed to be impaired. The principal balances of these nonaccrual loans amounted to $33.8 million and $29.4 million at June 30, 2016 and December 31, 2015, respectively, and are included in the tables above. For the six months ended June 30, 2016, the average balance of nonaccrual loans was $36.6 million compared to $17.3 million for the same period in 2015. Pinnacle Financial's policy is that the discontinuation of the accrual of interest income will occur when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well secured and in the process of collection. As such, at the date the above mentioned loans were placed on nonaccrual status, Pinnacle Financial reversed all previously accrued interest income against current year earnings. Pinnacle Financial's policy is that once a loan is placed on nonaccrual status each subsequent payment is reviewed on a case-by-case basis to determine if the payment should be applied to interest or principal pursuant to regulatory guidelines. Pinnacle Financial recognized approximately $41,000 and $88,000, respectively, in interest income from cash payments received on nonaccrual loans during the three and six months ended June 30, 2016, compared to $99,000 and $183,000 during the three and six months ended June 30, 2015. Had these nonaccruing loans been on accruing status, interest income would have been higher by $676,000 and $398,000 for the six months ended June 30, 2016 and 2015, respectively.

The following table details the recorded investment, unpaid principal balance and related allowance of Pinnacle Financial's nonaccrual loans at June 30, 2016 and December 31, 2015 by loan classification (in thousands):

	At June 30, 2016			At December 31, 2015		
	Recorded investment	Unpaid principal balances[(1)]	Related allowance[(2)]	Recorded investment	Unpaid principal balances[(1)]	Related allowance[(2)]
Collateral dependent nonaccrual loans:						
Commercial real estate – mortgage	$3,848	$ 4,571	$ -	$4,411	$ 5,659	$ -
Consumer real estate – mortgage	4,059	4,585	-	5,596	6,242	-
Construction and land development	7,055	7,797	-	7,531	7,883	-
Commercial and industrial	11,408	13,319	-	1,420	3,151	-
Consumer and other	382	406	-	-	-	-
Total	$26,752	$ 30,678	$ -	$18,958	$ 22,935	$ -
Cash flow dependent nonaccrual loans:						
Commercial real estate – mortgage	$1,336	$ 1,344	$ 172	$1,410	$ 1,661	$ 20
Consumer real estate – mortgage	2,957	2,914	249	3,750	4,098	616
Construction and land development	56	63	224	76	125	12
Commercial and industrial	510	515	701	263	281	19
Consumer and other	2,174	2,429	134	4,902	5,341	3,002
Total	$7,033	$ 7,265	$ 1,480	$10,401	$ 11,506	$ 3,669
Total nonaccrual loans	$33,785	$ 37,943	$ 1,480	$29,359	$ 34,441	$ 3,669

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The following table details the average recorded investment and the amount of interest income recognized on a cash basis throughout the three and six months ended June 30, 2016 and 2015, respectively, on Pinnacle Financial's nonaccrual loans that remain on the balance sheets (in thousands):

	For the three months ended June 30,				For the six months ended June 30,			
	2016		2015		2016		2015	
	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized	Average recorded investment	Interest income recognized
Collateral dependent nonaccrual loans:								
Commercial real estate – mortgage	$3,845	$ -	$3,205	$ 53	$3,474	$ -	$3,148	$ 53
Consumer real estate – mortgage	4,125	-	611	-	4,140	-	617	-
Construction and land development	7,125	41	3,219	46	7,293	88	3,277	130
Commercial and industrial	12,107	-	918	-	11,928	-	932	-
Consumer and other	383	-	-	-	385	-	-	-
Total	$27,585	$ 41	$7,953	$ 99	$27,220	$ 88	$7,974	$ 183
Cash flow dependent nonaccrual loans:								
Commercial real estate – mortgage	$1,352	$ -	$1,804	$ -	$725	$ -	$1,824	$ -
Consumer real estate – mortgage	3,163	-	3,982	-	3,181	-	4,037	-
Construction and land development	130	-	296	-	134	-	299	-
Commercial and industrial	1,838	-	193	-	2,396	-	204	-
Consumer and other	2,936	-	3,020	-	2,973	-	3,003	-
Total	$9,419	$ -	$9,295	$ -	$9,409	$ -	$9,367	$ -
Total nonaccrual loans	$37,004	$ 41	$17,248	$ 99	$36,629	$ 88	$17,341	$ 183

(1) Unpaid principal balance presented net of fair value adjustments recorded in conjunction with purchase accounting.
(2) Collateral dependent loans are typically charged-off to their net realizable value and no specific allowance is carried related to those loans.

Loans acquired with deteriorated credit quality are recorded pursuant to the provisions of ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, and are referred to as purchase credit impaired loans.

The following table provides a rollforward of purchase credit impaired loans from December 31, 2015 through June 30, 2016 (in thousands):

	Gross Contractual Receivable	Accretable Yield	Nonaccretable Yield	Carrying Value
December 31, 2015	$ 16,274	$ -	$ (4,143)	$12,131

Year-to-date settlements	(3,063)	-	668	(2,395)
Additional fundings	122	-	-	122
June 30, 2016	$ 13,333	$ -	$ (3,475)	$ 9,858

These loans have been deemed to be collateral dependent and as such, no accretable yield has been recorded for these loans. The carrying value is adjusted for additional draws, pursuant to contractual arrangements, offset by loan paydowns. Year-to-date settlements include both loans that were charged-off as well as loans that were paid off, typically as a result of refinancings at other institutions.

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Impaired loans also include loans that Pinnacle Bank has elected to formally restructure due to the weakening credit status of a borrower. The restructuring may facilitate a repayment plan that seeks to minimize the potential losses that Pinnacle Bank may otherwise incur. If on nonaccrual status as of the date of restructuring, the loans are included in nonaccrual loans. Loans that have been restructured that were performing as of the restructure date and continue to perform in accordance with the restructured terms are reported separately as troubled debt restructurings.

At June 30, 2016 and December 31, 2015, there were $9.9 million and $8.1 million, respectively, of troubled debt restructurings that were performing as of their restructure date and which were accruing interest. These troubled debt restructurings are considered impaired loans pursuant to U.S. GAAP. Troubled commercial loans are restructured by specialists within our Special Assets Group, and all restructurings are approved by committees and credit officers separate and apart from the normal loan approval process. These specialists are charged with reducing Pinnacle Financial's overall risk and exposure to loss in the event of a restructuring by obtaining some or all of the following: improved documentation, additional guaranties, increase in curtailments, reduction in collateral release terms, additional collateral or other similar strategies.

The following table outlines the amount of each loan category where troubled debt restructurings were made during the three and six months ended June 30, 2016 and 2015 (dollars in thousands):

	Three months ended June 30,			Six months ended June 30,		
2016	Number of contracts	Pre Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment, net of related allowance	Number of contracts	Pre Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment, net of related allowance
Commercial real estate – mortgage	-	$ -	$ -	-	$ -	$ -
Consumer real estate – mortgage	-	-	-	-	-	-
Construction and land development	-	-	-	-	-	-
Commercial and industrial	-	-	-	1	2,321	1,536
Consumer and other	-	-	-	-	-	-
	-	$ -	$ -	1	$ 2,321	$ 1,536
2015						
Commercial real estate – mortgage	-	$ -	$ -	-	$ -	$ -
Consumer real estate – mortgage	-	-	-	-	-	-
Construction and land development	-	-	-	-	-	-
Commercial and industrial	-	-	-	1	434	337
Consumer and other	-	-	-	-	-	-
	-	$ -	$ -	1	$ 434	$ 337

During the three and six months ended June 30, 2016 and 2015, Pinnacle Financial did not have any troubled debt restructurings that subsequently defaulted within twelve months of the restructuring.

The table below presents past due balances by loan classification and segment at June 30, 2016 and December 31, 2015, allocated between accruing and nonaccrual status (in thousands):

June 30, 2016	30-89 days past due and	90 days or more past due	Total past due and	Nonaccrual[1]	Current and accruing	Total Loans

	accruing	and accruing	accruing			
Commercial real estate:						
Owner-occupied	$ 629	$ -	$ 629	$ 4,663	$ 1,114,819	$ 1,120,111
All other	386	-	386	521	1,346,201	1,347,108
Consumer real estate – mortgage	5,476	1,046	6,522	7,016	1,055,082	1,068,620
Construction and land development	8,199	-	8,199	7,112	801,370	816,681
Commercial and industrial	1,166	-	1,166	11,917	2,478,933	2,492,016
Consumer and other	6,252	577	6,829	2,556	237,481	246,866
	$ 22,108	$ 1,623	$ 23,731	$ 33,785	$ 7,033,886	$ 7,091,402

December 31, 2015	30-89 days past due and accruing	90 days or more past due and accruing	Total past due and accruing	Nonaccrual[(1)]	Current and accruing	Total Loans
Commercial real estate:						
Owner-occupied	$ -	$ -	$ -	$ 5,103	$ 1,078,394	$ 1,083,497
All other	-	-	-	718	1,191,268	1,191,986
Consumer real estate – mortgage	6,380	1,396	7,776	9,346	1,029,395	1,046,517
Construction and land development	309	-	309	7,607	739,781	747,697
Commercial and industrial	4,798	-	4,798	1,683	2,222,061	2,228,542
Consumer and other	6,721	373	7,094	4,902	233,000	244,996
	$ 18,208	$ 1,769	$ 19,977	$ 29,359	$ 6,493,899	$ 6,543,235

(1) Approximately $23.7 million and $19.0 million of nonaccrual loans as of June 30, 2016 and December 31, 2015, respectively, were performing pursuant to their contractual terms at those dates.

The following table shows the allowance allocation by loan classification and accrual status at June 30, 2016 and December 31, 2015 (in thousands):

	Accruing Loans		Impaired Loans				Total Allowance for Loan Losses	
			Nonaccrual Loans		Troubled Debt Restructurings[(1)]			
	June 30, 2016	December 31, 2015	June 30, 2016	December 31, 2015	June 30, 2016	December 31, 2015	June 30, 2016	December 31, 2015
Commercial real estate –mortgage	$ 13,613	$ 15,452	$ 4	$ 20	$ 48	$ 41	$ 13,665	$ 15,513
Consumer real estate – mortgage	6,012	6,109	131	616	397	495	6,540	7,220
Construction and land development	3,920	2,891	2	12	1	-	3,923	2,903
Commercial and industrial	23,268	22,669	138	19	1,684	955	25,090	23,643
Consumer and other	9,923	12,609	1,205	3,002	10	5	11,138	15,616
Unallocated	-	-	-	-	-	-	1,056	537
	$ 56,736	$ 59,730	$ 1,480	$ 3,669	$ 2,140	$ 1,496	$ 61,412	$ 65,432

(1) Troubled debt restructurings of $9.9 million and $8.1 million as of both June 30, 2016 and December 31, 2015, respectively, are classified as impaired loans pursuant to U.S. GAAP; however, these loans continue to accrue interest at contractual rates.

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The following table details the changes in the allowance for loan losses from December 31, 2014 to December 31, 2015 to June 30, 2016 by loan classification and the allocation of the allowance for loan losses (in thousands):

	Commercial real estate – mortgage	Consumer real estate – mortgage	Construction and land development	Commercial and industrial	Consumer and other	Unallocated	Total
Allowance for Loan Losses:							
Balance at December 31, 2014	$22,202	$5,424	$5,724	$29,167	$1,570	$3,272	$67,359
Charged-off loans	(384)	(365)	(190)	(2,207)	(18,002)	-	(21,148)
Recovery of previously charged-off loans	85	874	1,479	1,730	5,865	-	10,033
Provision for loan losses	(6,390)	1,287	(4,110)	(5,047)	26,183	(2,735)	9,188
Balance at December 31, 2015	$15,513	$7,220	$2,903	$23,643	$15,616	$537	$65,432
Collectively evaluated for impairment	$15,452	$6,109	$2,891	$22,669	$12,609		$59,730
Individually evaluated for impairment	61	1,111	12	974	3,007		5,165
Loans acquired with deteriorated credit quality	-	-	-	-	-		-
Balance at December 31, 2015	$15,513	$7,220	$2,903	$23,643	$15,616		$65,432
Loans:							
Collectively evaluated for impairment	$2,269,439	$1,033,479	$740,090	$2,222,714	$240,066		$6,505,788
Individually evaluated for impairment	2,420	8,986	3,689	5,288	4,930		25,313
Loans acquired with deteriorated credit quality	3,624	4,052	3,918	540	-		12,134
Balance at December 31, 2015	$2,275,483	$1,046,517	$747,697	$2,228,542	$244,996		$6,543,235
Allowance for Loan Losses:							
Balance at December 31, 2015	$15,513	$7,220	$2,903	$23,643	$15,616	$537	$65,432
Charged-off loans	(196)	(379)	-	(2,243)	(13,555)	-	(16,373)
Recovery of previously charged-off loans	193	156	106	1,615	1,109	-	3,179
Provision for loan losses	(1,845)	(457)	914	2,075	7,968	519	9,174
Balance at June 30, 2016	$13,665	$6,540	$3,923	$25,090	$11,138	$1,056	$61,412
Collectively evaluated for impairment	$13,613	$6,012	$3,920	$23,268	$9,923		$56,736
Individually evaluated for impairment	52	528	3	1,822	1,215		3,620
Loans acquired with deteriorated credit quality	-	-	-	-	-		-
Balance at June 30, 2016	$13,665	$6,540	$3,923	$25,090	$11,138		$61,412

Loans:						
Collectively evaluated for impairment	$2,461,815	$1,058,152	$809,566	$2,473,957	$244,266	$7,047,756
Individually evaluated for impairment	1,922	8,068	4,129	17,483	2,219	33,821
Loans acquired with deteriorated credit quality	3,482	2,400	2,986	576	381	9,825
Balance at June 30, 2016	$2,467,219	$1,068,620	$816,681	$2,492,016	$246,866	$7,091,402

The adequacy of the allowance for loan losses is assessed at the end of each calendar quarter using a migration analysis compiled using loss data over the previous 24 quarters. The level of the allowance is based upon evaluation of the loan portfolio, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect the borrowers' ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, historical loss experience, industry and peer bank loan quality indications and other pertinent factors, including regulatory recommendations. The allowance for loan losses for purchased loans is calculated similarly to the method utilized for legacy Pinnacle Bank loans. Pinnacle Financial's accounting policy is to compare the computed allowance for loan losses for purchased loans to any remaining fair value adjustment. If the computed allowance is greater than the remaining fair value adjustment, the excess is added to the allowance for loan losses by a charge to the provision for loan losses.

Pinnacle Financial analyzes its commercial loan portfolio to determine if a concentration of credit risk exists to any industry. Pinnacle Financial utilizes broadly accepted industry classification systems in order to classify borrowers into various industry classifications. Pinnacle Financial has a credit exposure (loans outstanding plus unfunded lines of credit) exceeding 25% of Pinnacle Bank's total risk-based capital to borrowers in the following industries at June 30, 2016 with the comparative exposures for December 31, 2015 (in thousands):

	at June 30, 2016			
	Outstanding Principal Balances	Unfunded Commitments	Total exposure	Total Exposure at December 31, 2015
Lessors of nonresidential buildings	$945,924	$ 274,357	$1,220,281	$1,078,211
Lessors of residential buildings	432,711	189,627	622,338	500,266

At June 30, 2016, Pinnacle Bank had granted loans and other extensions of credit amounting to approximately $8.8 million to current directors, executive officers, and their related entities, of which $5.9 million had been drawn upon. At December 31, 2015, Pinnacle Bank had granted loans and other extensions of credit amounting to approximately $14.5 million to directors, executive officers, and their related entities, of which approximately $11.4 million had been drawn upon. None of these loans to directors, executive officers, and their related entities were impaired at June 30, 2016 or December 31, 2015.

At June 30, 2016, Pinnacle Financial had approximately $9.3 million in commercial loans held for sale. These loans held for sale consist solely of apartment loans originated for sale to a third-party as part of a multi-family loan program. Such loans are closed under a pass-through commitment structure wherein Pinnacle Bank's loan commitment to the borrower is the same as the third party's take-out commitment to Pinnacle Bank, and the third party purchase typically occurs within thirty days of Pinnacle Bank closing with the borrowers.

Residential Lending

At June 30, 2016, Pinnacle Financial had approximately $53.1 million of mortgage loans held-for-sale compared to approximately $47.9 million at December 31, 2015. Total loan volumes sold during the six months ended June 30, 2016 were approximately $198.2 million compared to approximately $208.4 million for the six months ended June 30, 2015. During the six months ended June 30, 2016, Pinnacle Financial recognized $7.8 million in gains on the sale of these loans, net of commissions paid, compared to $3.6 million during the six months ended June 30, 2015.

These mortgage loans held-for-sale are originated internally and are primarily to borrowers in Pinnacle Bank's geographic markets. These sales are typically on a mandatory basis to investors that follow conventional government sponsored entities (GSE) and the Department of Housing and Urban Development/U.S. Department of Veterans

Affairs (HUD/VA) guidelines.

Each purchaser has specific guidelines and criteria for sellers of loans, and the risk of credit loss with regard to the principal amount of the loans sold is generally transferred to the purchasers upon sale. While the loans are sold without recourse, the purchase agreements require Pinnacle Bank to make certain representations and warranties regarding the existence and sufficiency of file documentation and the absence of fraud by borrowers or other third parties such as appraisers in connection with obtaining the loan. If it is determined that the loans sold were in breach of these representations or warranties, Pinnacle Bank has obligations to either repurchase the loan for the unpaid principal balance and related investor fees or make the purchaser whole for the economic benefits of the loan. To date, repurchase activity pursuant to the terms of these representations and warranties has been insignificant to Pinnacle Bank.

Note 6. Income Taxes

ASC 740, Income Taxes, defines the threshold for recognizing the benefits of tax return positions in the financial statements as "more-likely-than-not" to be sustained by the taxing authority. This section also provides guidance on the derecognition, measurement and classification of income tax uncertainties, along with any related interest and penalties, and includes guidance concerning accounting for income tax uncertainties in interim periods.

A reconciliation of the beginning and ending unrecognized tax benefit related to uncertain tax positions is as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Beginning of period	$196	$391	$196	$391
Increases due to tax positions taken during the current year	-	-	-	-
Increases due to tax positions taken during a prior year	-	-	-	-
Decreases due to the lapse of the statute of limitations during the current year	-	-	-	-
Decreases due to settlements with the taxing authorities during the current year	-	-	-	-
Balance at June 30,	$196	$391	$196	$391

Pinnacle Financial's policy is to recognize interest and/or penalties related to income tax matters in income tax expense. The total amount of interest and penalties recorded in the income statement for the three and six months ended June 30, 2015 was $9,600 and $19,600, respectively. No interest and penalties were recorded for the three and six months ended June 30, 2016.

Pinnacle Financial's effective tax rate for the three and six months ended June 30, 2016 was 33.9% and 33.5%, respectively, compared to 33.2% and 33.1%, respectively, for the three and six months ended June 30, 2015. The difference between the effective tax rate and the Federal and State income tax statutory rate of 39.23% is primarily attributable to our investments in bank qualified municipal securities, investments in low-rate housing loans that qualify for Tennessee state excise tax credits and bank-owned life insurance, offset in part by meals and entertainment, a portion of which is non-deductible.

Note 7. Commitments and Contingent Liabilities

In the normal course of business, Pinnacle Financial has entered into off-balance sheet financial instruments which include commitments to extend credit (i.e., including unfunded lines of credit) and standby letters of credit. Commitments to extend credit are usually the result of lines of credit granted to existing borrowers under agreements that the total outstanding indebtedness will not exceed a specific amount during the term of the indebtedness. Typical borrowers are commercial concerns that use lines of credit to supplement their treasury management functions, and thus their total outstanding indebtedness may fluctuate during any time period based on the seasonality of their business and the resultant timing of their cash flows. Other typical lines of credit are related to home equity loans granted to consumers. Commitments to extend credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At June 30, 2016, these commitments amounted to $2.5 billion.

Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from Pinnacle Financial under certain prescribed circumstances. Subsequently, Pinnacle Financial would then seek reimbursement from the applicant pursuant to the terms of the standby letter of credit. At June 30, 2016, these commitments amounted to $101.8 million.

Pinnacle Financial follows the same credit policies and underwriting practices when making these commitments as it does for on-balance sheet instruments. Each customer's creditworthiness is evaluated on a case-by-case basis, and the amount of collateral obtained, if any, is based on management's credit evaluation of the customer. Collateral held varies but may include cash, real estate and improvements, marketable securities, accounts receivable, inventory, equipment and personal property.

The contractual amounts of these commitments are not reflected in the consolidated financial statements and only amounts drawn upon would be reflected in the future. Since many of the commitments are expected to expire without being drawn upon, the contractual amounts do not necessarily represent future cash requirements. However, should the commitments be drawn upon and should Pinnacle Financial's customers default on their resulting obligation to Pinnacle Financial, the maximum exposure to credit loss, without consideration of collateral, is represented by the contractual amount of those commitments. At June 30, 2016 and December 31, 2015, Pinnacle Financial had accrued $1.2 million and $1.4 million, respectively, for the inherent risks associated with these off-balance sheet commitments.

On May 9, 2016 a purported class action complaint was filed in the Chancery Court for the State of Tennessee, 20th Judicial District at Nashville, styled Stephen Bushansky, on behalf of himself and all others similarly situated, Plaintiff, versus Avenue Financial Holdings, Inc. Ronald L. Samuels, Kent Cleaver, David G. Anderson, Agenia Clark, James F. Deutsch, Marty Dickens, Patrick G. Emery, Nancy Falls, Joseph C. Galante, David Ingram. Stephen Moore, Ken Robold, Karen Saul and Pinnacle Financial Partners, Inc., Defendants (Case No. 16-489-IV), alleging that the individual defendants breached their fiduciary duties by, among other things, approving the sale of Avenue for an inadequate price as the result of a flawed sales process, agreeing to the inclusion of unreasonable deal protection devices in the Merger Agreement, approving the Avenue Merger in order to receive benefits not equally shared by all other shareholders of Avenue, and issuing materially misleading and incomplete disclosures to Avenue's shareholders. The lawsuit also alleges claims against Avenue and Pinnacle for aiding and abetting the individual defendants' breaches of fiduciary duties.

The plaintiff purports to seek class-wide relief, including but not limited to: monetary damages, and an award of interest, attorney's fees, and expenses. On May 18, 2016, the Bushansky litigation was transferred to the Davidson County, Tennessee Business Court Pilot Project (Business Court).

To avoid the costs, risks and uncertainties inherent in litigation, on June 10, 2016, the defendants entered into a memorandum of understanding with the plaintiff regarding settlement of the Bushansky litigation (the "memorandum of understanding"). The memorandum of understanding outlines the terms of the parties' agreement in principle to settle and release all claims which were or could have been asserted in the Bushansky action. In consideration for the settlement of the Bushansky litigation and release of claims contemplated thereby, the parties to the action agreed that Avenue and Pinnacle would make certain supplemental disclosures to the definitive proxy statement/prospectus. The memorandum of understanding contemplates that the parties will attempt in good faith to agree promptly upon a stipulation of settlement to be submitted to the Business Court for approval at the earliest practicable time. The stipulation of settlement will be subject to approval by the Business Court, which will consider the fairness, reasonableness and adequacy of such settlement. Under the terms of the proposed settlement, following final approval by the Business Court, the action will be dismissed with prejudice. There can be no assurance that the parties will ultimately enter into a stipulation of settlement or that the Business Court will approve the settlement even if the parties were to enter into such stipulation. In such event, the proposed settlement will be null and void and of no force and effect.

Pinnacle Financial believes the claims asserted in the Bushansky action are without merit and intends to continue to defend the litigation. At this time though, it is not possible to predict the outcome of the proceeding or its impact on Pinnacle Financial.

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of these claims outstanding at June 30, 2016 will not have a material adverse impact on Pinnacle Financial's consolidated financial condition, operating results or cash flows.

Note 8. Stock Options, Stock Appreciation Rights and Restricted Shares

As described more fully in the Annual Report on Form 10-K, as of June 30, 2016, Pinnacle Financial has one equity incentive plan under which it is able to grant awards, the 2014 Equity Incentive Plan (2014 Plan) and has assumed the stock option plan of CapitalMark (the CapitalMark Option Plan) in connection with the CapitalMark Merger. In addition, awards previously granted remain outstanding under equity plans previously adopted by Pinnacle Financial's Board of Directors or assumed in connection with acquisitions of Mid-America Bancshares, Inc. and Cavalry Bancorp, Inc. No new awards may be granted under these other plans or the CapitalMark Option Plan.

Total shares available for issuance under the 2014 Plan were approximately 1.0 million shares as of June 30, 2016, inclusive of shares returned to plan reserves during the six months ended June 30, 2016. The 2014 Plan also permits Pinnacle Financial to reissue awards currently outstanding that are subsequently forfeited, settled in cash or expired unexercised and returned to the 2014 Plan.

Common Stock Options and Stock Appreciation Rights

As of June 30, 2016, there were 916,745 stock options and 2,481 stock appreciation rights (SARS) outstanding to purchase common shares. A summary of the stock option and stock appreciation rights activity within the equity incentive plans during the six months ended June 30, 2016 and information regarding expected vesting, contractual terms remaining, intrinsic values and other matters is as follows:

	Number	Weighted-Average Exercise Price	Weighted-Average Contractual Remaining Term (in years)	Aggregate Intrinsic Value (000's)
Outstanding at December 31, 2015	1,251,601	$ 21.23	2.54	$ 37,714 (1)
Granted	-			
Exercised	(331,865)			
Stock appreciation rights exercised	(510)			
Forfeited	-			
Outstanding at June 30, 2016	919,226	$ 21.60	2.59	$ 25,049 (2)
Options exercisable at June 30, 2016	919,226	$ 21.60	2.59	$ 25,049 (2)

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted closing price of Pinnacle Financial common stock of $51.36 per common share at December 31, 2015 for the 1,251,601 options and stock appreciation rights that were in-the-money at December 31, 2015.

(2) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted closing price of Pinnacle Financial common stock of $48.85 per common share at June 30, 2016 for the 919,226 options and stock appreciation rights that were in-the-money at June 30, 2016.

(3) 510 SARS were converted into 229 common shares upon exercise.

Compensation costs related to unvested stock options granted under Pinnacle Financial's equity incentive plan have been fully recognized and all outstanding option awards are fully vested.

Restricted Share Awards

Additionally, the 2014 Plan provides for the granting of restricted share awards and other performance or market-based awards. There were no market-based awards outstanding as of June 30, 2016 under this plan.

Pinnacle Financial grants restricted share awards to associates, executive management and outside directors with a combination of time and, in the case of executive management, performance vesting criteria. The following table outlines restricted stock grants that were made, grouped by similar vesting criteria, during the six months ended June 30, 2016:

Grant Year	Group[1]	Vesting Period in years	Shares awarded	Restrictions Lapsed and shares released to participants	Shares Forfeited by participants[5]	Shares Unvested
Time Based Awards						
2016	Associates[2]	5	96,294	166	2,413	93,715
Performance Based Awards						

2016	Leadership team[3]	-[3]	43,694	-	-	43,694
Outside Director Awards[4]						
2016	Outside directors	1	16,604	-	1,186	15,418

(1) Groups include employees (referred to as associates above), the leadership team which includes our named executive officers and other key senior leadership members, and outside directors. When the restricted shares are awarded, a participant receives voting rights and forfeitable dividend rights with respect to the shares, but is not able to transfer the shares until the restrictions have lapsed. Once the restrictions lapse, the participant is taxed on the value of the award and may elect to sell some shares to pay the applicable income taxes associated with the award. For time-based restricted share awards, dividends paid on shares for which the forfeiture restrictions do not lapse will be recouped by Pinnacle Financial at the time of termination. For performance-based awards, dividends are placed into escrow until the forfeiture restrictions on such shares lapse.

(2) The forfeiture restrictions on these restricted share awards lapse in equal annual installments on the anniversary date of the grant.

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(3) Reflects conversion of restricted share units issued in prior years to restricted share awards. The forfeiture restrictions on these restricted share awards lapse in separate equal installments should Pinnacle Financial achieve certain soundness targets over each year of the subsequent vesting period. Half of the awards include a four year vesting period while the remainder include a three year vesting period.

(4) Restricted share awards are issued to the outside members of the board of directors in accordance with their board compensation plan. Restrictions lapse on February 28, 2017 based on each individual board member meeting their attendance goals for the various board and board committee meetings to which each member was scheduled to attend.

(5) These shares represent forfeitures resulting from recipients whose employment terminated during the year-to-date period ended June 30, 2016. Any dividends paid on shares for which the forfeiture restrictions do not lapse will be recouped by Pinnacle Financial at the time of termination.

A summary of activity for unvested restricted share awards for the six months ended June 30, 2016 is as follows:

	Number	Grant Date Weighted-Average Cost
Unvested at December 31, 2015	866,314	$ 31.39
Shares awarded	112,898	
Conversion of restricted share units to restricted share awards	43,694	
Restrictions lapsed and shares released to associates/directors	(203,588)	
Shares forfeited[1]	(15,261)	
Unvested at June 30, 2016	804,057	$ 36.02

(1) Represents shares forfeited due to employee termination and/or retirement. No shares were forfeited due to failure to meet performance targets.

Compensation expense associated with the time-based restricted share awards is recognized over the time period that the restrictions associated with the awards lapse on a straight-line basis based on the total grant date fair value. Compensation expense associated with performance-based restricted share awards is recognized over the time period that the restrictions associated with the awards are anticipated to lapse based on a schedule consistent with the nature of the award. For the three and six months ended June 30, 2016, Pinnacle Financial recognized approximately $1.8 million and $3.7 million, respectively, in compensation costs attributable to restricted share awards, compared to $1.4 million and $2.7 million for the three and six months ended June 30, 2015.

Restricted Share Units

Pinnacle Financial grants restricted share units to the senior executive officers and other members of the Leadership Team annually. The senior executive officers' restricted share unit award typically includes a range of shares that may be earned from the target level of performance to the maximum level of performance. The Leadership Team awards are granted at the target level of performance. Restricted share units awarded prior to 2015 will convert to a number of restricted share awards based on the achievement of certain performance metrics for each of the fiscal years to which the award relates, with the restrictions on the restricted shares lapsing if Pinnacle Bank achieves certain soundness levels in subsequent years. Beginning with grants made in 2015, the awards will be settled in shares of freely tradeable common stock of Pinnacle Financial if the one-year performance metrics and subsequent one-year service period requirements are met and subsequent soundness targets are achieved. The performance metrics for each of the performance periods is established concurrently with the award of the restricted share unit grants by the Human Resources and Compensation Committee. The awards may be issued with a post-vest holding period, as shown below. During the post-vest holding period, the shares will not be released to the recipient and cannot be transferred, subject to limited exceptions, but will continue to accrue dividends until the awards are released, which is expected to be commensurate with the filing of Pinnacle Financial's Annual Report on Form 10-K for the prescribed year. These restricted share units are being expensed based on the requisite service period of the underlying tranche of the award. Each period, the number of shares that is expected to lapse to the recipient is reevaluated and the associated compensation expense is adjusted accordingly. The expense is accrued using an anticipated performance level for the senior executive officers between the target and maximum performance levels and at the target performance level for the Leadership Team.

The following table details the Restricted Stock Unit awards outstanding at June 30, 2016:

	Units Awarded					
Grant year	Named Executive Officers (NEOs)(1)	Leadership Team other than NEOs	Applicable Performance Periods associated with each tranche (fiscal year)	Service period per tranch (in years)	Holding period per tranche (in years)	Shares settled into RSAs as of period end(2)
2016	73,474-110,223	26,683	2016	2	3	N/A
			2017	2	2	N/A
			2018	2	1	N/A
2015	58,200-101,850	28,378	2015	2	3	N/A
			2016	2	2	N/A
			2017	2	1	N/A
2014(3)	58,404-102,209	29,087	2014	5	N/A	21,856
			2014	4	N/A	21,856
			2015	4	N/A	21,847
			2015	3	N/A	21,847
			2016	3	N/A	
			2016	2	N/A	

(1) The named executive officers are awarded a range of awards that may be earned based on attainment of goals at a target level of performance to the maximum level of performance.

(2) Restricted stock unit awards granted in 2016 and 2015 will be earned and settled in shares of Pinnacle Financial common stock.

(3) Restrictions on half of the shares previously converted to RSAs will lapse commensurate with the filing of the Form 10-K for the year ended December 31, 2017 and 2018, respectively.

Stock compensation expense related to restricted stock units totaled $817,000 and $1.6 million for the three and six months ended June 30, 2016, respectively, compared to $336,000 and $634,000 for the three and six months ended June 30, 2015, respectively.

Note 9. Regulatory Matters

Pursuant to Tennessee banking law, Pinnacle Bank may not, without the prior consent of the Commissioner of the Tennessee Department of Financial Institutions (TDFI), pay any dividends to Pinnacle Financial in a calendar year in excess of the total of Pinnacle Bank's retained net income for that year plus the retained net income for the preceding two years. During the six months ended June 30, 2016, Pinnacle Bank paid $12.9 million in dividends to Pinnacle Financial. Pinnacle Financial increased its quarterly common stock dividend to $0.14 beginning in the first quarter of 2016. The amount and timing of all future dividend payments, if any, is subject to Board discretion and will depend on Pinnacle Financial's earnings, capital position, financial condition and other factors, including new regulatory capital requirements, as they become known to Pinnacle Financial.

Pinnacle Financial and Pinnacle Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions, by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Pinnacle

Financial and Pinnacle Bank must meet specific guidelines that involve quantitative measures of the assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices.

The minimum capital level requirements applicable to bank holding companies and banks are:

(i) a common equity Tier 1 capital ratio of 4.5%;
(ii) a Tier 1 risk-based capital ratio of 6%;
(iii) a total risk-based capital ratio of 8%; and
(iv) a Tier 1 leverage ratio of 4% for all institutions.

The capital level requirements also establish a "capital conservation buffer" of 2.5% (to be phased in over three years) above the regulatory minimum risk-based capital ratios, and result in the following required ratios once the capital conservation buffer is fully phased in:

(i) a common equity Tier 1 risk-based capital ratio of 7%;
(ii) a Tier 1 risk-based capital ratio of 8.5%; and
(iii) a total risk-based capital ratio of 10.5%.

As of January 1, 2016, compliance with the capital conservation buffer is determined by increasing the capital ratio minimum by 0.625% for the capital ratio with the least spread between regulatory minimum and calculated ratios. The buffer will increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if capital levels fall below minimum levels plus the buffer amounts. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

To be considered well capitalized under applicable banking regulations, Pinnacle Financial and Pinnacle Bank must maintain the following minimum capital ratios and not be subject to a written agreement, order or directive to maintain a higher capital level:

(i) a common equity Tier 1 capital ratio of 6.5%;
(ii) a Tier 1 risk based capital ratio of 8%;
(iii) a Total risk based capital ratio of 10%; and
(iv) in the case of Pinnacle Bank, a Tier 1 leverage ratio of 5%.

Under capital level requirements, Tier 1 capital generally consists of common stock (plus related surplus) and retained earnings, limited amounts of minority interest in the form of additional Tier 1 capital instruments, and non-cumulative preferred stock and related surplus, subject to certain eligibility standards, less goodwill and other specified intangible assets and other regulatory deductions. Cumulative preferred stock and trust preferred securities issued after May 19, 2010, will no longer qualify as Tier 1 capital, but such securities issued prior to May 19, 2010, including in the case of bank holding companies with less than $15.0 billion in total assets, trust preferred securities issued prior to that date, will continue to count as Tier 1 capital subject to certain limitations. As a result, Pinnacle Financial's Trust Preferred Securities continue to qualify as Tier 1 capital. The definition of Tier 2 capital is generally unchanged for most banking organizations, subject to certain new eligibility criteria.

Common equity Tier 1 capital generally consists of common stock (plus related surplus) and retained earnings plus limited amounts of minority interest in the form of common stock, less goodwill and other specified intangible assets and other regulatory deductions.

The current capital level requirements allow banks and their holding companies with less than $250 billion in assets a one-time opportunity to opt-out of a requirement to include unrealized gains and losses in accumulated other comprehensive income in their capital calculation. Each of Pinnacle Financial and Pinnacle Bank has opted-out of this requirement.

Management believes, as of June 30, 2016, that Pinnacle Financial and Pinnacle Bank met all capital adequacy requirements to which they are subject. To be categorized as well-capitalized under applicable banking regulations, Pinnacle Financial and Pinnacle Bank must maintain minimum total risk-based, Tier I risk-based, common equity Tier I and Tier I leverage ratios as set forth in the following table and not be subject to a written agreement, order or directive to maintain a higher capital level. Pinnacle Financial's and Pinnacle Bank's actual capital amounts and ratios are presented in the following table (in thousands):

	Actual		Minimum Capital Requirement		Minimum To Be Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
At June 30, 2016						
Total capital to risk weighted assets:						
Pinnacle Financial	$951,868	11.1 %	$688,798	8.0 %	$860,997	10.0 %
Pinnacle Bank	$910,455	10.6 %	$686,692	8.0 %	$858,364	10.0 %
Tier I capital to risk weighted assets:						
Pinnacle Financial	$761,868	8.8 %	$516,598	6.0 %	$688,798	8.0 %
Pinnacle Bank	$720,456	8.4 %	$515,019	6.0 %	$686,692	8.0 %
Common equity Tier I capital to risk weighted assets						
Pinnacle Financial	$681,746	7.9 %	$387,449	4.5 %	$559,648	6.5 %
Pinnacle Bank	$720,333	8.4 %	$386,264	4.5 %	$557,937	6.5 %
Tier I capital to average assets (*):						
Pinnacle Financial	$761,868	8.7 %	$348,653	4.0 %	N/A	N/A
Pinnacle Bank	$720,456	8.3 %	$347,549	4.0 %	$434,436	5.0 %

(*) Average assets for the above calculations were based on the most recent quarter.

Note 10. Derivative Instruments

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current period earnings.

Non-hedge derivatives

Pinnacle Financial enters into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these instruments to meet customer needs, Pinnacle Financial enters into offsetting positions in order to minimize the risk to Pinnacle Financial. These swaps are derivatives, but are not designated as hedging instruments.

Interest rate swap contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counter party or customer owes Pinnacle Financial, and results in credit risk to Pinnacle Financial. When the fair value of a derivative instrument contract is negative, Pinnacle Financial owes the customer or counterparty and therefore, has no credit risk.

A summary of Pinnacle Financial's interest rate swaps related to customers as of June 30, 2016 and December 31, 2015 is included in the following table (in thousands):

	June 30, 2016		December 31, 2015
	Notional	Estimated	Notional

	Amount	Fair Value	Amount	Estimated Fair Value
Interest rate swap agreements:				
Pay fixed / receive variable swaps	$577,923	$37,589	$396,112	$16,130
Pay variable / receive fixed swaps	577,923	(37,880)	396,112	(16,329)
Total	$1,155,846	$(291)	$792,224	$(199)

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Hedge derivatives

Pinnacle Financial has forward cash flow hedge relationships to manage future interest rate exposure. The hedging strategy converts the LIBOR based variable interest rate on forecasted borrowings to a fixed interest rate and protects Pinnacle Financial from floating interest rate variability. The initial hedge relationships were entered into during the second quarter of 2013. During the third quarter of 2014, Pinnacle Financial terminated three individual contracts of the initial hedge relationships based on changes in internal forecasts for future interest rates. As a result of terminating these contracts, Pinnacle Financial will incur a gain of $64,000 over the original terms of these agreements which were scheduled to begin in April 2015. Pinnacle Financial has since entered into additional forward cash flow hedge relationships for interest rate risk management purposes given the aforementioned changes in forecasted interest rates. The terms of the individual contracts within the relationship are as follows (in thousands):

					June 30, 2016		December 31, 2015	
	Forecasted Notional Amount	Receive Rate	Pay Rate	Term[1]	Asset/ (Liabilities)	Unrealized Loss in Accumulated Other Comprehensive Income	Asset/ (Liabilities)	Unrealized Loss in Accumulated Other Comprehensive Income
Interest Rate Swap	$ 33,000	3 month LIBOR	2.265 %	April 2016- April 2020	(1,785)	(1,085)	(784)	(476)
Interest Rate Swap	33,000	3 month LIBOR	2.646 %	April 2016- April 2022	(3,051)	(1,854)	(1,478)	(898)
Interest Rate Swap	33,000	3 month LIBOR	2.523 %	Oct. 2016- Oct. 2020	(2,048)	(1,245)	(908)	(552)
Interest Rate Swap	33,000	3 month LIBOR	2.992 %	Oct. 2017- Oct. 2021	(2,466)	(1,499)	(1,112)	(676)
Interest Rate Swap	34,000	3 month LIBOR	3.118 %	April 2018- July 2022	(2,626)	(1,596)	(1,170)	(711)
Interest Rate Swap	34,000	3 month LIBOR	3.158 %	July 2018- Oct. 2022	(2,611)	(1,587)	(1,158)	(704)
	$ 200,000				(14,587)	(8,866)	(6,610)	(4,017)

[1] No cash will be exchanged prior to the beginning of the term.

Pinnacle Financial has seven interest rate swap agreements designated as cash flow hedges intended to protect against the variability of cash flows on selected LIBOR based loans. The swaps hedge the interest rate risk, wherein Pinnacle Financial receives a fixed rate of interest from a counterparty and pays a variable rate, based on one month LIBOR. The terms of the respective swaps range from seven to ten years and started on July 1, 2014. The swaps were entered into with a counterparty that met Pinnacle Financial's credit standards and the agreements contain collateral provisions protecting the at-risk party. Pinnacle Financial believes that the credit risk inherent in the contract is not significant.

					June 30, 2016		December 31, 2015	
	Forecasted Notional Amount	Receive Rate	Pay Rate	Term[2]	Asset/ (Liabilities)	Unrealized Gain in Accumulated Other Comprehensive Income	Asset/ (Liabilities)	Unrealized Gain (Loss) in Accumulated Other Comprehensive Income
Interest Rate Swap	$ 27,500	2.090 %	1 month LIBOR	July 2014 - July 2021	1,553	944	663	403

Interest Rate Swap	25,000	2.270 %	1 month LIBOR	July 2014 - July 2022	2,178	1,324	968	588
Interest Rate Swap	27,500	2.420 %	1 month LIBOR	July 2014 - July 2023	2,859	1,737	1,320	802
Interest Rate Swap	30,000	2.500 %	1 month LIBOR	July 2014 - July 2024	2,964	1,801	1,333	810
Interest Rate Swap	-	1.048 %	1 month LIBOR	August 2015 - August 2018	-	-	(46)	(28)
Interest Rate Swap	-	1.281 %	1 month LIBOR	August 2015 - August 2019	-	-	(34)	(21)
Interest Rate Swap	15,000	1.470 %	1 month LIBOR	August 2015 - August 2020	448	272	(14)	(9)
	$ 125,000				10,002	6,078	4,190	2,545

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The cash flow hedges were determined to be fully effective during the period presented. Therefore, no amount of ineffectiveness has been included in net income. The aggregate fair value of the swaps is recorded in other assets or other liabilities with changes in fair value recorded in accumulated other comprehensive (loss) income, net of tax. If a hedge was deemed to be ineffective, the amount included in accumulated other comprehensive (loss) income would be reclassified into a line item within the statement of income that impacts operating results. The hedge would no longer be considered effective if a portion of the hedge becomes ineffective, the item hedged is no longer in existence or Pinnacle Financial discontinues hedge accounting. Pinnacle Financial expects the hedges to remain fully effective during the remaining terms of the swaps. Pinnacle Financial does not expect any amounts to be reclassified from accumulated other comprehensive (loss) income related to these swaps over the next twelve months.

Note 11. Fair Value of Financial Instruments

FASB ASC 820, Fair Value Measurements and Disclosures, which defines fair value, establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability.

Valuation Hierarchy

FASB ASC 820 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
Level 3 – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Following is a description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such assets and liabilities pursuant to the valuation hierarchy.

Assets

Securities available-for-sale – Where quoted prices are available for identical securities in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government securities and certain other financial products. If quoted market prices are not available, then fair values are estimated by using pricing models that use observable inputs or quoted prices of securities with similar characteristics and are classified within Level 2 of the valuation hierarchy. In certain cases where there is limited activity or less transparency around inputs to the valuation and more complex pricing models or discounted cash flows are used, securities are classified within Level 3 of the valuation hierarchy.

Other investments – Included in others assets are other investments recorded at fair value primarily in certain nonpublic private equity funds. The valuation of nonpublic private equity investments requires management judgment due to the absence of observable quoted market prices, inherent lack of liquidity and the long-term nature of such assets. These investments are valued initially based upon transaction price. The carrying values of other investments are adjusted either upwards or downwards from the transaction price to reflect expected exit values as evidenced by financing and sale transactions with third parties, or when determination of a valuation adjustment is confirmed through ongoing reviews by senior investment managers. A variety of factors are reviewed and monitored to assess positive and negative changes in valuation including, but not limited to, current operating performance and future expectations of the particular investment, industry valuations of comparable public companies and changes in market outlook and the third-party financing environment over time. In determining valuation adjustments resulting from the investment review process, emphasis is placed on current company performance and market conditions. These investments are included in Level 3 of the valuation hierarchy as these funds are not widely traded and the underlying investments of such funds are often privately-held and/or start-up companies for which market values are not readily available.

Other assets – Included in other assets are certain assets carried at fair value, including interest rate swap agreements, the cash flow hedge and interest rate locks associated with the mortgage loan pipeline. The carrying amount of interest rate swap agreements is based on Pinnacle Financial's pricing models that utilize observable market inputs. The fair value of the cash flow hedge is determined by calculating the difference between the discounted fixed rate cash flows and the discounted variable rate cash flows. The fair value of the mortgage loan pipeline is based upon the projected sales price of the underlying loans, taking into account market interest rates and other market factors at the measurement date, net of the projected fallout rate. Pinnacle Financial reflects these assets within Level 2 of the valuation hierarchy as these assets are valued using similar transactions that occur in the market.

Collateral dependent nonaccrual loans – A loan is classified as nonaccrual when it is probable Pinnacle Financial will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Nonaccrual loans are measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent. If the recorded investment in the nonaccrual loan exceeds the measure of fair value, a valuation allowance may be established as a component of the allowance for loan losses or the difference may be recognized as a charge-off. Nonaccrual loans are classified within Level 3 of the hierarchy due to the unobservable inputs used in determining their fair value such as collateral values and the borrower's underlying financial condition.

Other real estate owned – Other real estate owned (OREO) represents real estate foreclosed upon by Pinnacle Bank through loan defaults by customers or acquired by deed in lieu of foreclosure. Substantially all of these amounts relate to lots, homes and development projects that are either completed or are in various stages of construction for which Pinnacle Financial believes it has adequate collateral. Upon foreclosure, the property is recorded at the lower of cost or fair value, based on appraised value, less selling costs estimated as of the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation downward adjustments are determined on a specific property basis and are included as a component of noninterest expense along with holding costs. Any gains or losses realized at the time of disposal are also reflected in noninterest expense, as applicable. OREO is included in Level 3 of the valuation hierarchy due to the lack of observable market inputs into the determination of fair value. Appraisal values are property-specific and sensitive to the changes in the overall economic environment.

Liabilities

Other liabilities – Pinnacle Financial has certain liabilities carried at fair value including certain interest rate swap agreements to facilitate customer transactions. The fair value of these liabilities is based on Pinnacle Financial's pricing models that utilize observable market inputs and is reflected within Level 2 of the valuation hierarchy.

The following tables present financial instruments measured at fair value on a recurring basis as of June 30, 2016 and December 31, 2015, by caption on the consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above) (in thousands):

June 30, 2016	Total carrying value in the consolidated balance sheet	Quoted market prices in an active market (Level 1)	Models with significant observable market parameters (Level 2)	Models with significant unobservable market parameters (Level 3)
Investment securities available-for-sale:				
U.S. treasury securities	$ -	$ -	$ -	$ -
U.S. government agency securities	96,447	-	96,447	-
Mortgage-backed securities	771,950	-	771,950	-
State and municipal securities	169,077	-	169,077	-
Agency-backed securities	67,344	-	67,344	-
Corporate notes and other	4,403	-	4,403	-
Total investment securities available-for-sale	$ 1,109,221	$ -	$ 1,109,221	$ -
Other investments	10,381	-	-	10,381
Other assets	36,893	-	36,893	-
Total assets at fair value	$ 1,156,495	$ -	$ 1,146,114	$ 10,381
Other liabilities	$ 38,983	$ -	$ 38,983	$ -
Total liabilities at fair value	$ 38,983	$ -	$ 38,983	$ -
December 31, 2015				
Investment securities available-for-sale:				
U.S. treasury securities	$ -	$ -	$ -	$ -
U.S. government agency securities	128,193	-	128,193	-
Mortgage-backed securities	582,916	-	582,916	-
State and municipal securities	165,042	-	165,042	-
Agency-backed securities	48,801	-	48,801	-
Corporate notes and other	10,113	-	10,113	-
Total investment securities available-for-sale	935,065	-	935,065	-
Other investments	9,764	-	-	9,764
Other assets	15,147	-	15,147	-
Total assets at fair value	$ 959,976	$ -	$ 950,212	$ 9,764
Other liabilities	$ 16,568	$ -	$ 16,568	$ -
Total liabilities at fair value	$ 16,568	$ -	$ 16,568	$ -

The following table presents assets measured at fair value on a nonrecurring basis as of June 30, 2016 and December 31, 2015 (in thousands):

June 30, 2016	Total carrying value in the consolidated balance sheet	Quoted market prices in an active market (Level 1)	Models with significant observable market parameters (Level 2)	Models with significant unobservable market parameters (Level 3)	Total losses for the year-to-date period then ended
Other real estate owned	$ 5,006	$ -	$ -	$ 5,006	$ (219)
Collateral dependent nonaccrual loans, net	26,752	-	-	26,752	(2,804)
Total	$ 31,758	$ -	$ -	$ 31,758	$ (3,023)
December 31, 2015					
Other real estate owned	$ 5,083	$ -	$ -	$ 5,083	$ (41)
Collateral dependent nonaccrual loans, net	18,958	-	-	18,958	(2,637)
Total	$ 24,041	$ -	$ -	$ 24,041	$ (2,678)

In the case of the investment securities portfolio, Pinnacle Financial monitors the portfolio to ascertain when transfers between levels have been affected. The nature of the remaining assets and liabilities is such that transfers in and out of any level are expected to be rare. For the six months ended June 30, 2016, there were no transfers between Levels 1, 2 or 3.

The table below includes a rollforward of the balance sheet amounts for the six months ended June 30, 2016 (including the change in fair value) for financial instruments classified by Pinnacle Financial within Level 3 of the valuation hierarchy for assets and liabilities measured at fair value on a recurring basis. When a determination is made to classify a financial instrument within Level 3 of the valuation hierarchy, the determination is based upon the significance of the unobservable factors to the overall fair value measurement. However, since Level 3 financial instruments typically include, in addition to the unobservable or Level 3 components, observable components (that is, components that are actively quoted and can be validated to external sources), the gains and losses in the table below include changes in fair value due in part to observable factors that are part of the valuation methodology (in thousands):

	For the six months ended June 30,			
	2016		2015	
	Other assets	Other liabilities	Other assets	Other liabilities
Fair value, January 1	$9,764	$ -	$8,004	$ -
Total realized gains included in income	336	-	173	-
Change in unrealized gains/losses included in other comprehensive income for assets and liabilities still held at period end	-	-	-	-
Purchases	571	-	548	-
Issuances	-	-	-	-
Settlements	(290)	-	(563)	-
Transfers out of Level 3	-	-	-	-
Fair value, June 30	10,381	-	8,162	-
Total realized gains included in income related to financial assets and liabilities still on the consolidated balance sheet at June 30	$336	$ -	$173	$ -

The following methods and assumptions were used by Pinnacle Financial in estimating its fair value disclosures for financial instruments that are not measured at fair value. In cases where quoted market prices are not available, fair values are based on estimates using discounted cash flow models. Those models are significantly affected by the assumptions used, including the discount rates, estimates of future cash flows and borrower creditworthiness. The fair value estimates presented herein are based on pertinent information available to management as of June 30, 2016 and December 31, 2015. Such amounts have not been revalued for purposes of these consolidated financial statements since those dates and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

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Securities held-to-maturity - Estimated fair values for investment securities are based on quoted market prices where available. If quoted market prices are not available, then fair values are estimated by using pricing models that use observable inputs or quoted prices of securities with similar characteristics.

Loans, net - The fair value of our loan portfolio includes a credit risk factor in the determination of the fair value of our loans. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. Our loan portfolio is initially fair valued using a segmented approach. We divide our loan portfolio into the following categories: variable rate loans, impaired loans and all other loans. The results are then adjusted to account for credit risk.

For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values approximate carrying values. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral. For other loans, fair values are estimated using discounted cash flow models, using current market interest rates offered for loans with similar terms to borrowers of similar credit quality. The values derived from the discounted cash flow approach for each of the above portfolios are then further discounted to incorporate credit risk to determine the exit price.

Mortgage loans held-for-sale - Mortgage loans held-for-sale are carried at the lower of cost or fair value. The estimate of fair value is based on pricing models and other information.

Deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, subordinated debt and other borrowings - The carrying amounts of demand deposits, savings deposits, securities sold under agreements to repurchase, floating rate advances from the FHLB, floating rate subordinated debt and other borrowings, and floating rate loans approximate their fair values due to having no stated maturity. Fair values for certificates of deposit, fixed rate advances from the FHLB and fixed rate subordinated debt are estimated using discounted cash flow models, using current market interest rates offered on certificates, advances and other borrowings with similar remaining maturities. For fixed rate subordinated debt, the maturity is assumed to be as of the earliest date that the indebtedness will be repriced.

Off-balance sheet instruments - The fair values of Pinnacle Financial's off-balance-sheet financial instruments are based on fees charged to enter into similar agreements. However, commitments to extend credit do not represent a significant value to Pinnacle Financial until such commitments are funded.

The following table presents the carrying amounts, estimated fair value and placement in the fair value hierarchy of Pinnacle Financial's financial instruments at June 30, 2016 and December 31, 2015. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as non-interest bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity (in thousands).

(in thousands) June 30, 2016	Carrying/ Notional Amount	Estimated Fair Value[(1)]	Quoted market prices in an active market (Level 1)	Models with significant observable market parameters (Level 2)	Models with significant unobservable market parameters (Level 3)
Financial assets:					
Securities held-to-maturity	$28,512	$29,093	$ -	$ 29,093	$ -
Loans, net	7,029,990	6,972,722	-	-	6,972,722
Mortgage loans held-for-sale	53,119	54,335	-	54,335	-
Loans held-for-sale	9,323	9,531	-	9,531	-
Financial liabilities:					
Deposits and securities sold under agreements to repurchase	7,366,143	7,054,670	-	-	7,054,670
Federal Home Loan Bank advances	783,240	783,733	-	-	783,733
Subordinated debt and other borrowings	229,714	211,594	-	-	211,594
Off-balance sheet instruments:					
Commitments to extend credit [(2)]	2,548,355	700	-	-	700
Standby letters of credit [(3)]	101,845	486	-	-	486
December 31, 2015					
Financial assets:					
Securities held-to-maturity	$31,377	$31,586	$ -	$ 31,586	$ -
Loans, net	6,477,803	6,379,153	-	-	6,379,153
Mortgage loans held for sale	47,930	48,365	-	48,365	-
Financial liabilities:					
Deposits and securities sold under agreements to repurchase	7,050,498	6,562,509	-	-	6,562,509
Federal Home Loan Bank advances	300,305	299,214	-	-	299,214
Subordinated debt and other borrowings	141,606	131,494	-	-	131,494
Off-balance sheet instruments:					
Commitments to extend credit [(2)]	2,218,784	1,017	-	-	1,017
Standby letters of credit [(3)]	93,534	354	-	-	354

(1) Estimated fair values are consistent with an exit-price concept. The assumptions used to estimate the fair values are intended to approximate those that a market-participant would realize in a hypothetical orderly transaction.

(2) At the end of each quarter, Pinnacle Financial evaluates the inherent risks of the outstanding off-balance sheet commitments. In making this evaluation, Pinnacle Financial evaluates the credit worthiness of the borrower, the collateral supporting the commitments and any other factors similar to those used to evaluate the inherent risks of our loan portfolio. Additionally, Pinnacle Financial evaluates the probability that the outstanding commitment will eventually become a funded loan. As a result, at June 30, 2016 and December 31, 2015, Pinnacle Financial included in other liabilities $700,000 and $1.0 million, respectively, representing the inherent risks associated with these off-balance sheet commitments.

(3) At June 30, 2016 and December 31, 2015, the fair value of Pinnacle Financial's standby letters of credit was $486,000 and $354,000, respectively. This amount represents the unamortized fee associated with these standby letters of credit and is included in the consolidated balance sheet of Pinnacle Financial and is believed to approximate fair value. This fair value will decrease over time as the existing standby letters of credit approach their expiration dates.

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Note 12. Other borrowings

On March 10, 2016, Pinnacle Bank completed the issuance of an additional $70.0 million aggregate principal amount of its 4.875% Fixed-to-Floating Rate Subordinated Notes due 2025 (the Notes) in a private placement transaction to accredited institutional investors. The Notes were priced at 99.023% of the principal amount per note, for an effective interest rate of 5.125%. The maturity date of the Notes is July 30, 2025, although Pinnacle Bank may redeem some or all of the Notes beginning on the interest payment date of July 30, 2020 and on any interest payment date thereafter at a redemption price equal to 100% of the principal amount of the Notes to be redeemed plus accrued and unpaid interest to the date of redemption, subject to the prior approval of the Federal Deposit Insurance Corporation (the FDIC).

From the date of the issuance through July 29, 2020, the Notes will bear interest at the rate of 4.875% per year and will be payable semi-annually in arrears on January 30 and July 30 of each year, beginning on January 30, 2016. From July 30, 2020, the Notes will bear interest at a rate per annum equal to the three-month LIBOR rate plus 3.128%, payable quarterly in arrears on each January 30, April 30, July 30, and October 30, beginning on July 30, 2020, through the maturity date or the early redemption date of the Notes.

The sale of the Notes yielded net proceeds of approximately $68.3 million after deducting the placement agents' fees and estimated expenses payable by Pinnacle Bank. Pinnacle Bank used the net proceeds from the offering for general corporate purposes (including the repayment of short term borrowings of Pinnacle Bank used to pay a portion of the cash portion of the purchase price for the additional equity interests of BHG acquired by Pinnacle Bank on March 1, 2016).

The subordinated debt evidenced by the Notes is recorded net of associated financing fees in accordance with ASU No. 2015-03, Simplifying the Presentation of Debt Issuance Costs and totals $127.4 million as of June 30, 2016, compared to $59.0 million at December 31, 2015, net of associated debt issuance costs.

On March 29, 2016, Pinnacle Financial entered into a revolving credit agreement with a bank for borrowings of up to $75 million (the Loan Agreement). Borrowings under the revolving credit facility are anticipated to be used to fund the cash portion of the purchase price and the transaction costs associated with acquisitions made by Pinnacle Financial from time to time and for general corporate purposes including to fund capital contributions to Pinnacle Bank. Pinnacle Financial's borrowings under the Loan Agreement bear interest at a rate equal to 2.25% plus the greater of (i) zero percent (0%) or (ii) the one-month LIBOR rate quoted by the lender. The Loan Agreement also requires Pinnacle Financial to pay a quarterly fee beginning June 30, 2016 equal to 0.35% per annum on the average daily unused amount of available borrowings. As of June 30, 2016, there were $19.8 million of borrowings under the Loan Agreement, net of associated debt issuance costs, which were utilized to fund a capital contribution to Pinnacle Bank. An additional $10.0 million was drawn on July 1, 2016 to fund a portion of the cash portion of the merger consideration payable to Avenue's shareholders.
Upon consummation of the Avenue Merger, Pinnacle Financial assumed Avenue's obligations under its outstanding $20.0 million subordinated notes issued on December 29, 2014 (Avenue Subordinated Notes). The Avenue Subordinated Notes mature on December 29, 2024 and bear interest at a rate of 6.75% per annum until January 1, 2020. Beginning on January 1, 2020, the Avenue Subordinated Notes will bear interest at a floating rate equal to the three-month LIBOR determined on the determination date of the applicable interest period plus 4.95%. Interest on the Avenue Subordinated Notes is payable quarterly in arrears on January 1, April 1, July 1 and October 1 of each year, through December 29, 2024 or the earlier date of redemption of all of the Avenue Subordinated Notes. These notes will be recorded at fair value as of the acquisition date.

The Avenue Subordinated Notes will be redeemable by Pinnacle Financial, in whole or in part, on or after January 1, 2020 or, in whole but not in part, upon the occurrence of certain specified tax events, capital events or investment company events. The Avenue Subordinated Notes are not subject to redemption at the option of the holders.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our financial condition at June 30, 2016 and December 31, 2015 and our results of operations for the three and six months ended June 30, 2016 and 2015. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein.

Overview

Our diluted net income per common share for the three and six months ended June 30, 2016 was $0.73 and $1.42, respectively, compared to $0.64 and $1.25 for the three and six months ended June 30, 2015, respectively. At June 30, 2016, loans had increased to $7.091 billion, as compared to $6.543 billion at December 31, 2015, and total deposits increased to $7.293 billion at June 30, 2016 from $6.971 billion at December 31, 2015.

We acquired a 30% membership interest in Bankers Healthcare Group, LLC (BHG) on February 1, 2015 for $75.0 million and acquired an additional 19% membership interest in BHG on March 1, 2016 for $74.1 million in cash and 860,470 shares of common stock, with a fair value of $39.9 million on the date of the acquisition. We acquired CapitalMark Bank and Trust (CapitalMark) on July 31, 2015 and Magna Bank (Magna) on September 1, 2015. At the acquisition date, CapitalMark had net assets of $73.2 million, including loans of $857.5 million and deposits valued at $953.2 million. At the acquisition date, Magna had net assets of $50.5 million, including loans of $442.3 million and deposits valued at $452.7 million. These acquisitions further expanded our footprint into East and West Tennessee.

During the first quarter of 2016, we announced that we had signed a definitive agreement for Avenue Financial Holdings, Inc. (Avenue) to merge with us. The merger was consummated on July 1, 2016. Each holder of Avenue common stock (including restricted shares) received 0.36 shares of Pinnacle Financial's common stock plus $2.00 per share in cash for each share of Avenue common stock held by each shareholder on the closing date. This acquisition increases our market share in the Nashville MSA. At the closing of the merger, Avenue had 10,445,349 shares of common stock issued and outstanding (including shares of restricted stock whose restrictions lapsed upon acquisition) and 101,389 outstanding unexercised stock options. We issued approximately 3.76 million shares of our common stock and paid cash consideration of approximately $20.9 million (including payments related to fractional shares) to the Avenue shareholders and approximately $1.0 million to holders of unexercised options to purchase shares of Avenue common stock. As of June 30, 2016, Avenue had total assets of $1.225 billion, $982.8 million in loans and $965.3 million in deposits.

Results of Operations. Our net interest income increased $23.2 million to $75.0 million for the second quarter of 2016 compared to $51.8 million for the second quarter of 2015. Our net interest income increased $45.8 million to $148.9 million for the six months ended June 30, 2016 compared to $103.1 million in the same period in 2015. The net interest margin (the ratio of net interest income to average earning assets) for the three and six months ended June 30, 2016 was 3.72% and 3.75%, respectively, compared to 3.65% and 3.71% for the same periods in 2015, respectively.

Our provision for loan losses was $5.3 million and $9.2 million for the three and six months ended June 30, 2016 compared to $1.2 million and $1.5 million for the same periods in 2015. Provision expense for the three and six month periods when compared to the comparable periods in 2015 was impacted by increased charge-offs realized in our consumer portfolio, primarily related to automobile loans. Net charge-offs were $6.1 million and $13.2 million for the three and six months ended June 30, 2016, compared to $1.9 million and $3.3 million for the same periods in 2015.

Our allowance for loan losses as a percentage of total loans decreased from 1.00% at December 31, 2015 to 0.87% at June 30, 2016. Management believes the decrease in the allowance for loan losses as a percentage of total loans was supported by the credit quality in our loan portfolio despite increasing charge-offs related to automobile financing, which represents a small portion of the total portfolio. The overall methodology used to estimate the allowance for loan losses is consistent with the quarter ended March 31, 2016. For purchased loans (including those acquired in connection with our recent mergers that have been consummated), the allowance for loan losses subsequent to the acquisition date is consistent with that utilized for legacy Pinnacle Financial loans. Our accounting policy is to compare the computed allowance for loan losses on purchased loans to the remaining fair value adjustment at the individual loan level. If the computed allowance is greater than the remaining fair value adjustment, the excess is added to the allowance for loan losses by a provision for loan losses.

Noninterest income increased by $12.7 million and $20.1 million during the three and six months ended June 30, 2016, compared to the same periods in 2015. Income from equity method investment was $9.6 million and $14.8 million for the three and six months ended June 30, 2016 compared to $4.3 million and $7.5 million in the same prior year periods. As discussed above, we increased our investment in BHG from 30% to 49% on March 1, 2016, which impacted the comparable periods. Gains on mortgage loans sold increased $2.6 million and $4.2 million, respectively, over the same periods in the prior year due to continued strength in the local housing economy in many of our markets. The remaining growth in noninterest income was primarily attributable to increased interchange revenues as well as increased production in our fee-based products such as investments, insurance and trust.

Noninterest expense increased by $19.2 million and $36.4 million during the three and six months ended June 30, 2016, as compared to the three and six months ended June 30, 2015, primarily as a result of increased salaries and employment benefits resulting from annual merit increases awarded in the first quarter of 2016, new hires resulting from our acquisitions of CapitalMark and Magna and the overall increase in our associate base. Our associate base has expanded from 800.5 full-time equivalent employees at June 30, 2015 to 1,061.0 full-time equivalent employees at June 30, 2016, due to both opportunistic hires and our acquisitions of CapitalMark and Magna.

During the three and six months ended June 30, 2016, we recorded income tax expense of $15.8 million and $29.6 million, respectively. Pinnacle Financial's effective tax rate for the six months ended June 30, 2016 and 2015 of 33.5% and 33.1%, respectively, differs from the combined federal and state income tax statutory rate primarily due to investments in bank qualified municipal securities, our real estate investment trust, participation in the Community Investment Tax Credit program and bank-owned life insurance offset in part by limited deductibility of meals and entertainment expense.

Our efficiency ratio (the ratio of noninterest expense to the sum of net interest income and noninterest income) was 51.9% and 53.0% for the three and six months ended June 30, 2016, compared to 51.1% and 52.0% for the same periods in 2015. Net income for the three and six months ended June 30, 2016 was $30.8 million and $58.8 million, respectively, compared to $22.7 million and $44.5 million for the same periods in 2015.

Financial Condition. Net loans increased $552.2 million, or 8.5%, during the six months ended June 30, 2016, of which $169.2 million were purchased from a bank in the Memphis MSA. Total deposits were $7.293 billion at June 30, 2016, compared to $6.971 billion at December 31, 2015, an increase of $321.4 million. At June 30, 2016, our capital ratios, including our bank's capital ratios, exceeded those levels necessary to be considered well-capitalized under applicable regulatory guidelines.

From time to time we may be required to support the capital needs of Pinnacle Bank. At June 30, 2016, we had approximately $31.8 million of cash at the holding company substantially all of which could be used to support our bank. During the first quarter of 2016, we established a revolving line of credit with another bank that can be utilized to provide additional capital support to Pinnacle Bank.

Critical Accounting Estimates

The accounting principles we follow and our methods of applying these principles conform with U.S. GAAP and with general practices within the banking industry. There have been no significant changes to our Critical Accounting Policies as described in our Annual Report on Form 10-K for the year ended December 31, 2015.

Results of Operations
The following is a summary of our results of operations (dollars in thousands, except per share data):

	Three months ended June 30,		2016 - 2015 Percent Increase	Six months ended June 30,		2016-2015 Percent Increase
	2016	2015		2016	2015	
Interest income	$83,762	$55,503	50.9 %	$164,736	$110,181	49.5 %
Interest expense	8,718	3,672	137.4 %	15,790	7,082	123.0 %
Net interest income	75,044	51,831	44.8 %	148,946	103,099	44.5 %
Provision for loan losses	5,280	1,186	345.2 %	9,174	1,501	511.1 %
Net interest income after provision for loan losses	69,764	50,645	37.8 %	139,772	101,598	37.6 %
Noninterest income	32,713	20,019	63.4 %	58,569	38,512	52.1 %
Noninterest expense	55,931	36,747	52.2 %	109,994	73,578	49.5 %
Net income before income taxes	46,546	33,916	37.2 %	88,346	66,532	32.8 %
Income tax expense	15,759	11,252	40.0 %	29,594	22,025	34.4 %
Net income	$30,787	$22,664	35.8 %	$58,752	$44,507	32.0 %
		-		-	-	
Basic net income per common share	$$0.75	$$0.65	15.4 %	$$1.44	$$1.27	13.4 %
Diluted net income per common share	$$0.73	$$0.64	14.1 %	$$1.42	$$1.25	13.6 %

Net Interest Income. Net interest income represents the amount by which interest earned on various earning assets exceeds interest paid on deposits and other interest-bearing liabilities and is the most significant component of our revenues. Net interest income totaled $75.0 million and $148.9 million for the three and six months ended June 30, 2016, an increase of $23.2 million and $45.8 million, from the levels recorded in the same periods of 2015. We were able to increase net interest income during the six months ended June 30, 2016 compared to the same period in 2015 due primarily to our focus on growing our loan portfolio both organically and by acquisition. Average loans for the six months ended June 30, 2016 were 46.8% greater than average balances for the same period in 2015.
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The following tables set forth the amount of our average balances, interest income or interest expense for each category of interest-earning assets and interest-bearing liabilities and the average interest rate for interest-earning assets and interest-bearing liabilities, net interest spread and net interest margin for the three and six months ended June 30, 2016 and 2015 (dollars in thousands):

	Three Months Ended June 30, 2016			Three Months Ended June 30, 2015		
	Average Balances	Interest	Rates/ Yields	Average Balances	Interest	Rates/ Yields
Interest-earning assets:						
Loans [1,2]	$6,997,592	$77,043	4.53 %	$4,736,818	$50,326	4.27 %
Securities:						
Taxable	880,976	4,572	2.09 %	681,829	3,460	2.04 %
Tax-exempt [2]	183,084	1,443	4.25 %	154,596	1,400	4.86 %
Federal funds sold and other	301,005	704	0.94 %	191,271	316	0.66 %
Total interest-earning assets	8,362,657	$83,762	4.06 %	5,764,514	$55,502	3.91 %
Nonearning assets						
Intangible assets	440,504			245,964		
Other nonearning assets	502,780			309,234		
Total assets	$9,305,941			$6,319,712		
Interest-bearing liabilities:						
Interest-bearing deposits:						
Interest checking	$1,352,898	$904	0.27 %	$1,074,853	$532	0.20 %
Savings and money market	3,085,734	3,019	0.39 %	1,951,863	1,488	0.31 %
Time	651,194	1,151	0.71 %	420,514	572	0.55 %
Total interest-bearing deposits	5,089,826	5,074	0.40 %	3,447,230	2,592	0.30 %
Securities sold under agreements to repurchase	65,121	40	0.24 %	61,355	29	0.19 %
Federal Home Loan Bank advances	653,750	1,256	0.77 %	388,963	224	0.23 %
Subordinated debt and other borrowings	225,240	2,348	4.19 %	135,884	826	2.44 %
Total interest-bearing liabilities	6,033,937	8,718	0.58 %	4,033,432	3,671	0.37 %
Noninterest-bearing deposits	2,003,523	-	-	1,437,276	-	-
Total deposits and interest-bearing liabilities	8,037,460	$8,718	0.44 %	5,470,708	$3,671	0.27 %
Other liabilities	20,719			12,213		
Stockholders' equity	1,247,762			836,791		
Total liabilities and stockholders' equity	$9,305,941			$6,319,712		
Net interest income		$75,044			$51,831	
Net interest spread [3]			3.48 %			3.54 %
Net interest margin [4]			3.72 %			3.65 %

1. Average balances of nonaccrual loans are included in the above amounts.
2. Yields based on the carrying value of those tax exempt instruments are shown on a fully tax equivalent basis.
3. Yields realized on interest-bearing assets less the rates paid on interest-bearing liabilities. The net interest spread calculation excludes the impact of demand deposits. Had the impact of demand deposits been included, the net interest spread for the three months ended June 30, 2016 would have been 3.62% compared to a net interest spread of 3.64% for the three months ended June 30, 2015.
4. Net interest margin is the result of annualized net interest income calculated on a tax-equivalent basis divided by average interest-earning assets for the period.

	Six Months Ended June 30, 2016 Average Balances	Interest	Rates/ Yields	Six Months Ended June 30, 2015 Average Balances	Interest	Rates/ Yields
Interest-earning assets:						
Loans [1,2]	$6,869,823	$151,447	4.51 %	$4,681,194	$99,792	4.31 %
Securities:						
Taxable	845,945	9,039	2.15 %	654,011	6,905	2.13 %
Tax-exempt [2]	182,923	2,937	4.33 %	158,609	2,884	4.90 %
Federal funds sold and other	291,782	1,313	0.91 %	179,703	601	0.67 %
Total interest-earning assets	8,190,473	$164,736	4.08 %	5,673,517	$110,182	3.96 %
Nonearning assets						
Intangible assets	440,485			246,138		
Other nonearning assets	447,996			292,065		
Total assets	$9,078,954			$6,211,720		
Interest-bearing liabilities:						
Interest-bearing deposits:						
Interest checking	$1,378,931	$1,835	0.27 %	$1,052,405	$1,005	0.19 %
Savings and money market	3,041,660	5,972	0.39 %	1,973,818	2,898	0.30 %
Time	662,788	2,182	0.66 %	422,057	1,121	0.54 %
Total interest-bearing deposits	5,083,379	9,989	0.40 %	3,448,280	5,024	0.29 %
Securities sold under agreements to repurchase	67,125	88	0.26 %	63,916	60	0.19 %
Federal Home Loan Bank advances	518,440	1,792	0.70 %	339,763	444	0.26 %
Subordinated debt and other borrowings	193,904	3,921	4.07 %	128,499	1,555	2.44 %
Total interest-bearing liabilities	5,862,848	15,790	0.54 %	3,980,458	7,083	0.36 %
Noninterest-bearing deposits	1,981,803	-	-	1,390,201	-	-
Total deposits and interest-bearing liabilities	7,844,651	$15,790	0.40 %	5,370,659	$7,083	0.27 %
Other liabilities	16,346			14,754		
Stockholders' equity	1,217,957			826,307		
Total liabilities and stockholders' equity	$9,078,954			$6,211,720		
Net interest income		$148,946			$103,099	
Net interest spread [3]			3.53 %			3.60 %
Net interest margin [4]			3.75 %			3.71 %

1. Average balances of nonaccrual loans are included in the above amounts.
2. Yields based on the carrying value of those tax exempt instruments are shown on a fully tax equivalent basis.
3. Yields realized on interest-bearing assets less the rates paid on interest-bearing liabilities. The net interest spread calculation excludes the impact of demand deposits. Had the impact of demand deposits been included, the net interest spread for the six months ended June 30, 2016 would have been 3.67% compared to a net interest spread of 3.70% for the six months ended June 30, 2015.
4. Net interest margin is the result of annualized net interest income calculated on a tax-equivalent basis divided by average interest-earning assets for the period.

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For the three months ended June 30, 2016 and 2015, our net interest margin was 3.72% and 3.65%, respectively. For the six months ended June 30, 2016 and 2015, our net interest margin was 3.75% and 3.71% , respectively. In the fourth quarter of 2015, we experienced an increase in the Fed Funds rate, which, including the impact to other short-term notes, contributed to increased loan yields in the first and second quarters of 2016 with minimal impact to deposit costs. The net interest margin for the three and six months ended June 30, 2016 was also favorably impacted by the accretion of the fair value adjustment recorded on the recently acquired loan and deposit portfolios. We expect the net interest margin to decrease in future periods as the accretion amounts from the CapitalMark and Magna mergers continue to become less impactful in future periods. We also expect that we will incur increased funding costs as a result of competition for deposits in our markets. Additionally, loan pricing for creditworthy borrowers is very competitive in our markets and has continued to limit our ability to increase pricing on new and renewed loans over the last several quarters. We anticipate that this challenging competitive environment will continue throughout the remainder of 2016.

We continue to believe our net interest income should increase throughout the remainder of 2016 compared to 2015 due to an increase in average earning asset volumes, primarily loans, as a result of organic loan growth and our acquisition of Avenue. We anticipate funding these increased earning assets primarily by growing our core deposits, and utilizing limited wholesale funding to fund the shortfall, if any, resulting from loan growth outpacing deposit growth.

Provision for Loan Losses. The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the inherent losses on outstanding loans. Based upon management's assessment of the loan portfolio, we adjust our allowance for loan losses to an amount we believe is appropriate to adequately cover probable losses inherent in the loan portfolio. Our allowance for loan losses as a percentage of total loans decreased from 1.00% at December 31, 2015 to 0.87% at June 30, 2016, primarily as a result of the credit quality in our loan portfolio despite elevated charge-offs related to automobile financing, which represents a small portion of the total portfolio.

Based upon our evaluation of the loan portfolio, we believe the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at June 30, 2016. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management, they are necessarily approximate and imprecise. There are factors beyond our control, such as conditions in the local and national economy, local real estate markets, or particular industry or borrower-specific conditions, which may materially negatively impact our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

The provision for loan losses amounted to $5.3 million and $9.2 million for the three and six months ended June 30, 2016 compared to $1.2 million and $1.5 million for the three and six months ended June 30, 2015. Provision expense is impacted by the absolute level of loans, loan growth, the credit quality of the loan portfolio and the amount of net charge-offs. Provision expense increased in the three and six months ended June 30, 2016 compared to the three and six months ended June 30, 2015 due to increased charge-offs realized in our consumer portfolio, primarily related to automobile loans.

Noninterest Income. Our noninterest income is composed of several components, some of which vary significantly between quarterly and annual periods. Service charges on deposit accounts and other noninterest income generally reflect customer growth trends, while fees from our wealth management departments, the origination of mortgage loans, income from our equity method investment and gains and losses on the sale of securities will often reflect market conditions and fluctuate from period to period.

The following is a summary of our noninterest income for the three and six months ended June 30, 2016 and 2015 (dollars in thousands):

	Three months ended June 30,		2016-2015		Six months ended June 30,		2016-2015	
	2016	2015	Percent Increase (Decrease)		2016	2015	Percent Increase (Decrease)	
Noninterest income:								
Service charges on deposit accounts	$3,430	$3,076	11.5	%	$6,873	$5,988	14.8	%
Investment services	2,500	2,399	4.2	%	4,845	4,658	4.0	%
Insurance sales commissions	1,193	1,106	7.9	%	2,899	2,618	10.7	%
Gains on mortgage loans sold, net	4,221	1,652	155.5	%	7,789	3,593	116.8	%
Gain on sale of investment securities, net	-	556	(100.0	%)	-	562	(100.0	%)
Trust fees	1,492	1,230	21.3	%	3,073	2,542	20.9	%
Income from equity method investment	9,644	4,266	126.1	%	14,792	7,467	98.1	%
Other noninterest income:								
Interchange and other consumer fees	5,768	3,893	48.2	%	11,587	7,692	50.6	%
Bank-owned life insurance	878	573	53.2	%	1,641	1,173	39.9	%
Loan swap fees	1,780	611	191.3	%	2,511	1,093	129.7	%
Other noninterest income	1,807	657	174.9	%	2,559	1,126	127.3	%
Total other noninterest income	10,233	5,734	78.5	%	18,298	11,084	65.1	%
Total noninterest income	$32,713	$20,019	63.4	%	$58,569	38,512	52.1	%

The increase in service charges on deposit accounts in the three and six months ended June 30, 2016 compared to the three and six months ended June 30, 2015 is primarily related to increased analysis fees due to an increase in the volume and number of commercial checking accounts, related to both organic and merger-related growth.

Income from our wealth management groups (investments, insurance and trust) is also included in noninterest income. For the three and six months ended June 30, 2016, commissions and fees from investment services at our financial advisory unit, Pinnacle Asset Management, a division of Pinnacle Bank, increased by $101,000 and $187,000 as compared to the three and six months ended June 30, 2015. At June 30, 2016, Pinnacle Asset Management was receiving commissions and fees in connection with approximately $2.0 billion in brokerage assets held with Raymond James Financial Services, Inc, compared to $1.8 billion at June 30, 2015. Revenues from the sale of insurance products by our insurance subsidiary for the three and six months ended June 30, 2016 were approximately $1.2 million and $2.9 million, respectively, compared to $1.1 million and $2.6 million for the three and six months ended June 30, 2015. Included in insurance revenues for the six months ended June 30, 2016 was $474,000 of contingent income received based on 2015 sales production compared to $403,000 recorded in the same period in the prior year. Additionally, at June 30, 2016, our trust department was receiving fees on approximately $953.6 million of managed assets compared to $924.6 million at June 30, 2015. Trust fees for the six months ended June 30, 2016 increased by 20.9% when compared to the same period in 2015.

Gains on mortgage loans sold, net, consists of fees from the origination and sale of mortgage loans. These mortgage fees are for loans originated in our current markets that are subsequently sold to third-party investors. Substantially all of these loan sales transfer servicing rights to the buyer. Generally, mortgage origination fees increase in lower interest rate environments and more robust housing markets and decrease in rising interest rate environments and more challenging housing markets. Mortgage origination fees will fluctuate from quarter to quarter as the rate environment changes. Gains on mortgage loans sold, net, were $4.2 million and $7.8 million, respectively, for the three and six months ended June 30, 2016 as compared to $1.7 million and $3.6 million, respectively, for the same periods in the prior year. The increase between the two periods is attributable to the strong economy in our markets as well as additional personnel in our production unit at June 30, 2016 compared to June 30, 2015.

Income from equity-method investment is comprised of income from our equity-method investment in BHG, which was entered into during the first quarter of 2015 and was increased from 30% to 49% on March 1, 2016. Income from equity-method investment was $9.6 million and $14.8 million for the three and six months ended June 30, 2016 compared to $4.3 million and $7.5 million for the same periods in the prior year. Income from our equity-method investment is reported net of amortization and accretion of fair value adjustments recorded as of the acquisition date. Amortization expense of $575,000 and $953,000 was included for the three and six months ended June 30, 2016 compared to $600,000 and $1.0 million for the same periods in the prior year. The income associated with this equity-method investment may fluctuate from period to period.

Included in other noninterest income are interchange and other consumer fees, gains from bank-owned life insurance, swap fees earned for the facilitation of derivative transactions for our clients, changes in the fair value of our other equity investments and other items. Interchange revenues increased as a result of the number of cards being used throughout our expanded client network as compared to the comparable periods in 2015. Other noninterest income included changes in the cash surrender value of bank-owned life insurance which was $878,000 and $1.6 million for the three and six months ended June 30, 2016 compared to $573,000 and $1.2 million for the three and six months ended June 30, 2015. Also during the second quarter of 2016, Pinnacle received a settlement on a bank-owned life insurance policy reducing the asset balance by $969,000 and recorded a realized gain of $461,000 included in other income. The assets that support these policies are administered by the life insurance carriers and the income we receive (i.e., increases or decreases in the cash surrender value of the policies) on these policies is dependent upon the returns the insurance carriers are able to earn on the underlying investments that support the policies. Earnings on these policies generally are not taxable. Loan swap fees are also included in other noninterest income and increased by $1.2 million and $1.4 million when compared to the three and six months ended June 30, 2015 as a result of increase in market demand in the current rate environment.

In conjunction with the acquisition of Magna, Pinnacle Bank acquired a residential mortgage servicing portfolio which was recorded at fair value upon acquisition. The residential mortgage servicing portfolio was recorded at $6.4 million as of December 31, 2015, net of related amortization. During the first quarter of 2016 in conjunction with a decision to exit the residential servicing line of business, Pinnacle Bank sold the mortgage servicing rights associated with the $830 million Fannie Mae portion of the residential servicing portfolio for $6.6 million, net of associated costs to sell. Approximately $241,000 was recorded as income in the first quarter of 2016 as a result of the sale.

Noninterest Expense. Noninterest expense consists of salaries and employee benefits, equipment and occupancy expenses, other real estate expenses, and other operating expenses. The following is a summary of our noninterest expense for the three and six months ended June 30, 2016 and 2015 (in thousands):

	Three months ended June 30, 2016	2015	2016-2015 Percent Increase		Six months ended June 30, 2016	2015	2016-2015 Percent Increase	
Noninterest expense:								
Salaries and employee benefits:								
Salaries	$19,393	$13,468	44.0	%	$38,598	$26,292	46.8	%
Commissions	1,487	1,383	7.5	%	2,919	2,771	5.3	%
Cash and equity incentives	7,916	5,308	49.1	%	13,764	10,787	27.6	%
Employee benefits and other	5,458	3,616	50.9	%	11,490	7,455	54.1	%
Total salaries and employee benefits	34,254	23,775	44.1	%	66,771	47,305	41.1	%
Equipment and occupancy	8,312	5,878	41.4	%	16,442	11,924	37.9	%
Other real estate expense (benefit), net	222	(115)	294.2	%	335	281	19.2	%
Marketing and business development	1,538	1,186	29.6	%	2,801	2,146	30.5	%
Postage and supplies	1,050	731	43.6	%	2,007	1,380	45.4	%
Amortization of intangibles	847	227	272.3	%	1,720	455	278.1	%
Merger related expense	980	59	*NM*		2,810	59	*NM*	
Other noninterest expense	8,728	5,006	74.4	%	17,108	10,028	70.6	%
Total noninterest expense	$55,931	36,747	52.2	%	$109,994	$73,578	49.5	%

Total salaries and employee benefits expenses increased approximately $19.5 million for the first six months of 2016 over the same period in 2015. The increase in salaries is the result of our annual merit increases being effective January 1 as well as the overall increase in our associate base. At June 30, 2016, our associate base had expanded to 1,061.0 full-time equivalent associates as compared to 800.5 at June 30, 2015 resulting from both organic and merger-related growth. We expect salary expenses will continue to rise as we hire more experienced bankers throughout our expanded footprint and add the Avenue employees that we will retain following the closing of that acquisition. Moreover, since the acquisition of Avenue results in our exceeding $10 billion in total assets triggering certain provisions of the Dodd-Frank Act, we also expect our compliance costs, FDIC insurance assessment expense and salaries and benefits costs to increase.

We believe that cash and equity incentives are a valuable tool in motivating an employee base that is focused on providing our clients effective financial advice and increasing shareholder value. As a result, and unlike many other financial institutions, all of our non-commissioned associates participate in our annual cash incentive plan and all of our associates participate in our equity compensation plans. Under the annual cash incentive plan, the targeted level of incentive payments requires achievement of a certain soundness threshold, a revenue component and a targeted level of earnings (subject to certain adjustments). To the extent that the soundness threshold is met and revenues and earnings are above or below the targeted amount, the aggregate incentive payments are increased or decreased. Historically, we have paid between 0% and 125% of our targeted incentives. We currently believe based on our performance through the end of the second quarter of 2016, our performance for fiscal 2016 will achieve our targeted level of earnings, therefore we are currently accruing incentive costs for the cash incentive plan in 2016 at 100% of targeted awards.

Under our equity incentive plans, we provide a broad-based equity incentive program for all associates utilizing restricted share awards and, for certain of our associates, performance unit awards. We believe that equity incentives provide a vehicle for all associates to become meaningful stockholders of Pinnacle Financial over an extended period of time and create a stockholder-centric culture throughout our organization. We expect that compensation expense associated with equity awards for the remainder of 2016 will continue to increase when compared to comparable periods in 2015 as a result of the additional associates we have already hired in 2016 and our intention to hire additional experienced financial advisors throughout the remainder of 2016.

Equipment and occupancy expenses for the three and six months ended June 30, 2016, increased $2.4 million and $4.5 million, respectively, as compared to the same periods in the prior year primarily due to our acquisitions of CapitalMark and Magna. An additional location will be open or under construction in each of our markets before the end of 2016. We expect to supplement our retail network with the construction of a new retail office in the Chattanooga, Knoxville and Memphis markets each year for the next few years. In future periods, these expansions and our acquisition of Avenue may lead to higher equipment and occupancy expenses as well as related increases in salaries and benefits expense.

At June 30, 2016, we had $5.0 million in OREO assets compared to $5.1 million at December 31, 2015. We recognized other real estate expense of $222,000 and $335,000 for the three and six months ended June 30, 2016, respectively, compared to a benefit of $115,000 and an expense of $281,000 for the same periods in the prior year. Other real estate expense includes realized gains and losses on dispositions and holding losses due to reduced valuations of OREO properties as well as carrying costs to maintain or improve the properties.

Intangible amortization expense was $847,000 and $1.7 million for the three and six months ended June 30, 2016 compared to $227,000 and $455,000 for the same periods in 2015. The following table outlines our amortizing intangible assets, their initial valuation and amortizable lives:

	Year Acquired	Initial Valuation (in millions)	Amortizable Life (in years)
Core Deposit Intangible:			
Mid-America	2007	$ 9.5	10
CapitalMark	2015	6.2	7
Magna	2015	3.2	6
Book of Business Intangibles:			
Miller Loughry Beach	2008	1.3	20
CapitalMark Trust Department	2015	0.3	16

These assets are being amortized on an accelerated basis which reflects the anticipated life of the underlying assets. Amortization expense is estimated to approximate between $740,000 and $3.2 million per year for each of the next five years with lesser amounts for the remaining amortization period (excluding any additional amortization expense resulting from our July 1, 2016 acquisition of Avenue). Intangible amortization expense will increase in future periods as a result of our merger with Avenue.

During the three and six months ended June 30, 2016, merger related charges of $980,000 and $2.8 million were incurred associated with our acquisitions. We will continue to incur merger related charges as we complete the operational integration of Avenue, which we currently expect to be in September 2016.

Total other noninterest expenses increased by $3.7 million and $7.1 million during the three and six months ended June 30, 2016 when compared to the same periods in 2015. The increase is attributable to a variety of factors including increased collections expense attributable to our consumer auto portfolio, increased directors fees, franchise tax expense, and regulatory and audit fees.

Our efficiency ratio (ratio of noninterest expense to the sum of net interest income and noninterest income) was 51.9% and 53.0% for the three and six months ended June 30, 2016 compared to 51.1% and 52.0% for the three and six months ended June 30, 2015. The efficiency ratio measures the amount of expense that is incurred to generate a dollar of revenue. The efficiency ratio for the quarter and year-to-date periods ended June 30, 2016 was negatively impacted by merger-related charges.

Income Taxes. During the three and six months ended June 30, 2016, we recorded income tax expense of $15.8 million and $29.6 million compared to $11.3 million and $22.0 million for the three and six months ended June 30, 2015. Our income tax expense for the year-to-date period ended June 30, 2016 reflects an effective income tax rate of 33.5% compared to 33.1% for the year-to-date period ended June 30, 2015. Our effective tax rate differs from the statutory tax rate by our investments in municipal securities, our real estate investment trust, participation in the Community Investment Tax Credit program and bank-owned life insurance offset in part by limited deductibility of meals and entertainment expense.

Financial Condition

Our consolidated balance sheet at June 30, 2016 reflects an increase in total loans outstanding to $7.091 billion at June 30, 2016 compared to $6.543 billion at December 31, 2015. Total deposits increased by $321.4 million between December 31, 2015 and June 30, 2016. Total assets were $9.736 billion at June 30, 2016 compared to $8.715 billion at December 31, 2015.

Loans. The composition of loans at June 30, 2016 and at December 31, 2015 and the percentage (%) of each classification to total loans are summarized as follows (dollars in thousands):

	June 30, 2016			December 31, 2015		
	Amount	Percent		Amount	Percent	
Commercial real estate – mortgage	$2,467,219	34.8	%	$2,275,483	34.8	%
Consumer real estate – mortgage	1,068,620	15.1	%	1,046,517	16.0	%
Construction and land development	816,681	11.5	%	747,697	11.4	%
Commercial and industrial	2,492,016	35.1	%	2,228,542	34.1	%
Consumer and other	246,866	3.5	%	244,996	3.7	%
Total loans	$7,091,402	100.0	%	$6,543,235	100.0	%

At June 30, 2016, our loan portfolio composition remained relatively consistent with the composition at December 31, 2015. The commercial real estate – mortgage category includes owner-occupied commercial real estate loans which is similar in many ways to our commercial and industrial lending in that these loans are generally made to businesses on the basis of the cash flows of the business rather than on the valuation of the real estate. At June 30, 2016, approximately 45.2% of the outstanding principal balance of our commercial real estate mortgage loans was secured by owner-occupied properties. Growth in the construction and development loan segment reflects the development of the local economies in which we participate and is diversified between commercial, residential and land.

The following table classifies our fixed and variable rate loans at June 30, 2016 according to contractual maturities of (1) one year or less, (2) after one year through five years, and (3) after five years. The table also classifies our variable rate loans pursuant to the contractual repricing dates of the underlying loans (dollars in thousands):

	Amounts at June 30, 2016			Percentage At June 30, 2016	
	Fixed Rates	Variable Rates	Totals		
Based on contractual maturity:					
Due within one year	$335,262	$1,182,726	$1,517,988	21.4	%
Due in one year to five years	1,741,940	1,440,904	3,182,844	44.9	%
Due after five years	922,273	1,468,297	2,390,570	33.7	%
Totals	$2,999,475	$4,091,927	$7,091,402	100.0	%
Based on contractual repricing dates:					
Daily floating rate (*)	$-	$1,704,152	$1,704,152	24.0	%
Due within one year	335,262	2,047,589	2,382,851	33.6	%

Due in one year to five years	1,741,940	291,269	2,033,209	28.7	%
Due after five years	922,273	48,917	971,190	13.7	%
Totals	$2,999,475	$4,091,927	$7,091,402	100.0	%

The above information does not consider the impact of scheduled principal payments.

(*) Daily floating rate loans are tied to Pinnacle Bank's prime lending rate or a national interest rate index with the underlying loan rates changing in relation to changes in these indexes. Interest rate floors are currently in effect on approximately $297.0 million of our daily floating rate loan portfolio and on approximately $330.0 million of the remaining variable rate loan portfolio at varying maturities. The weighted average rate of the floors for the daily floating rate portfolio is 4.57% compared to the average coupon of 3.76% for this portfolio. The weighted average rate of the floors for the remaining variable rate portfolio is 4.29% compared to the average coupon rate of 3.51% for this portfolio. As a result, interest income on these loans will not adjust until the contractual rate on the underlying loan exceeds the interest rate floor.

Accruing Loans in Past Due Status. The following table is a summary of our accruing loans that were past due at least 30 days but less than 89 days and 90 days or more past due as of June 30, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016	December 31, 2015
Accruing loans past due 30 to 89 days:		
Commercial real estate – mortgage	$1,015	$ -
Consumer real estate – mortgage	5,476	6,380
Construction and land development	8,199	309
Commercial and industrial	1,166	4,798
Consumer and other	6,252	6,721
Total accruing loans past due 30 to 89 days	$22,108	$ 18,208
Accruing loans past due 90 days or more:		
Commercial real estate – mortgage	$-	$ -
Consumer real estate – mortgage	1,046	1,396
Construction and land development	-	-
Commercial and industrial	-	-
Consumer and other	577	373
Total accruing loans past due 90 days or more	$1,623	$ 1,769
Ratios:		
Accruing loans past due 30 to 89 days as a percentage of total loans	0.31 %	0.28 %
Accruing loans past due 90 days or more as a percentage of total loans	0.02 %	0.03 %
Total accruing loans in past due status as a percentage of total loans	0.33 %	0.31 %

Potential Problem Loans. Potential problem loans, which are not included in nonperforming assets, amounted to approximately $98.1 million or 1.4% of total loans at June 30, 2016 compared to $105.0 million or 1.6% of total loans at December 31, 2015. Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by Pinnacle Bank's primary regulators, for loans classified as substandard, excluding the impact of substandard nonaccrual loans and substandard troubled debt restructurings. Troubled debt restructurings are not included in potential problem loans. Approximately $447,000 of potential problem loans were past due at least 30 days but less than 90 days as of June 30, 2016.

Nonperforming Assets and Troubled Debt Restructurings. At June 30, 2016, we had $39.0 million in nonperforming assets compared to $36.4 million at December 31, 2015. Included in nonperforming assets were $33.8 million in nonaccrual loans, $5.0 million in OREO and $177,000 in other repossessed assets at June 30, 2016 and $29.4 million in nonaccrual loans, $5.1 million in OREO and $1.9 million of other repossessed assets at December 31, 2015. At June 30, 2016 and December 31, 2015, there were $9.9 million and $8.1 million, respectively, of troubled debt restructurings, all of which were accruing as of the restructured date and remain on accrual status but are considered impaired loans pursuant to U.S. GAAP.

Allowance for Loan Losses (allowance). We maintain the allowance at a level that our management deems appropriate to adequately cover the probable losses inherent in the loan portfolio. As of June 30, 2016 and December 31, 2015, our allowance for loan losses was approximately $61.4 million and $65.4 million, respectively, which our management deemed to be adequate at each of the respective dates. Purchased loans were recorded at fair value upon acquisition with an aggregate balance of $1.3 billion and an aggregate fair value adjustment of $33.4 million of which $6.1 million was attributable to purchase credit impaired loans and will not be accreted into income. Since the acquisition date, approximately $13.3 million has been recorded as income, resulting from the accretion of the fair value discount over the remaining life of the underlying loan or upon the settlement of the underlying credit. These loans are subject to the same allowance methodology as our legacy portfolio. The calculated allowance is compared to the remaining fair value discount, on a loan-by-loan basis, to determine if additional provisioning should be recognized. At June 30, 2016, $3.3 million of our allowance for loan losses related to purchased loans resulting from either additional draws or from credit deterioration compared to $3.2 million of our allowance for loan losses at December 31, 2015. The judgments and estimates associated with our allowance determination are described under Critical Accounting Estimates in our Annual Report on Form 10-K for the year ended December 31, 2015.

The following table sets forth, based on management's best estimate, the allocation of the allowance to categories of loans as well as the unallocated portion as of June 30, 2016 and December 31, 2015 and the percentage of loans in each category to total loans (dollars in thousands):

	June 30, 2016		December 31, 2015	
	Amount	Percent	Amount	Percent
Commercial real estate - mortgage	$13,665	34.8 %	$15,513	34.8 %
Consumer real estate - mortgage	6,540	15.1 %	7,220	16.0 %
Construction and land development	3,923	11.5 %	2,903	11.4 %
Commercial and industrial	25,090	35.1 %	23,643	34.1 %
Consumer and other	11,138	3.5 %	15,616	3.7 %
Unallocated	1,056	NA	537	NA
Total allowance for loan losses	$61,412	100.0 %	$65,432	100.0 %

The following is a summary of changes in the allowance for loan losses for the year-to-date period ended June 30, 2016 and for the year ended December 31, 2015 and the ratio of the allowance for loan losses to total loans as of the end of each period (dollars in thousands):

	Six months ended June 30, 2016	Year ended December 31, 2015
Balance at beginning of period	$65,432	$67,359
Provision for loan losses	9,174	9,188
Charged-off loans:		
Commercial real estate – mortgage	(196)	(384)
Consumer real estate – mortgage	(379)	(365)
Construction and land development	-	(190)
Commercial and industrial	(2,243)	(2,207)
Consumer and other loans	(13,555)	(18,002)
Total charged-off loans	(16,373)	(21,148)
Recoveries of previously charged-off loans:		
Commercial real estate – mortgage	193	85
Consumer real estate – mortgage	156	874
Construction and land development	106	1,479
Commercial and industrial	1,615	1,730
Consumer and other loans	1,109	5,865
Total recoveries of previously charged-off loans	3,179	10,033
Net charge-offs	(13,194)	(11,115)
Balance at end of period	$61,412	$65,432
Ratio of allowance for loan losses to total loans outstanding at end of period	0.87 %	1.00 %
Ratio of net charge-offs to average total loans outstanding for the period (1)	0.39 %	0.21 %

(1) Net charge-offs for the year-to-date period ended June 30, 2016 have been annualized.

Management assesses the adequacy of the allowance prior to the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The level of the allowance is based upon management's evaluation of the loan portfolio, past loan loss experience, known and inherent risks in the portfolio, the views of Pinnacle Bank's regulators, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. For further discussion regarding our allowance for loan losses, refer to the Annual Report on Form 10-K as of and for the year ended December 31, 2015.

Investments. Our investment portfolio, consisting primarily of U.S. Treasuries, Federal agency bonds, mortgage-backed securities, and state and municipal securities amounted to $1.1 billion and $966.4 million at June 30, 2016 and December 31, 2015, respectively. Our investment portfolio serves many purposes including serving as a stable source of income, as collateral for public funds deposits and as a potential liquidity source. A summary of our investment portfolio at June 30, 2016 and December 31, 2015 follows:

	June 30, 2016	December 31, 2015
Weighted average life	4.0 years	4.90 years
Effective duration	2.38%	3.04%
Weighted average coupon	2.97%	3.04%
Tax equivalent yield	2.49%	2.45%

Deposits and Other Borrowings. We had approximately $7.293 billion of deposits at June 30, 2016 compared to $6.971 billion at December 31, 2015. Our deposits consist of noninterest and interest-bearing demand accounts, savings accounts, money market accounts and time deposits. Additionally, we entered into agreements with certain customers to sell certain securities under agreements to repurchase the security the following day. These agreements (which are typically associated with comprehensive treasury management programs for our clients and provide them with short-term returns for their excess funds) amounted to $73.3 million at June 30, 2016 and $79.1 million at December 31, 2015. Additionally, at June 30, 2016 and December 31, 2015, Pinnacle Bank had borrowed $783.2 million and $300.3 million, respectively, in advances from the FHLB. At June 30, 2016, Pinnacle Bank had approximately $523.0 million in additional availability with the FHLB.

Generally, we have classified our funding base as either core funding or non-core funding. Core funding consists of all deposits other than time deposits issued in denominations greater than $250,000. All other funding is deemed to be non-core. The following table represents the balances of our deposits and other funding and the percentage of each type to the total at June 30, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016	Percent	December 31, 2015	Percent
Core funding:				
Noninterest-bearing deposit accounts	$2,013,847	24.0 %	$1,889,865	25.2 %
Interest-bearing demand accounts	1,284,593	15.3 %	1,355,405	18.1 %
Savings and money market accounts	2,843,895	33.9 %	2,683,046	35.8 %
Time deposit accounts less than $250,000	448,727	5.4 %	404,494	5.4 %
Total core funding	6,591,062	78.7 %	6,332,810	84.5 %
Non-core funding:				
Relationship based non-core funding:				
Reciprocating NOW deposits (1)	32,060	0.4 %	34,144	0.5 %
Reciprocating money market accounts (1)	393,108	4.7 %	318,905	4.3 %
Reciprocating time deposits	11,571	0.1 %	50,203	0.7 %

Other time deposits	150,298	1.8 %	228,064	3.0 %
Securities sold under agreements to repurchase	73,317	0.9 %	79,084	1.1 %
Total relationship based non-core funding	660,354	7.9 %	710,400	9.5 %
Wholesale funding:				
Brokered deposits	114,727	1.4 %	7,288	0.1 %
Federal Home Loan Bank advances	783,240	9.4 %	300,305	4.0 %
Subordinated debt - Pinnacle Bank	147,238	1.8 %	60,000	0.8 %
Subordinated debt- Pinnacle Financial	82,476	1.0 %	82,476	1.1 %
Total wholesale funding	1,127,681	13.5 %	450,069	6.0 %
Total non-core funding	1,788,035	21.3 %	1,160,469	15.5 %
Totals	$8,379,097	100.0 %	$7,493,279	100.0 %

[(1)] The reciprocating categories consists of deposits we receive from a bank network (the CDARS network) in connection with deposits of our customers in excess of our FDIC coverage limit that we place with the CDARS network.

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Our funding policies impose limits on the amount of non-core funding we can utilize. Periodically, we may exceed our policy limitations, at which time management will develop plans to bring our core funding ratios back within compliance. At June 30, 2016 and December 31, 2015, we were in compliance with our core funding policies. As noted in the table above, our core funding as a percentage of total funding decreased from 84.5% at December 31, 2015 to 78.7% at June 30, 2016, primarily as a result of our increased FHLB advances used to fund loan growth that outpaced deposit growth.

Continuing to grow our core deposit base is a key strategic objective of our firm. We have numerous commercial and affluent consumer depositors that maintain significant balances in their transaction and money market accounts. These deposits are subject to significant fluctuations from time to time for such purposes as distributions to owners, taxes, business acquisitions, etc. As a result, our core funding ratios may also fluctuate meaningfully based on these factors.

The amount of time deposits as of June 30, 2016 amounted to $725.3 million. The following table shows our time deposits in denominations of $100,000 and less and in denominations greater than $100,000 by category based on time remaining until maturity and the weighted average rate for each category (in thousands):

	Balances	Weighted Avg. Rate	
Denominations less than $100,000			
Three months or less	$43,616	0.58	%
Over three but less than six months	38,968	1.61	%
Over six but less than twelve months	61,991	1.80	%
Over twelve months	46,963	2.99	%
	$191,538	1.78	%
Denominations $100,000 and greater			
Three months or less	$132,676	0.57	%
Over three but less than six months	157,658	0.72	%
Over six but less than twelve months	129,400	0.78	%
Over twelve months	114,051	0.54	%
	$533,785	0.66	%
Totals	$725,323	0.95	%

Subordinated debt and other borrowings. We have four wholly-owned subsidiaries that are statutory business trusts. We are the sole sponsor of the Trusts and acquired each Trust's common securities. The Trusts were created for the exclusive purpose of issuing 30-year capital trust preferred securities and using the proceeds to acquire junior subordinated debentures (Subordinated Debentures) issued by ourselves. The sole assets of the Trusts are the Subordinated Debentures. At June 30, 2016, our $2,476,000 investment in the Trusts is included in other investments in the accompanying consolidated balance sheets and our $82,476,000 obligation is reflected as subordinated debt.

	Date Established	Maturity	Common Securities	Subordinated Debentures	Floating Interest Rate	Interest Rate at June 30, 2016	
Trust I	December 29, 2003	December 30, 2033	$310,000	$10,000,000	Libor + 2.80%	3.46	%
Trust II	September 15, 2005	September 30, 2035	619,000	20,000,000	Libor + 1.40%	2.03	%
Trust III	September 7, 2006	September 30, 2036	619,000	20,000,000	Libor + 1.65%	2.28	%
Trust IV	October 31, 2007	September 30, 2037	928,000	30,000,000	Libor + 2.85%	3.50	%

The Trust Preferred Securities bear a floating interest rate based on a spread over 3-month LIBOR which is set each quarter. Distributions are payable quarterly. The Trust Preferred Securities are subject to mandatory redemption upon repayment of the Subordinated Debentures at their stated maturity date or their earlier redemption in an amount equal to their liquidation amount plus accumulated and unpaid distributions to the date of redemption. We guarantee the payment of distributions and payments for redemption or liquidation of the Trust Preferred Securities to the extent of funds held by the Trusts. Our obligations under the Subordinated Debentures together with the guarantee and other back-up obligations, in the aggregate, constitute a full and unconditional guarantee by ourselves of the obligations of the Trusts under the Trust Preferred Securities.

The Subordinated Debentures are unsecured, bear interest at a rate equal to the rates paid by the Trusts on the Trust Preferred Securities and mature on the same dates as those noted above for the Trust Preferred Securities. Interest is payable quarterly. We may defer the payment of interest at any time for a period not exceeding 20 consecutive quarters provided that the deferral period does not extend past the stated maturity. During any such deferral period, distributions on the Trust Preferred Securities will also be deferred and our ability to pay dividends on our common shares and preferred shares will be restricted.

The Trust Preferred Securities may be redeemed prior to maturity at our option. The Trust Preferred Securities may also be redeemed at any time in whole (but not in part) in the event of unfavorable changes in laws or regulations that result in (1) the Trust becoming subject to federal income tax on income received on the Subordinated Debentures, (2) interest payable by the parent company on the Subordinated Debentures becoming non-deductible for federal tax purposes, (3) the requirement for the Trust to register under the Investment Company Act of 1940, as amended, or (4) loss of the ability to treat the trust preferred securities as "Tier I capital" under the Federal Reserve capital adequacy guidelines. Under current Federal Reserve regulations, the trust preferred securities qualify as Tier 1 capital. The Federal Reserve published final Basel III capital regulations in June 2013 which continued the treatment of preferred securities as Tier I capital for holding companies under $15.0 billion in assets.

On July 30, 2015, Pinnacle Bank issued $60.0 million in aggregate principal amount of Fixed-to-Floating Rate Subordinated Notes due 2025 (Notes) in a private placement transaction to accredited institutional investors. On March 10, 2016, Pinnacle Bank issued an additional $70.0 million in aggregate principal amount of the Notes. The Notes issued on March 10, 2016 were priced at 99.023% of the principal amount per note, for an effective interest rate of 5.125%. The maturity date of the Notes is July 30, 2025, although Pinnacle Bank may redeem some or all of the Notes beginning on the interest payment date of July 30, 2020 and on any interest payment date thereafter at a redemption price equal to 100% of the principal amount of the Notes to be redeemed plus accrued and unpaid interest to the date of redemption, subject to the prior approval of the FDIC.

From the date of the issuance through July 29, 2020, the Notes will bear interest at the rate of 4.875% per year and will be payable semi-annually in arrears on January 30 and July 30 of each year, beginning on January 30, 2016. From July 30, 2020, the Notes will bear interest at a rate per annum equal to the three-month LIBOR rate plus 3.128%, payable quarterly in arrears on each January 30, April 30, July 30, and October 30, beginning on July 30, 2020, through the maturity date or the early redemption date of the Notes.

Pinnacle Bank used the net proceeds from the June 30, 2015 offering, together with available cash, to pay the cash portion of the merger consideration payable to the shareholders of CapitalMark and Magna in connection with those mergers, to pay the amounts necessary to redeem the preferred shares that each of CapitalMark and Magna had issued to the United States Department of the Treasury in connection with their participation in the Treasury's Small Business Lending Fund and for general corporate purposes. The sale of the Notes on March 10, 2016 yielded net proceeds of approximately $68.3 million after deducting the placement agents' fees and expenses payable by Pinnacle Bank. Pinnacle Bank used the net proceeds from the offering for general corporate purposes, (including the repayment of short term borrowings of Pinnacle Bank used to pay a portion of the cash portion of the purchase price for the additional equity interests of BHG acquired by Pinnacle Bank on March 1, 2016).

On March 29, 2016, Pinnacle Financial entered into a revolving credit facility with a bank for borrowings of up to $75 million under a loan agreement Pinnacle Financial entered into with the bank (the Loan Agreement). Borrowings under the revolving credit facility are anticipated to be used to fund the cash portion of the purchase price and the transaction costs associated with acquisitions made by Pinnacle Financial from time to time and for general corporate purposes including to fund capital contributions to Pinnacle Bank. Pinnacle Financial's borrowings under the Loan Agreement bear interest at a rate equal to 2.25% plus the greater of (i) zero percent (0%) or (ii) the one-month LIBOR rate quoted by the lender. The Loan Agreement also requires Pinnacle Financial to pay a quarterly fee beginning June 30, 2016 equal to 0.35% per annum on the average daily unused amount of available borrowings. As of June 30, 2016, there were $19.8 million of borrowings under the Loan Agreement, net of associated debt issuance costs, which were used to fund a capital contribution to Pinnacle Bank. Pinnacle Financial borrowed an additional $10.0 million on July 1, 2016 to fund a portion of the cash portion of the merger consideration payable to Avenue's shareholders.

In addition, upon consummation of the Avenue Merger, Pinnacle Financial assumed Avenue's obligations under its outstanding $20.0 million subordinated notes issued in December 2014 (the Avenue Subordinated Notes) that mature in December 2024. The Avenue Subordinated Notes bear interest at a rate of 6.75% per annum until January 1, 2020 and may not be redeemed prior to such date. Beginning on January 1, 2020, if not redeemed on such date, the Avenue Subordinated Notes will bear interest at a floating rate equal to the three-month LIBOR determined on the determination date of the applicable interest period plus 4.95%. Interest on the Avenue Subordinated Notes is payable quarterly in arrears on January 1, April 1, July 1 and October 1 of each year, through December 29, 2024 or the earlier date of redemption of all the Avenue Subordinated Notes. The Avenue Subordinated Notes are not subject to redemption at the option of the holders. These notes will be recorded at fair value as of the acquisition date.

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Capital Resources. At June 30, 2016 and December 31, 2015, our stockholders' equity amounted to $1.3 billion and $1.2 billion, respectively, an increase of approximately $106.5 million. Approximately $39.7 million of this increase is attributable to equity issued in connection with our supplemental investment in BHG. The remaining increase is attributable to net income, equity compensation and changes in our other comprehensive income.

Dividends. Pursuant to Tennessee banking law, our bank may not, without the prior consent of the TDFI, pay any dividends to us in a calendar year in excess of the total of our bank's retained net profits for that year plus the retained net profits for the preceding two years. During the six months ended June 30, 2016, our bank paid dividends of $12.9 million to us which is within the limits allowed by the TDFI.

During the six months ended June 30, 2016, we paid $11.7 million in dividends to common shareholders. On July 19, 2016, our Board of Directors declared a $0.14 per share quarterly cash dividend to common shareholders which should approximate $6.5 million in aggregate dividend payments that will be paid on August 26, 2016 to common shareholders of record as of the close of business on August 5, 2016. The amount and timing of all future dividend payments, if any, is subject to Board discretion and will depend on our earnings, capital position, financial condition and other factors, including new regulatory capital requirements, as they become known to us.

Market and Liquidity Risk Management

Our objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies. Our Asset Liability Management Committee (ALCO) is charged with the responsibility of monitoring these policies, which are designed to ensure acceptable composition of asset/liability mix. Two critical areas of focus for ALCO are interest rate sensitivity and liquidity risk management.

Interest Rate Sensitivity. In the normal course of business, we are exposed to market risk arising from fluctuations in interest rates. ALCO measures and evaluates the interest rate risk so that we can meet customer demands for various types of loans and deposits. ALCO determines the most appropriate amounts of on-balance sheet and off-balance sheet items. Measurements which we use to help us manage interest rate sensitivity include an earnings simulation model and an economic value of equity ("EVE") model.

Our interest rate sensitivity modeling incorporates a number of assumptions for both earnings simulation and EVE, including loan and deposit re-pricing characteristics, the rate of loan prepayments, etc. ALCO periodically reviews these assumptions for accuracy based on historical data and future expectations. Our ALCO policy requires that the base scenario assume rates remain flat and is the scenario to which all others are compared in order to measure the change in net interest income and EVE. Policy limits are applied to the results of certain modeling scenarios. While the primary policy scenarios focus on a twelve month time frame, longer time horizons are also modeled. All policy scenarios assume a static balance sheet, although other scenarios are modeled.

Earnings simulation model. We believe interest rate risk is best measured by our earnings simulation modeling. Earning assets, interest-bearing liabilities and off-balance sheet financial instruments are combined with forecasts of interest rates for the next 12 months and are combined with other factors in order to produce various earnings simulations. To limit interest rate risk, we have policy guidelines for our earnings at risk which seek to limit the variance of net interest income in both gradual and instantaneous changes to interest rates. For changes up or down in rates from management's flat interest rate forecast over the next twelve months, management establishes policy limits in the decline in net interest income for the following scenarios:

- +/- 10.0% for a gradual change of 400 points; +/-20.0% for an instantaneous change of 400 basis points
- +/- 7.5% for a gradual change of 300 points; +/- 15.0% for an instantaneous change of 300 basis points
- +/- 5.0% for a gradual change of 200 points; +/- 10.0% for an instantaneous change of 200 basis points

· +/- 2.5% for a gradual change of 100 points; +/- 5.0% for an instantaneous change of 100 basis points

At June 30, 2016, our earnings simulation model indicated we were in compliance with our policies for both the gradual and instantaneous interest rate changes.

Economic value of equity. Our EVE model measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are determined by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case EVE. To help limit interest rate risk, we have stated policy guidelines for an instantaneous basis point change in interest rates, in the following scenarios:

- +/- 400 basis point change in interest rates, EVE shall not decrease by more than 40 percent
- +/- 300 basis point change in interest rates, EVE shall not decrease by more than 30 percent
- +/- 200 basis point change in interest rates, EVE shall not decrease by more than 20 percent
- +/- 100 basis point change in interest rates, EVE shall not decrease by more than 10 percent

At June 30, 2016, our EVE model indicated we were in compliance with our policies noted above. However, our policies provide that during certain interest rate cycles, the down basis point rate changes may not be particularly significant given the current slope of the yield curve. Accordingly, we have currently suspended the calculation of the down rate scenarios for EVE measurement for the down 300 and down 400 scenarios.

Another commonly analyzed scenario is a most-likely earnings simulation scenario that projects the expected change in rates based on a forward yield curve adopted by management using expected balance sheet volumes forecasted by management. Separate growth assumptions are developed for loans, investments, deposits, etc. Other interest rate scenarios analyzed by management may include delayed rate shocks, yield curve steepening or flattening, or other variations in rate movements to further analyze or stress our balance sheet under various interest rate scenarios.

Each of the above analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios as part of its responsibility to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies.

We may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage our interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. We may also enter into interest rate swaps to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, even though they are not designated as hedging instruments.

Based on information gathered from these various modeling scenarios, management believes that at June 30, 2016, our balance sheet would likely be asset sensitive.

ALCO may determine that Pinnacle Financial should over time become more or less asset or liability sensitive depending on the underlying balance sheet circumstances and the firm's conclusions as to anticipated interest rate fluctuations in future periods. At present, ALCO has determined that its "most likely" rate scenario considers an initial rise in short-term interest rates in late-2016 and that such rates will increase gradually over several quarters

while the longer end of the rate curve will rise only slightly. The firm's "most likely" rate forecast is based primarily on information we acquire from a service which includes a consensus forecast of numerous benchmarks. As a result and in preparing for an eventual rise in interest rates, we have implemented the following strategies:
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- Reduced our exposure to fixed rate investment securities in relation to total assets from approximately 23% as of December 31, 2010 to a current position of approximately 12% of total assets. This reduction should assist us in becoming more asset sensitive over time.
- Executed a series of cash flow hedges involving approximately $200 million in FHLB borrowings at pre-established fixed rates. Fixed rate liabilities also provide for a more asset sensitive balance sheet.
- Participated in interest rate swaps whereby our customers pay a fixed rate which we remit to our counterparty while we receive in return a floating rate on these commercial loans. These loans amounted to approximately $578.0 million at June 30, 2016. Floating rate loans promote an asset sensitive balance sheet.
- Reduced the amount of "in the money" rate floors attached to floating and variable rate commercial loans from $1.100 billion at December 31, 2013 to $627.0 million as of June 30, 2016 thus promoting a more asset sensitive balance sheet over time.
- Reduced the difference between the weighted average floor rate on floating and variable rate commercial loans and the weighted average contract rate on these type of loans from 0.81% at December 31, 2015 to 0.80% at June 30, 2016. This reduction results in requiring a lesser increase in shorter-term rates for the floors to be overcome, thus making these loans with rate floors more asset sensitive over time.

We believe current growth in our balance sheet will also assist us in achievement of increased asset sensitivity over time; however, we may also implement a series of actions designed to accelerate our achievement of neutrality or asset sensitivity as conditions warrant.

Liquidity Risk Management. The purpose of liquidity risk management is to ensure that there are sufficient cash flows to satisfy loan demand, deposit withdrawals, and our other needs. Traditional sources of liquidity for a bank include asset maturities and growth in core deposits. A bank may achieve its desired liquidity objectives from the management of its assets and liabilities and by internally generated funding through its operations. Funds invested in marketable instruments that can be readily sold and the continuous maturing of other earning assets are sources of liquidity from an asset perspective. The liability base provides sources of liquidity through attraction of increased deposits and borrowing funds from various other institutions.

To assist in determining the adequacy of our liquidity, we perform a variety of liquidity stress tests including idiosyncratic, systemic and combined scenarios for both moderate and severe events. Liquidity is defined as the ability to convert assets into cash or cash equivalents without significant loss and to raise additional funds by increasing liabilities. Liquidity management involves maintaining our ability to meet the daily cash flow requirements of our customers, both depositors and borrowers. We maintain a minimum liquid asset balance to ensure our ability to meet our obligations. The size of the minimum liquid asset balance is determined through severe liquidity stress testing. At June 30, 2016, we were in compliance with our liquidity coverage ratio.

Changes in interest rates also affect our liquidity position. We currently price deposits in response to market rates and our management intends to continue this policy. If deposits are not priced in response to market rates, a loss of deposits could occur which would negatively affect our liquidity position.

Scheduled loan payments are a relatively stable source of funds, but loan payoffs and deposit flows fluctuate significantly, being influenced by interest rates, general economic conditions and competition. Additionally, debt security investments are subject to prepayment and call provisions that could accelerate their payoff prior to stated maturity. We attempt to price our deposit products to meet our asset/liability objectives consistent with local market conditions. Our ALCO is responsible for monitoring our ongoing liquidity needs. Our regulators also monitor our liquidity and capital resources on a periodic basis.

In addition, our bank is a member of the FHLB. As a result, our bank receives advances from the FHLB, pursuant to the terms of various borrowing agreements, which assist it in the funding of its home mortgage and commercial real estate loan portfolios. Under the borrowing agreements with the FHLB, our bank has pledged certain qualifying residential mortgage loans and, pursuant to a blanket lien, all qualifying commercial mortgage loans as collateral. At June 30, 2016, our bank had received advances from the FHLB totaling $783.2 million at the following rates and maturities (dollars in thousands):

Scheduled Maturities	Amount	Interest Rates[1]	
2016	$650,000	0.56	%
2017	133,000	0.76	%
2018	3	2.00	%
2019	-	0.00	%
2020	209	2.25	%
Thereafter	28	2.75	%
Total	$783,240		
Weighted average interest rate		0.59	%

[1] Some FHLB advances include variable interest rates and could increase in the future. The table reflects rates in effect as of June 30, 2016.

Our bank also has accommodations with upstream correspondent banks available for unsecured short-term advances which aggregate $140.0 million. These accommodations have various covenants related to their term and availability, and in most cases must be repaid within a month. There were no outstanding borrowings at June 30, 2016, or during the quarter then ended under these agreements. Our bank also has approximately $1.5 billion in available Federal Reserve discount window lines of credit.

At June 30, 2016, excluding reciprocating time deposits issued through the CDARS network, we had $114.7 million of brokered certificates of deposit. Historically, we have issued brokered certificates through several different brokerage houses based on competitive bid. Typically, these funds have been for varying maturities of up to two years and were issued at rates which were competitive to rates we would be required to pay to attract similar deposits within our local markets as well as rates for FHLB advances of similar maturities. Although we consider these deposits to be a ready source of liquidity under current market conditions, we anticipate that these deposits will not represent a significant percentage of our total funding in 2016 as we seek to maintain a significant portion of our funding in the form of core deposits.

At June 30, 2016, we had no significant commitments for capital expenditures, although we intend to construct a new retail location in each of the Knoxville, Chattanooga and Memphis MSAs annually as we expand our footprint in these newer markets. Our management believes that we have adequate liquidity to meet all known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next twelve months.

Industry regulators have defined additional liquidity guidelines, through the issuance of the Basel III Liquidity Coverage Ratio (LCR) and the Modified LCR, for banking institutions greater than $250 billion in assets, and $50 billion in assets respectively, in the United States. These regulatory guidelines became effective January 2015 with phase in over subsequent years and will require these large institutions to follow prescriptive guidance in determining an absolute level of a high quality liquid asset (HQLA) buffer that must be maintained on their balance sheets in order to withstand a potential liquidity crisis event. Although Pinnacle follows the principles outlined in the Interagency Policy Statement on Liquidity Risk Management, issued March 2010, to determine its HQLA buffer, Pinnacle is not currently subject to these regulations. However, these formulas could eventually be imposed on smaller banks, such as Pinnacle Bank, and require an increase in the absolute level of liquidity on our balance sheet. Consequently, this could result in lower net interest margins for us in future periods.

Off-Balance Sheet Arrangements. At June 30, 2016, we had outstanding standby letters of credit of $101.8 million and unfunded loan commitments outstanding of $2.5 billion. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, Pinnacle Bank has the ability to liquidate Federal funds sold or on a short-term basis to borrow and purchase Federal funds from other financial institutions.

Impact of Inflation

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with U.S. GAAP and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

Recent Accounting Pronouncements

Except as set forth below, there are currently no new accounting standards that have been issued that will have a significant impact on the Company's financial position, results of operations or cash flows upon adoption that were not disclosed in the Company's most recent Annual Report on Form 10-K.

In February 2016, the FASB issued Accounting Standards Update 2016-02 Leases guidance requiring the recognition in the statement of financial position of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. The guidance requires that a lessee should recognize lease assets and lease liabilities as compared to previous GAAP that did not require lease assets and lease liabilities to be recognized for most leases. The guidance becomes effective for us on January 1, 2019. Pinnacle Financial is currently evaluating the impact on our financial statements.

In March 2016, the FASB issued updated guidance to Accounting Standards Update 2016-09 Stock Compensation Improvements to Employee Share-Based Payment Activity intended to simplify and improve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of such awards as either equity or liabilities and classification on the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. Pinnacle Financial is currently assessing the impact of the new guidance on its consolidated financial statements.

In June 2016, the FASB issued Accounting Standards Update 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments (the ASU), which introduces the current expected credit losses methodology. Among other things, the ASU requires the measurement of all expected credit losses for financial assets, including available-for-sale debt securities, held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The new model will require institutions to calculate all probable and estimable losses that are expected to be incurred through the financial asset's entire life. ASU 2016-13 also requires the allowance for credit losses for purchased financial assets with credit deterioration since origination to be determined in a manner similar to that of other financial assets measured at amortized cost; however, the initial allowance will be added to the purchase price rather than recorded as credit loss expense. The disclosure of credit quality indicators related to the amortized cost of financing receivables will be further disaggregated by year of origination (or vintage). Disaggregation by vintage will be optional for nonpublic business entities. Institutions are to apply the changes through a cumulative-effect adjustment to their retained earnings as of the beginning of the first reporting period in which the standard is effective. The amendments are effective for fiscal years beginning after December 15, 2020. Early application will be permitted for fiscal years beginning after December 15, 2018. Pinnacle Financial is currently assessing the impact of the new guidance on its consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this Item 3 is included on pages 40 through 59 of Part I - Item 2 - "Management's Discussion and Analysis of Financial Condition and Results of Operations."

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Pinnacle Financial maintains disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act"), that are designed to ensure that information required to be disclosed by it in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to Pinnacle Financial's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Pinnacle Financial carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this report. Based on the evaluation of these disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer concluded that Pinnacle Financial's disclosure controls and procedures were effective.

Changes in Internal Controls

There were no changes in Pinnacle Financial's internal control over financial reporting during Pinnacle Financial's fiscal quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, Pinnacle Financial's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Various legal proceedings to which Pinnacle Financial or a subsidiary of Pinnacle Financial is a party arise from time to time in the normal course of business. Except as noted below, there are no material pending legal proceedings to which Pinnacle Financial or a subsidiary of Pinnacle Financial is a party or of which any of their property is the subject.

On May 9, 2016 a purported class action complaint was filed in the Chancery Court for the State of Tennessee, 20th Judicial District at Nashville, styled Stephen Bushansky, on behalf of himself and all others similarly situated, Plaintiff, versus Avenue Financial Holdings, Inc. Ronald L. Samuels, Kent Cleaver, David G. Anderson, Agenia Clark, James F. Deutsch, Marty Dickens, Patrick G. Emery, Nancy Falls, Joseph C. Galante, David Ingram. Stephen Moore, Ken Robold, Karen Saul and Pinnacle Financial Partners, Inc., Defendants (Case No. 16-489-IV), alleging that the individual defendants breached their fiduciary duties by, among other things, approving the sale of Avenue for an inadequate price as the result of a flawed sales process, agreeing to the inclusion of unreasonable deal protection devices in the Merger Agreement, approving the Avenue Merger in order to receive benefits not equally shared by all other shareholders of Avenue, and issuing materially misleading and incomplete disclosures to Avenue's shareholders. The lawsuit also alleges claims against Avenue and Pinnacle for aiding and abetting the individual defendants' breaches of fiduciary duties.

The plaintiff purports to seek class-wide relief, including but not limited to: monetary damages, and an award of interest, attorney's fees, and expenses. On May 18, 2016, the Bushansky litigation was transferred to the Davidson County, Tennessee Business Court Pilot Project (Business Court).

To avoid the costs, risks and uncertainties inherent in litigation, on June 10, 2016, the defendants entered into a memorandum of understanding with the plaintiff regarding settlement of the Bushansky litigation (the "memorandum of understanding"). The memorandum of understanding outlines the terms of the parties' agreement in principle to settle and release all claims which were or could have been asserted in the Bushansky action. In consideration for the settlement of the Bushansky litigation and release of claims contemplated thereby, the parties to the action agreed that Avenue and Pinnacle would make certain supplemental disclosures to the definitive proxy statement/prospectus. The memorandum of understanding contemplates that the parties will attempt in good faith to agree promptly upon a stipulation of settlement to be submitted to the Business Court for approval at the earliest practicable time. The stipulation of settlement will be subject to approval by the Business Court, which will consider the fairness, reasonableness and adequacy of such settlement. Under the terms of the proposed settlement, following final approval by the Business Court, the action will be dismissed with prejudice. There can be no assurance that the parties will ultimately enter into a stipulation of settlement or that the Business Court will approve the settlement even if the parties were to enter into such stipulation. In such event, the proposed settlement will be null and void and of no force and effect.

Pinnacle Financial believes the claims asserted in the Bushansky action are without merit and intends to continue to defend the litigation. At this time though, it is not possible to predict the outcome of the proceeding or its impact on Pinnacle Financial.

ITEM 1A. RISK FACTORS

Investing in our common stock involves various risks which are particular to our company, our industry and our market area. These matters could cause the trading price of our common stock to decline in future periods. We believe all significant risks to investors in Pinnacle Financial have been outlined in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. However, other risks may prove to be important in the future, and new risks may emerge at any time. We cannot predict with certainty all potential developments which could materially affect our financial performance or condition. There has been no material change to our risk factors as previously disclosed in the above described Annual Report on Form 10-K.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table discloses shares of our common stock repurchases during the three months ended June 30, 2016.

Period	Total Number of Shares Repurchased [1]	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Programs
April 1, 2016 to April 30, 2016	620	$ 50.17	-	-
May 1, 2016 to May 31, 2016	3,107	48.17	-	-
June 1, 2016 to June 30, 2016	122	49.66	-	-
Total	3,849	$ 48.51	-	-

(1) During the quarter ended June 30, 2016, 13,745 shares of restricted stock previously awarded to certain of our associates vested. We withheld 3,849 shares to satisfy tax withholding requirements associated with the vesting of these restricted shares.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES
Not applicable

ITEM 4. MINE SAFETY DISCLOSURES
Not applicable

ITEM 5. OTHER INFORMATION
None

ITEM 6. EXHIBITS

2.1	Agreement and Plan of Merger by and between Pinnacle Financial Partners, Inc. and Avenue Financial Holdings, Inc., dated as of January 28, 2016 (schedules and exhibits omitted pursuant to Item 601(b)(2) of Regulations S-K will be furnished supplementally to the Securities and Exchange Commission upon request) (incorporated by reference to the Registrant's Current Report on Form 8-K filed on January 29, 2016).
4.1	Form of Certificate for Avenue Financial Holdings, Inc. Fixed/Floating Rate Subordinated Note due December 29, 2024 (incorporated by reference to the Registrant's Current Report on Form 8-K filed on July 7, 2016)
10.1	Employment Agreement, effective July 1, 2016, by and among Pinnacle Financial Partners, Inc. and Ronald L. Samuels (incorporated by reference to the Registrant's Current Report on Form 8-K filed on July 7, 2016)
10.2	Form of Pinnacle Financial Partners, Inc. 2016 Restricted Stock Award Agreement (incorporated by reference to the Registrant's Current Report on Form 8-K filed on July 7, 2016)
10.3	Supplemental Executive Retirement Plan Agreement between Avenue Bank and Ronald Samuels, dated October 26, 2007 (incorporated by reference to the Registrant's Current Report on Form 8-K filed on July 7, 2016)
31.1	Certification pursuant to Rule 13a-14(a)/15d-14(a)
31.2	Certification pursuant to Rule 13a-14(a)/15d-14(a)
32.1	Certification pursuant to 18 USC Section 1350 – Sarbanes-Oxley Act of 2002
32.2	Certification pursuant to 18 USC Section 1350 – Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document
101.DEF	XBRL Definition Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	PINNACLE FINANCIAL PARTNERS, INC.
August 5, 2016	/s/ M. Terry Turner M. Terry Turner President and Chief Executive Officer
August 5, 2016	/s/ Harold R. Carpenter Harold R. Carpenter Chief Financial Officer

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