FC 5668

70th Annual Report

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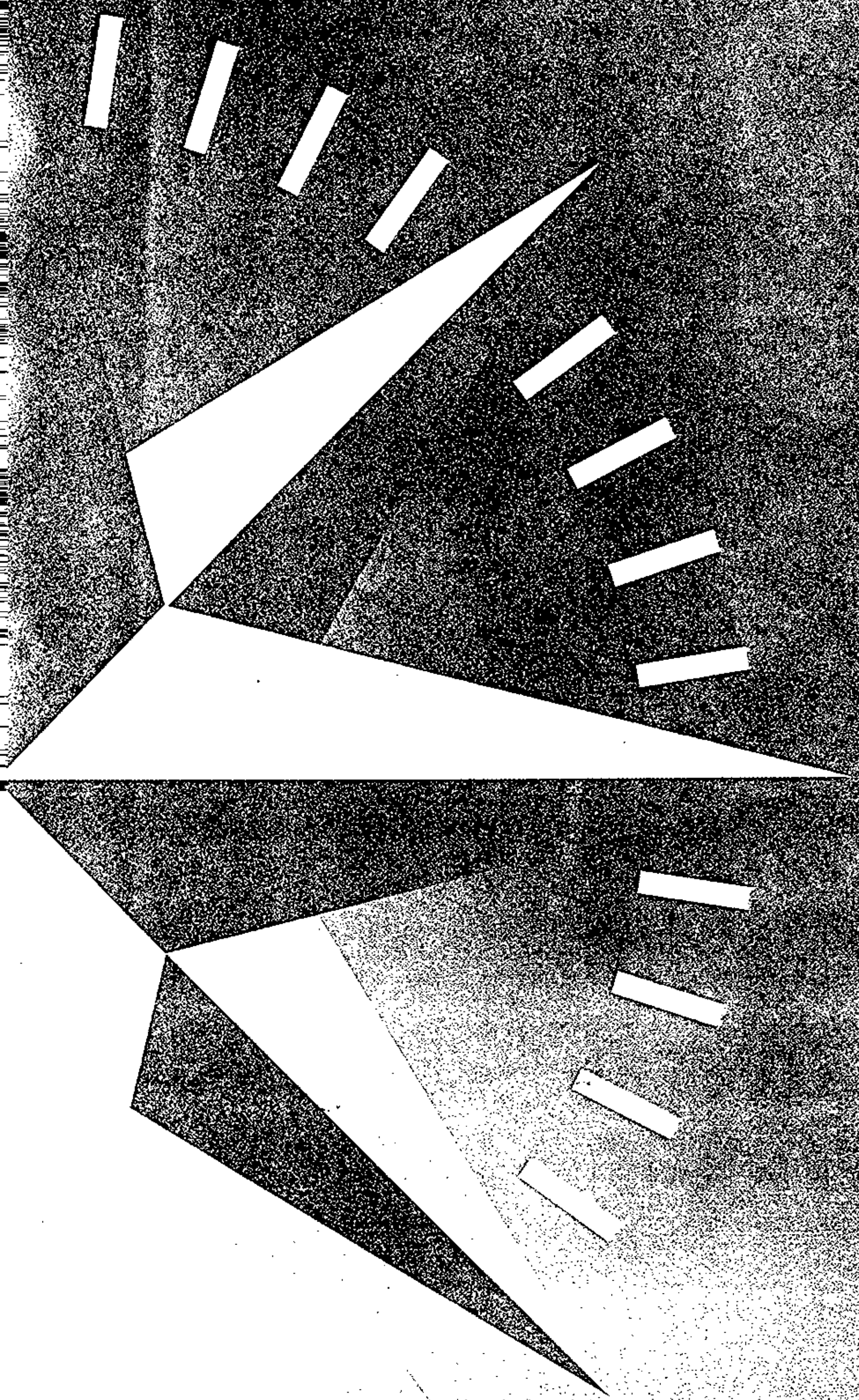
COMPANIES HOUSE 28/11/97

VARIG

"VARIG", S.A.
(Viação Aérea Rio-Grandense)
A Brazilian Publicly Traded Company
C.G.C. nº 92.772.821/0001-64

Free translation from
portuguese language original
Founded May 7, 1927



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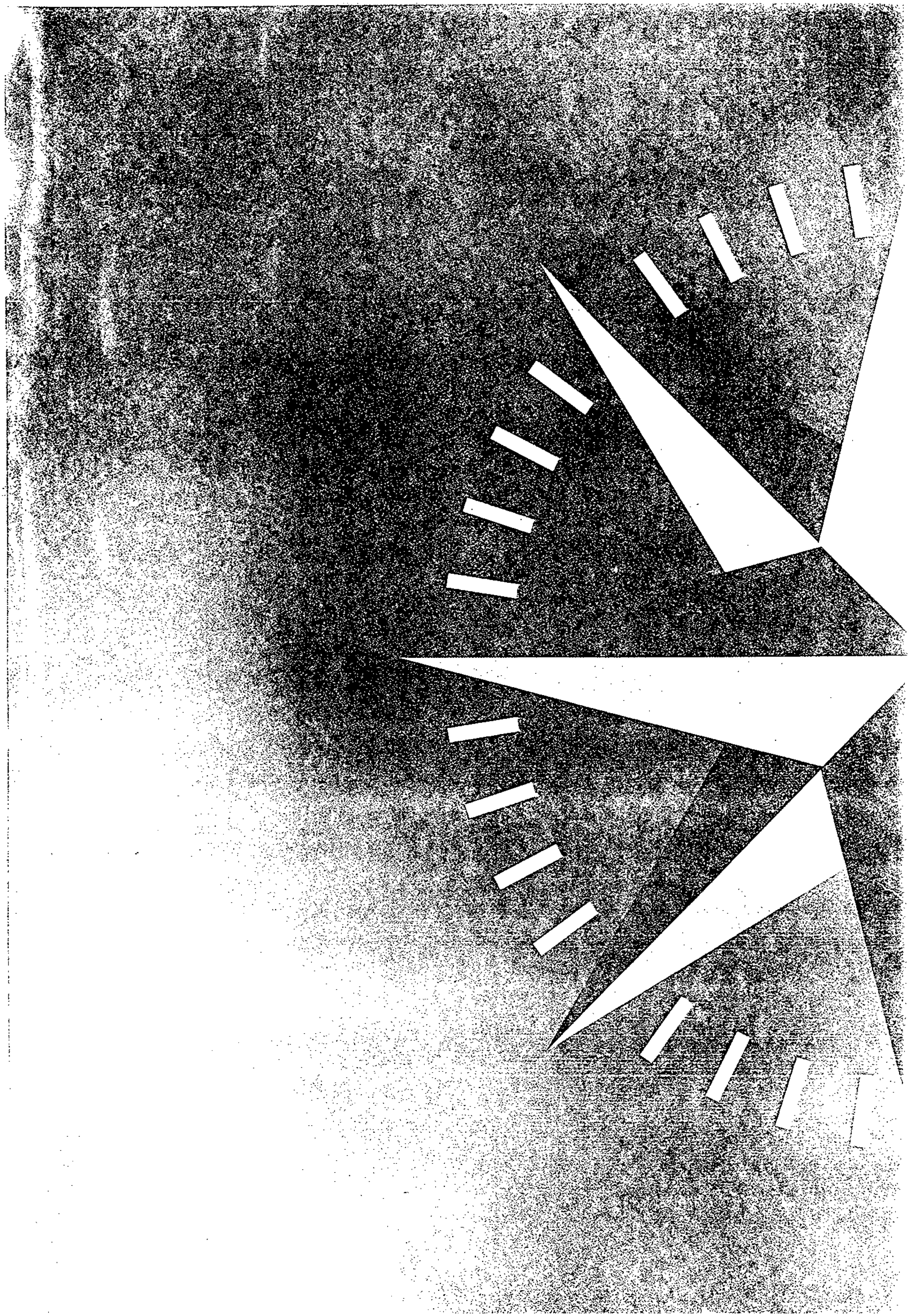


To the Stockholders

We herewith submit for your consideration the Report of Management for the year ended December 31, 1996, together with the financial statements and reports of the Statutory Audit Committee and Independent Accountants.

In the President's Message that served as the introduction to our 69th Annual Report for 1995, it was pointed out that our efforts would be concentrated on five priorities in 1996. It only seems fitting, therefore, that we begin the 70th Annual Report for 1996 by seeing what happened this past year, in concrete terms, with respect to these five priorities:

I - Profitability: this continues to stand out as our major concern. Revenue losses, already a factor in 1995, persisted until May of 1996. The latter month marked the turnaround point, due to a series of measures taken on several fronts. At the root of the recovery process was introduction of the yield management system and changes in seating arrangements in our aircraft. Key to the latter was expansion of the number of executive class seats. On the other hand, a program was implemented to cut expenses. These had been threatening to get out of control, mainly due to the collective salary settlement of December, 1995. The plan put into effect allowed us to trim costs by US$ 140 million this past year. Prospects are that it will be extended in 1997.

II - Quality of Services: the surveys we have conducted are proof positive that there has been a considerable improvement in the quality of our services as perceived by our customers. We have received numerous expressions of appreciation and congratulations in this regard. Punctuality is at an all time high in recent years - 97% on domestic and 94% on international flights. Thanks to a highly

1. Looking Back on 96

positive attitude on the part of our personnel, both on-board and ground services have markedly improved as we constantly strive towards excellence.

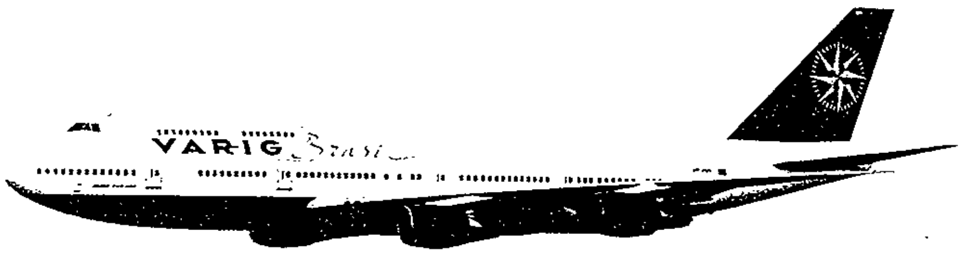
III - Human Resources: as commented in Chapter 4, projects to modernize our human resources policy were implemented, with highly encouraging results.

IV - Corporate Image: The Corporate Image Program was particularly successful and has already earned its place in the seven-decades' long history of VARIG. The aim of the program, developed over a period of 5 months, was to radically alter the Company's image, albeit still preserving some of the basic points of the VARIG tradition. The main goal - putting out the message that we are a modern leading-edge concern - is being achieved.

By August of 1997 our entire fleet will have been internally rearranged: 24 months thereafter, all our aircraft will be displaying the new corporate image. 1997 will also see our new image firmly in place at VARIG service desks. It will also be the year for supplementing the Program with a view to standardizing all elements of the Company's visual image.

V - Information Technology: Projects are underway to purchase the same systems used and tested by the biggest international airlines. Likewise worthy of comment are the contracts to be signed in 1997 with major suppliers that will permit outsourcing of data processing and telecommunications machinery and systems. This set of initiatives will be focused on allowing VARIG to make a giant leap in information technology by mid 1998.

VARIG Brasil



Boeing 747-300

The new corporate identity expresses our commitment with quality, with the continuous quest for excellence on all services performed to our clients.

2.1

Worldwide demand by market segment was as follows (expressed as percentages of passenger kilometers and metric tons per kilometer of cargo flown):

ROUTES	DEMAND BY SEGMENT (%)	
	PASSENGER	CARGO
Domestic	27.9	21.8
International	72.1	78.2
TOTAL	100.0	100.0
INTERNATIONAL MARKETS BY REGION		
North America	19.7	39.9
Europe	27.6	26.2
Asia	14.0	6.7
Latin America	10.8	5.4
TOTAL	72.1	78.2

Note - *Information on services to Africa are included in the data related to Asia, due to the present VARIG route structure.*

2.2 - Our domestic and international route network regularly serves 36 cities in Brazil and 34 cities in 23 countries around the world, distributed throughout the three Americas, Europe, Asia and Africa.

Among the various modifications that occurred in our route system, special mention should be made of the start of flights to Orlando (Florida), Cordoba and Rosário (Argentina).

2.3 - The Company's sales structure presently totals 125 outlets in Brazil and 182 overseas. Of these, 93 are branches and administrative sales outlets proper, 37 located in Brazil and 56 overseas.

2. Market and Business Environment

2.4 - In the context of increasingly globalized air transportation, in which the demands of competitiveness expand far beyond one's home country and even beyond territories covered by an airline's route network, the formation of partnerships, agreements and alliances has become a powerful competitive instrument.

Accordingly, VARIG continued to tighten bonds with other airlines in order to obtain mutual benefits. Most noteworthy in this regard were the following events in 1996:

- Continuation and intensification of the code-sharing operation linking Brazil with Germany, in partnership with Lufthansa. The results obtained and synergy arising from this agreement herald broader cooperation between the two companies, involving other areas as well.
- Winding up of the agreement with Delta in 1997 and continuation of negotiations of alliances with other U.S. airlines.
- Furtherance of the code-sharing operation with Scandinavian Airlines System (SAS).
- Continued code-sharing operation linking Brazil with Japan twice a week, once to Tokyo and another to Nagoya with Japan Airlines (JAL).
- Furtherance of the code-sharing operation in some domestic Brazilian flights with Transbrasil.

2.5 - The domestic coverage of the VARIG flight grid is enhanced by integrated operations with its subsidiaries RIO-SUL and NORDESTE; the same is true in the South American context with the Uruguayan air transportation company PLUNA.

MD-11

3.1 The following statistics show traffic volumes and respective changes in 1995 and 1996.

TRAFFIC STATISTICS	1995	1996	CHANGE (%)
HOURS FLOWN			
Total	270,780	280,795	+ 3.7
KILOMETERS FLOWN (Millions)			
Total	201	209	+ 4.0
PASSENGERS CARRIED			
Total	9,334,720	9,738,346	+ 4.3
AVAILABLE SEAT KILOMETERS (Millions)			
International	24,546	26,015	+ 6.0
Domestic	10,279	10,410	+ 1.3
Total	34,825	36,425	+ 4.6
REVENUE PASSENGER KILOMETERS (Millions)			
International	16,630	17,405	+ 4.7
Domestic	6,451	6,748	+ 4.6
Total	23,081	24,153	+ 4.6
PASSENGER LOAD FACTOR (%)			
International	68	67	- 1 p.p.
Domestic	63	65	+ 2 p.p.
Total	66	66	
REVENUE CARGO KM (Millions of metric tons)			
International	996	978	- 1.8
Domestic	317	273	- 13.9
Total	1,313	1,251	- 4.7

3. Traffic and Fleet

Boeing 737-300

3.2 The following table details the VARIG fleet as of December 31, 1996.

AIRCRAFT TYPE	AIRCRAFT IN USE ON DECEMBER 31, 1996
B-747-300 (PASSENGER)	3
B-747-300 (COMBI)	2
MD-11	6
DC-10-30 (PASSENGER)	8*
DC-10-30 (CARGO)	2
B-767-300 ER	4
B-767-200 ER	6
B-727-100 (CARGO)	5
B-737-300	25
B-737-200	17
PASSENGER AIRCRAFT SUBTOTAL	71
CARGO AIRCRAFT SUBTOTAL	7
TOTAL	78

* *The eighth aircraft in the DC-10-30 fleet was added in 1996; previously, it had been leased to PLUNA.*

3.3 - Based on a technical report as of July 31, 1996, we adjusted the period of the economic useful lifespan of the aircraft to the new market reality with respect to the time of operation and residual value (see Note 6-a to the Financial Statements).


VARIG
Brasil

4. *Organization and Human Resources*

4.1 The Marketing Department was created in 1996 and the former General Planning Superintendent's Office was transformed into a full-fledged Department. These changes increased the number of department directors from 8 to 10.

4.2 - In terms of executive and management training and development (T&D), VARIG's investments in 1996 amounted to US$ 10.5 million, involving a total of 22,032 participants. As part of the broader project entitled "Service Quality", the Training and Development Managership sponsored projects emphasizing excellence in customer service and managerial education - the VARIG Management Program (graduate business administration program) under an agreement with Fluminense Federal University; "Service Plus" and "Together We Can" ("Juntos Podemos") for desk personnel, as well as the Flight Captains Managerial Development program.

4.3 - To encourage our staff to achieve and even surpass the operating targets and results projected at the beginning of each year, VARIG is presently developing a results-sharing program. This program, which will be extended to all employees, including aircraft crews and directors, calls for payment of bonuses that are variable based on the extent to which targets are achieved and contribute to the results of each position or function.

4.4 - The changes in our work force are reflected in the following table:

	1995	1996	% change
Ground personnel	12,894	11,910	- 7.6
Crew members	4,885	4,823	- 1.2
On-board personnel	1,391	1,386	- 0.3
Total	19,170	18,119	- 5.5

Total payroll expenses for 1996 were US$ 826.8 million (US$ 788.6 million in 1995).

4.5 - The Aerus Social Security Institute is responsible for the supplementary retirement plan for ground personnel and crew members. This pension fund institute is sponsored by the main airline companies in Brazil. As of December, 1996, AERUS had 35,224 active participants, of which 26,814 (76%) fall under the umbrella of the VARIG Group. Of the total number of participants receiving assistance, 4,406 (89%) belong to the VARIG Group. With assets on the order of R$ 1,162 million as of December 31, 1996, AERUS continues to rank first among Brazilian pension funds sponsored by private-sector entities.

5.1 The most important aspect of our 1996 financial statements is the existence of two "net incomes for the year". One is a loss R$ 63,964 thousand as measured by accounting principles generally accepted in Brazil on the basis of corporate legislation; the other is a profit of R$ 97,143 thousand in terms of constant purchasing power (full monetary restatement). This leads us to reiterate our conviction -- repeatedly expressed in our quarterly reports -- that non-recognition of the effects of domestic inflation on balance sheet accounts creates distortions. The higher the volumes of property and equipment and the corresponding financing charges, the greater the distortions.

5.2 - In order to prevent such distortions, the Company's financial planning emphasizes operating leases. Under this type of lease the respective flight equipment is not recorded under permanent assets and neither are the financial obligations recorded under long-term liabilities. Such a measure is also being adopted with respect to already existing leasing agreements, which were converted from financial to operating leases through sale/lease-back. In 1996, 10 Boeing 737-200 aircraft were retired from our assets under such conversion (see Note 14 to the financial statements).

5.3 - From the standpoint of constant purchasing power (Note 13), we see that the 1996 numbers show a marked improvement over those for 1995, particularly with respect to Book Stockholders' Equity, which rose from R$ 334,459 thousand to R$ 431,602 thousand (+ 29%) and Net Income for the Year, which rose from a loss of R$ 7,498 thousand to a profit of R$ 97,143 thousand. Further regarding Stockholders' Equity, it should be pointed out that the credit mentioned in Note 16 has not been included in the financial statements, for the reasons set out therein.

5.4 - The remaining groups of accounts did not fluctuate to any considerable extent. Even so, mention should be made of the fact that -- due directly to the growth in Stockholders' Equity and the slight reduction in overall indebtedness -- the Debt/Equity Ratio dropped to 6.83 from 9.45.

5. Economic-Financial Aspects

5.5 - Still according to the full restatement criteria, the unit book value of VARIG shares rose from R$ 5.20 (December, 1995) to R$ 6.70 (December, 1996), while earnings per share reached R$ 1.51. The net results for this past year indicated profitability of 23% on year-end equity and 29% on beginning of year equity.

5.6 - All told, trading of VARIG common (ON) and preferred (PN) stock on Brazilian stock exchanges, involved a total volume of 10,580,000 shares, representing R$ 11,188,900 on the nation's leading market, the São Paulo Stock Exchange (Bovespa) and R$ 16,008,210 on the other exchanges. Even so, the profitability ratio was negative.

5.7 - For the first time, VARIG is presenting consolidated financial statements prepared according to the criteria set out in Note 2.2. At first reading, they evidence the major concentration in the parent company of the amounts of assets and liabilities, as well as those comprising results for the year, as follows: Permanent Assets (99%), Total Asset (95%), Net Operating Revenues (89%), Cost of Services Rendered (89%), Gross Profit (88%) and Operating Results (93%).

5.8 - Special mention should be made of the healthy earnings posted by our subsidiary RIO-SUL and the major contribution it made to overall results.

5.9 - Finally, we should stress that 1996 results were considerably influenced by taxes recoverable, as referred to in Note 15.1.

6. Looking Ahead

6.1 The Goals Program implemented in 1996 produced positive results and continuation thereof surely warrants Management's total dedication. Moreover, there are now two additional programs of a wide-spanned nature oriented to reformulation of two major processes. The first is in the marketing and sales area, where we are conducting step-by-step surveys of all methods and processes that can lead to enhanced revenue quality, especially on international routes, where we are seeking a drastic drop in the break-even point. The second will involve thorough re-analysis of administrative processes, with a view to making them more efficient and the Company more competitive. We are absolutely convinced that these programs will make an important contribution to our priority goal of increasing operating profitability.

6.2 - VARIG-CARGO is a special project intended to turn around performance in the cargo area in 1996. With the modernization we are planning, it will become a part of the Unisys Virtual Integrated Cargo System. This will permit maximization of capacity, increased revenues, detailed tracking of transportation and considerable improvement in the quality of information provided to users.

6.3 - Management has decided to expand and accelerate our divestiture program. This involves selling off fixed assets and equity interests not directly related to VARIG's core business. Several negotiations are in progress and they will likely succeed. For the months ahead, we can predict solid results in terms of incoming cash, which will effectively contribute to reducing the present imbalance in our capitalization between our own and third-party funds.

6.4 - Given the high level of demand, which is nearing the critical point on certain routes, the Company should be expanding its capacity in 1997 by adding the following aircraft to its fleet: 3 MD-11, 1 Boeing 737-200 and 3 Boeing 737-300; these will all be covered by lease agreements.

6.5 - Finally, VARIG is presently concluding important partnership agreements with major international carriers. Besides the support for the information technology area, as commented on in item 1-V of this report, these efforts should provide a substantial boost to the Company's market penetration capacity.

The year behind us represented a period of intensive efforts undertaken to consolidate the restructuring of VARIG that is presently underway.

The work carried out and the results obtained would not have been possible were it not for the continual support and essential participation for project development received from so many sources.

7. Acknowledgments

We wish to record here in closing our sincere gratitude to:

- our stockholders, for the understanding they have shown during this difficult transition period;
- our employees, for their efforts and constant dedication;
- our customers, who honor us with their preference and whose satisfaction constitutes the major objective of our activities;
- our nation's aviation authorities, who have coordinated and guided our air transportation policy.

Porto Alegre, Brazil
May 7, 1997

MANAGERS

Fernando Abs da Cruz Souza Pinto
Chairman

Carlos Ebner Neto
Market Relations and Financial Director

Claudio Affonso Junqueira
Engineering and Maintenance Director

Eloy Jorge Binder
Flight Operations Director

Gilson Gomes Novo
Commercial Director

Luiz da Gama Mor
Operacional Logistic Director

Manoel José Fontes Torres
Planning Director

Odilon Cesar Nogueira Junqueira
Human Resources and Administration Director

Oscar Luiz de Britto Guerra
Marketing Director

CONSELHO DE ADMINISTRAÇÃO

Walterson Fontoura Caravajal
President

Carlos Willy Engels
Vice-President

Aguinaldo de M. Junqueira Filho

Fernando Tigre de Barros Rodrigues

Ingo Ploger

Joaquim Fernandes dos Santos

Lino Pereira

Nelson de Sampaio Bastos

Paulo Pavarini

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ATHENS - GREECE
AZORES ISLANDS - PORTUGAL
BARCELONA - SPAIN
BARI - ITALY
BILBAO - SPAIN
BOLOGNA - ITALY
BRUSSELS - BELGIUM
BUDAPEST - HUNGARY
CATANIA - ITALY
COLOGNE - GERMANY
COPENHAGEN - DENMARK
DÜSSELDORF - GERMANY
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GENEVA - SWISS
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ISTAMBUL - TURKEY
LISBON - PORTUGAL
LIVORNO - ITALY
LOMBARDIA - ITALY
LONDON - UNITED KINGDOM
LUXEMBOURG - LUXEMBOURG
LYON - FRANCE
MADEIRA ISLANDS - PORTUGAL
MADRID - SPAIN
MALTA - MALTA
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AREQUIPA - PERU
ASUNCION - PARAGUAY
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BAHIA BLANCA - ARGENTINA
BARRANQUILLA - COLOMBIA
BOGOTA - COLOMBIA
BOSTON - U.S.A.
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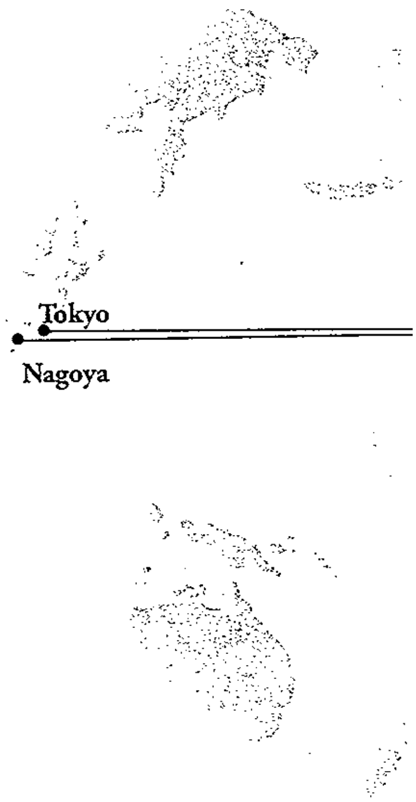

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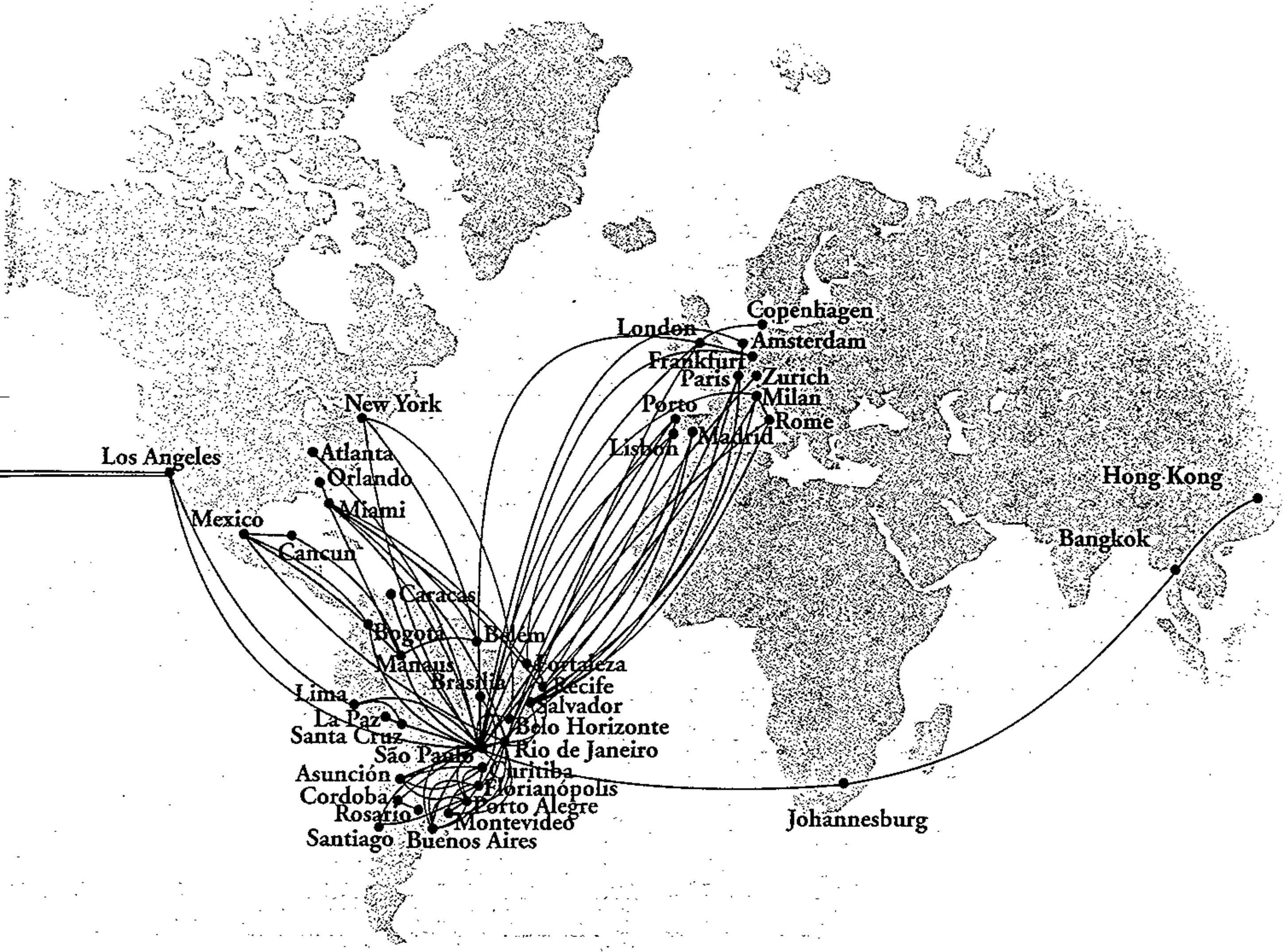
International Routes



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KUWAIT - KUWAIT
MANILA - PHILIPPINES
MEDAN - INDONESIA
NAGOYA - JAPAN
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ST. DENIS - REUNION ISLANDS
TUNIS - TUNISIA

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BRISBANE - AUSTRALIA
MELBOURNE - AUSTRALIA
PERTH - AUSTRALIA
RAROTONGA - COOK ISLANDS
SIDNEY - AUSTRALIA

Financial Statements
For the Years Ended
December 31, 1996 and 1995

VARIG
Brasil

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BALANCE SHEETS

As of December 31, 1996 and 1995

ASSETS

(Expressed in thousands of Reais)

	Parent Company 12.31.96	Parent Company 12.31.95	Consolidated 12.31.96
CURRENT ASSETS			
Cash and Cash Equivalents	59,988	94,380	77,357
Accounts Receivable			
Customers	338,373	349,872	375,521
Brazilian Government	9,140	10,649	9,992
Other Airlines	34,611	32,347	36,034
Subsidiaries (7)	9,637	10,195	7,231
Other Receivables	62,363	75,608	65,854
Less: Allowance for Doubtful Accounts	(17,740)	(3,545)	(22,746)
Total Accounts Receivable	436,384	475,126	471,886
Special Deposits (4)	32,537	41,861	48,933
Taxes Recoverable	110,050	—	148,042
Maintenance and Operating Supplies (3)	108,196	128,395	120,689
Advances to Suppliers	52,518	58,195	55,462
Prepaid Expenses	65,445	46,209	77,345
TOTAL CURRENT ASSETS	865,118	844,166	999,714
LONG-TERM ASSETS			
Subsidiaries (7)	21,727	21,334	5,515
Special Deposits (4)	96,162	57,802	102,773
Taxes Recoverable	122,970	2,006	122,970
Others	5,871	4,103	9,717
TOTAL LONG-TERM ASSETS	246,730	85,245	240,975
PERMANENT ASSETS			
Investments			
Subsidiaries and Associated Companies (5)	183,986	171,952	27,339
Other Companies and Investments	27,689	8,116	33,231
Total Investments	211,675	180,068	60,570
Property and Equipment			
Property and Equipment (6)	3,190,800	3,583,718	3,482,882
Less: Accumulated Depreciation (6)	(1,342,555)	(1,526,198)	(1,468,205)
Subtotal	1,848,245	2,057,520	2,014,677
Work in Progress	10,750	21,677	12,651
Total Property and Equipment	1,858,995	2,079,197	2,027,328
Deferred Charges			
Amortizable Expenses	14,964	16,238	22,085
Less: Accumulated Amortization	(8,504)	(8,270)	(10,910)
Total Deferred Charges	6,460	7,968	11,175
TOTAL PERMANENT ASSETS	2,077,130	2,267,233	2,099,073
TOTAL ASSETS	3,188,978	3,196,644	3,339,762

The accompanying notes are an integral part of the financial statements

LIABILITIES

(Expressed in thousands of Reais)

	Parent Company 12.31.96	Parent Company 12.31.95	Consolidated 12.31.96
CURRENT LIABILITIES			
Suppliers	67,726	60,492	77,856
Loans and Financings-Working Capital (8)	162,657	344,295	168,416
Lease Agreements (9)	184,470	187,020	188,918
Debentures (11)	51,779	—	51,779
Accrued Interest	28,569	46,202	28,569
Fees and Contributions	87,618	57,727	92,595
Wages and Salaries	28,278	29,726	35,724
Payable to Other Airlines	4,721	5,641	3,070
Accounts Payable	35,126	39,964	57,791
Unearned Transportation Revenues	246,572	196,973	266,737
Provisions for:			
Labor Contingencies	89,978	67,751	95,838
Flight Equipment Overhaul	17,126	14,159	22,205
TOTAL CURRENT LIABILITIES	**1,004,620**	**1,049,950**	**1,089,498**
LONG-TERM LIABILITIES			
Loans and Financings - Working Capital (8)	699,504	394,504	720,815
Lease Agreements (9)	1,006,832	1,209,309	1,025,197
Debentures (11)	120,817	158,108	120,817
Accrued Interest	87,614	57,264	87,614
Subsidiaries (7)	27,632	21,586	27,632
Accounts Payable	—	—	13,061
TOTAL LONG-TERM LIABILITIES	**1,942,399**	**1,840,771**	**1,995,136**
MINORITY SHARE	—	—	**13,169**
STOCKHOLDERS' EQUITY			
Restated Paid-in Capital Stock			
Paid-in Capital Stock (12)	272,023	190,654	272,023
Monetary Restatement of Paid-in Capital Stock (12)	—	81,369	—
Total Restated Paid-in Capital Stock	272,023	272,023	272,023
Revaluation Reserves			
Property and Equipment	15,334	27,123	21,101
Investments	7,163	8,349	1,396
Total Revaluation Reserves	22,497	35,472	22,497
Retained Earnings (Deficit)	(52,561)	(1,572)	(52,561)
TOTAL STOCKHOLDERS' EQUITY	**241,959**	**305,923**	**241,959**
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**3,188,978**	**3,196,644**	**3,339,762**

The accompanying notes are an integral part of the financial statements

STATEMENTS OF INCOME

for the years ended December 31, 1996 e 1995

(Expressed in thousands of Reais)

	Parent Company		Consolidated
	12.31.96	12.31.95	12.31.96
Operating Revenues			
Flight Revenues	2,995,036	2,752,671	3,351,964
Other Operating Revenues	49,500	52,583	91,298
	3,044,536	2,805,254	3,443,262
Less: Taxes on Revenues - PIS and COFINS Levies	(29,272)	(21,384)	(42,391)
Net Operating Revenues	3,015,264	2,783,870	3,400,871
Operating Costs			
Flight Operations	(1,931,959)	(1,619,992)	(2,159,734)
Other Operating Expenses	(35,254)	(28,670)	(47,839)
Depreciation Aggregated to Service Costs	(25,490)	(39,847)	(38,501)
Depreciation of Leased Equipment	(69,287)	(116,318)	(69,287)
	(2,061,990)	(1,804,827)	(2,315,361)
GROSS PROFIT	**953,274**	**979,043**	**1,085,510**
Commercial Expenses	(787,301)	(618,967)	(867,406)
General Expenses			
Officers and Board Salaries	(2,665)	(2,125)	(2,665)
Administrative Expenses	(142,697)	(164,732)	(173,183)
	(145,362)	(166,857)	(175,848)
FLIGHT OPERATING PROFIT	**20,611**	**193,219**	**42,256**
Net Financial Income (Expenses)			
Financial Income	65,994	91,092	68,354
Financial Expenses	(182,138)	(167,980)	(189,450)
Interest on Long-Term Debt for Flight Equipment	(92,905)	(104,941)	(94,666)
	(209,049)	(181,829)	(215,762)
Gains (Losses) on Foreign Currency Assets and Liabilities	(125,030)	(304,348)	(126,103)
Income from Investments			
Income from Investments in Subsidiaries and Associated Companies (5)	23,696	6,811	(10,744)
Dividends and Income from Other Investments	30	4	30
	23,726	6,815	(10,714)
Gains (Losses) on non-Interest Monetary Items	—	377,945	—
OPERATING INCOME (LOSS)	**(289,742)**	**91,802**	**(310,323)**
Non-Operating Income (Loss) (14)	225,778	(98,661)	257,237
Employee Profit - Sharing	—	—	(2,050)
Provision for Income Tax and Social Contribution	—	—	(8,117)
NET INCOME (LOSS) FOR THE YEAR	**(63,964)**	**(6,859)**	**(63,964)**
NET INCOME (LOSS) PER SHARE	**(0.99)**	**(0.11)**	**—**

The accompanying notes are an integral part of the financial statements

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

for the years ended December 31, 1996 e 1995

(Expressed in thousands of Reais)

DESCRIPTION	Paid-in Capital Stock	Restatement of Capital Stock	Capital to be Homologated	Revaluation Reserves		Retained Earnings (Deficit)	Total
				Property and Equipment	Investments		
A - Balances as of December 31, 1994	39,924	361,413	25,419	26,190	7,093	(186,972)	273,067
- Capital Increase from Reserves	361,413	(361,413)	—	—	—	—	—
- Capital Increase by Conversion of Debentures	9,030	—	—	—	—	—	9,030
- Capital Reduction/ Offset of Retained Deficit	(219,713)	—	—	—	—	219,713	—
- Realization of Revaluation Reserves - Property and Equipment	—	—	—	(4,382)	—	4,382	—
- Realization of Revaluation Reserves - Investments	—	—	—	—	(337)	337	—
- Monetary Restatement	—	81,369	4,451	5,315	1,593	(32,173)	60,555
- Reversal of Reserves	—	—	(29,870)	—	—	—	(29,870)
- Net Loss for the Year	—	—	—	—	—	(6,859)	(6,859)
B - Balances as of December 31, 1995	190,654	81,369	—	27,123	8,349	(1,572)	305,923
- Capital Increase from Reserves	81,369	(81,369)	—	—	—	—	—
- Realization of Revaluation Reserves - Property and Equipment	—	—	—	(11,789)	—	11,789	—
- Realization of Revaluation Reserves - Investments	—	—	—	—	(1,186)	1,186	—
- Net Loss for the Year	—	—	—	—	—	(63,964)	(63,964)
C - Balances as of December 31, 1996	272,023	—	—	15,334	7,163	(52,561)	241,959

The accompanying notes are an integral part of the financial statements

STATEMENTS OF CHANGES IN FINANCIAL POSITION

for the years ended December 31, 1996 e 1995

(Expressed in thousands of Reais)

	Parent Company		Consolidated
	12.31.96	12.31.95	12.31.96
SOURCES			
Operations			
Net Loss for the Year	(63,964)	(6,859)	(63,964)
Minority Shares	—	—	711
Depreciation and Amortization	58,976	91,745	73,959
Depreciation - Leased Equipment	69,287	116,318	69,287
Monetary Gains (Losses) on Long-Term Liabilities	112,950	238,980	114,552
Monetary Gains (Losses) on Long-Term Assets	(5,223)	(20,138)	(5,223)
Equity in Subsidiaries	(23,696)	(6,811)	10,744
Monetary Restatement Income (Loss)	—	(377,945)	—
Write-off of Property and Equipment at Net Cost	155,857	77,869	157,269
Write-off of Investments	9,032	31,986	9,378
Capital Losses - Equity Stakes	2,631	7,999	2,631
	315,850	153,144	369,344
Stockholders and Third Parties			
Long-Term Financings	227,012	216,653	239,922
Reduction of Long-Term Liabilities	—	42,265	—
Total Sources	542,862	412,062	609,266
USES			
Increase in Permanent Assets			
Investments	20,234	32,853	20,949
Property and Equipment	58,119	42,726	78,522
Deferred Charges	3,630	2,267	7,347
	81,983	77,846	106,818
Increase in Long-Term Assets	156,262	—	165,937
Reduction of Long-Term Debt	238,335	378,617	245,580
Total Uses	476,580	456,463	518,335
Changes in Net Working Capital	66,282	(44,401)	90,931
	542,862	412,062	609,266
REPRESENTED BY:			
Current Assets			
At End of Year	865,118	844,166	999,714
At Beginning of Year	844,166	646,039	942,676
	20,952	198,127	57,038
Current Liabilities			
At End of Year	(1,004,620)	(1,049,950)	(1,089,498)
At Beginning of Year	(1,049,950)	(807,422)	(1,123,391)
	45,330	(242,528)	33,893
Changes in Net Working Capital	66,282	(44,401)	90,931

The accompanying notes are an integral part of the financial statements

NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 1996 AND 1995

1. BUSINESS OF THE COMPANY

The main business of VARIG, together with its subsidiaries RIO-SUL and Nordeste, is operating passenger, cargo, baggage and mail air transport services over both domestic and international routes, under government concessions or licenses, and rendering related services to third parties. The Company's other subsidiary, Rede Tropical de Hotéis, is mainly engaged in the management of hotels and related tourist activities.

2. PRESENTATION OF THE FINANCIAL STATEMENTS

The financial statements have been prepared and are being presented in conformity with accounting principles generally accepted in Brazil on the basis of corporate legislation and the rules established by the Brazilian Securities Commission (CVM), which as of January 1, 1996 do not provide for recognition of the effects of inflation as required by Brazilian fundamental accounting principles. These effects, as well as the balance sheets and income statements in currency of constant purchasing power, are shown in Note 13 to the financial statements.

2.1. Summary of Significant Accounting Policies

a. Effects of Inflation

Through December 31, 1995, the effects of the loss of the purchasing power of Brazilian currency on equity components were recognized in results for the year based on the change in the nominal value of the Fiscal Reference Unit (UFIR) for that year.

b. Denomination of Foreign Currency or Index-Linked Amounts

Current and long-term assets and current and long-term liabilities denominated in foreign currencies or otherwise index-linked are determined by reference to the appropriate exchange rates and other indices in effect at the balance sheet date.

c. Marketable Securities

Marketable securities are stated at cost plus yields accrued on a prorated basis through the balance sheet date and are represented by regular market transactions without any characteristics that would classify them as derivatives. Management's evaluation did not identify material differences between market and book values of loans, financing and debentures (Notes 8, 9 and 11). Additionally, the Company has commitments defined in operating lease agreements, which are shown in Note 10.

The market value of the other asset and liability financial instruments as of December 31, 1996, do not differ substantially from those recognized in the financial statements.

d. Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on historical experience and is considered sufficient to cover any losses expected on realizing accounts receivable.

e. Maintenance and Operating Supplies

The Spare Parts and Sundry Materials and Work in Progress Inventories are stated at acquisition or production cost, monetarily restated through December 31, 1995, limited to the replacement cost. Imports in Progress are stated at costs incurred through the balance sheet date.

f. Investments

Investments in subsidiaries and associated companies are recognized by the equity method. Other investments are recorded at cost, monetarily restated through December 31, 1995 and less a provision for estimated losses.

g. Property and Equipment

The Company's own equipment and that acquired under purchase leasing are stated at acquisition cost, monetarily restated through December 31, 1995, except for flight equipment, revalued in October, 1988 at the Parent Company and May, 1990 at subsidiary RIO-SUL, and monetarily restated as from that date through December 31, 1995.

Depreciation of property and equipment and lease agreements is computed by the straight-line method at the rates shown in Note 6, with no residual value.

h. Provisions

The Provision for Flight Overhaul is computed based on hours flown and covers future equipment overhaul costs, except for latest generation equipment, the overhaul costs of which are recognized as incurred.

i. Revenue Recognition

Sales of the Parent Company and its Subsidiaries RIO-SUL and Nordeste are recorded as a Current Liability - "Unearned Transportation Revenues" - until such time as the transportation services are provided, at which point they are transferred to the statement of income as revenue earned. Accordingly, in the balance sheet this account represents services to be rendered.

j. Income Tax and Social Contribution

Income Tax and the Social Contribution levy were computed in accordance with the provisions of applicable legislation with respect to the inclusion of non-deductible expenses and non-taxable revenues, consideration of temporary differences and the rates applicable to fiscal year 1996.

2.2. Consolidation Criteria

The 1996 consolidated financial statements include the statements of the Parent Company VARIG along with those of its subsidiaries RIO-SUL, Serviços Aéreos Regionais S.A., Nordeste Linhas Aéreas S.A., Companhia Tropical de Hotéis and Companhia Tropical de Hotéis da Amazônia. All intercompany accounts were eliminated upon consolidation and the share of minority stockholders is recorded separately.

The Company's subsidiaries ÍCARO Editora Ltda. and Novo Norte Adm. de Negócios e Cobrança Ltda. were not consolidated due to discontinuation of their operations. The reason for non-inclusion of the other subsidiary, SATA Serv.Aux. de Transp. Aéreo S.A. is that sale of this investment is already being negotiated and should be concluded in the first half of 1997.

3. MAINTENANCE AND OPERATING SUPPLIES

	R$ thousand		
	Parent Company		Consolidated
	12.31.96	12.31.95	12.31.96
- Sundry materials	79,639	89,108	89,109
- Work in progress	14,781	14,601	16,951
- Importation in progress	13,776	24,686	14,629
	108,196	128,395	120,689

4. SPECIAL DEPOSITS

	R$ thousand				
	Parent Company				Consolidated
	Short-Term	Long-Term	12.31.96	12.31.95	12.31.96
- As guarantee for lease contracts (Security Deposits and Maintenance Deposits)	6,563	75,157	81,720	54,108	101,616
- As guarantee for aircraft manufacture (Progress Payments)	—	15,458	15,458	14,464	15,458
- Other Deposits	25,974	5,547	31,521	31,091	34,632
	32,537	96,162	128,699	99,663	151,706

5. SUBSIDIARIES AND ASSOCIATED COMPANIES

VARIG's shares in its subsidiaries and associated companies are monetarily restated and accounted for by the equity method. Details on these investments are as follows as of December 31, 1996:

	R$ thousand				R$ thousand		
	Stockholders' Equity	Income (Loss) for the Year	% Share of Capital Total	% Share of Capital Voting	Adjusted Book Value	Equity Income (Loss)	1995 Adjusted Book Value
Cia. Tropical de Hotéis	41,020	(7,940)	92.83	—	38,079	(7,370)	45,124
Cia. Tropical de Hotéis da Amazônia	60,091	(469)	29.82	54.84	17,919	(140)	21,987
Novo Norte Adm.Negócios e Cobrança Ltda.	9,041	86	46.67	9.53	4,220	40	4,180
SATA Serv. Auxiliares de Transp.Aéreo S.A.	12,015	(7,599)	77.68	21.15	9,333	(5,903)	15,047
RIO-SUL Serv. Aéreos Regionais S.A.	110,419	41,487	96.78	—	106,866	40,152	73,819
VARIG Agropecuária S.A.	32,493	(16,037)	19.22	—	6,246	(3,083)	9,756
Nordeste Linhas Aéreas S.A.	1,502	(1,064)	—	96.57	—	—	—
Other Companies	—	—	—	—	1,323	—	2,039
					183,986	23,696	171,952

6. PROPERTY & EQUIPMENT

	R$ thousand					
	Parent Company				Consolidated	
	12.31.96			12.31.95	12.31.96	
	Restated Amount	Accumulated Depreciation	Residual Value	Residual Value	Residual Value	(a) % Rate per year
OWN PROPERTY & EQUIPMENT						
- Flight Equipment	535,517	(336,883)	198,634	220,590	259,170	3.3 to 20.0
-Training Equipment - Planes and Simulators	77,275	(50,289)	26,986	32,690	26,986	10.0
- Ground Equipment	193,614	(154,603)	39,011	51,974	60,148	10.0
- Vehicles	10,866	(10,303)	563	900	1,010	20.0
- Real Estate Properties	337,448	(183,802)	153,646	171,111	237,958	4.0 and 5.0
Total Own Property & Equipment	1,154,720	(735,880)	418,840	477,265	585,272	
LEASED EQUIPMENT						
- Flight Equipment	2,020,278	(591,676)	1,428,602	1,579,312	1,428,602	3.3
- Training Equipment - Simulators	15,802	(14,999)	803	943	803	14.2
Total Leased Equipment	2,036,080	(606,675)	1,429,405	1,580,255	1,429,405	
TOTAL PROPERTY & EQUIPMENT	3,190,800	(1,342,555)	1,848,245	2,057,520	2,014,677	

(a) Depreciation is calculated in accordance with the service life of the equipment, which in the case of flight equipment is based on an appraisal report of July 31, 1996 that reflects the reduction in the depreciation expense in 1996 in the amount of R$ 87,698 thousand.

6.1. As a result of reappraisals carried out in prior years at the Parent Company, depreciation expense and cost of assets written off, in the total amount of R$ 325 thousand, were charged to results of 1996 operations. An amount of R$ 95,088 thousand out of the total revalued amount remains under Property & Equipment and will be recorded in the results of future years when realized through depreciation or sale. At subsidiaries RIO-SUL and Rede Tropical de Hotéis, the charge to the results of 1996 operations is R$ 1,323, with an amount of R$ 6,213 out of the total revalued amount remaining under Property & Equipment.

6.2. The Company and its subsidiaries will maintain the appraised assets at their restated cost, reappraised according to option B of Article 68 of Deliberation No. 183 issued by the Brazilian Securities Commission (CVM) on June 19, 1995.

7. INTERCOMPANY TRANSACTIONS - SUBSIDIARIES, ASSOCIATED COMPANIES AND HEAD OFFICE

Amounts classified as Current refer to normal market operations. Amounts classified as Long-Term refer to mutual loans, earning interest at market rates.

7.1. Current

	R$ thousand		
	Parent Company		Consolidated
	Assets		Assets
	12.31.96	12.31.95	12.31.96
Cia. Tropical de Hotéis	573	496	—
SATA Serv. Auxiliares de Transporte Aéreo S.A.	2,527	1,810	2,527
RIO-SUL Serviços Aéreos Regionais S.A.	1,854	2,447	—
Fundação Ruben Berta	4,413	4,953	4,434
Others	270	489	270
	9,637	10,195	7,231

7.2. Long-Term

	RS thousand				
	Assets			Liabilities	
	Parent Company		Consolidated	Parent Company & Consolidated	
	12.31.96	12.31.95	12.31.96	12.31.96	12.31.95
SATA Serv. Auxiliares de Transporte Aéreo S.A.	5,106	—	5,106	—	—
Fundação Ruben Berta	—	—	—	27,605	21,405
VARIG Agropecuária S.A.	—	8,534	—	—	—
Cia. Tropical de Hotéis	8,642	6,847	—	—	—
Companhia Tropical de Hotéis da Amazônia	7,621	5,953	—	—	—
Others	358	—	409	27	181
	21,727	21,334	5,515	27,632	21,586

8. WORKING CAPITAL LOANS AND FINANCING

	RS thousand				
	Parent Company				Consolidated
	12.31.96			12.31.95	12.31.96
	Short-Term	Long-Term	Total	Total	Total
Working Capital Loans	70,363	262,650	333,013	234,080	334,229
Foreign Credit Lines	11,987	—	11,987	6,561	11,987
Financed Imports	17,461	—	17,461	22,854	17,461
Financing of Taxes and Levies	47,852	436,843	484,695	454,478	510,549
Financing of Fuel Purchases	9,162	—	9,162	10,301	9,162
Financing related to Property & Equipment	45	11	56	98	56
Others	5,787	—	5,787	10,427	5,787
	162,657	699,504	862,161	738,799	889,231

Interest incurred and not due is classified as Current and Long-Term Liabilities, depending on the respective maturity dates, under "Accrued Interest".

8.1. Working Capital Loans

	R$ thousands				
	Parent Company				
	12.31.96			12.31.95	
	Short-Term	Long-Term	Total	Total	Final Maturity
Brazil	375	—	375	3,665	—
Exterior					
- Orix Corp. - USA (US$ 108.2 million)	—	112,452	112,452	—	OCT/2005
- Banco do Brasil - USA (US$ 50.6 million)	28,335	24,253	52,588 (a)	51,867	DEC/99
- Banespa - USA (US$ 18.6 million)	19,371	—	19,371	23,340	JAN/97
- Banco Crédito Nacional - USA (US$ 11.8 million)	12,223	—	12,223	13,420	FEB/97
- Brazilian American Merchant Bank-USA(US$ 111.2 million)	—	115,551	115,551 (b)	105,612	DEC/2012
- Others	10,059	10,394	20,453	36,176	
	69,988	262,650	332,638	230,415	
	70,363	262,650	333,013	234,080	

(a) Loans guaranteed by sales in Argentina and Italy, with variable interest rates in accordance with LIBOR;

(b) Loans for 18- and 5-year periods with a 5- year grace period for payment of the principal. Interest calculated based on LIBOR plus a spread of 3.5% and 3% per year, respectively, due semi-annually. As a consequence of the sale operation of DCBs - Debt Conversion Bonds and IDUs - Obligations issued by the Brazilian Treasury, a discount equivalent to US$ 41.5 million was obtained on these loans, to be accrued to results over the loan amortization term. Real estate properties in Brasília and Manaus and all shares owned in RIO-SUL, Sata, Cia. Tropical de Hotéis and Cia. Tropical de Hotéis da Amazônia were included as collateral for these operations.

8.2. Financing of Taxes, Levies and Social Security and Pension Fund Contributions

	R$ thousand					
	Parent Company				Consolidated	
	12.31.96			12.31.95		
	Short-Term	Long-Term	Total	Total	1994 Total	Final Maturity
- INSS (a)	28,940	192,937	221,877	205,280	238,689	AUG/2004
- COFINS (b)	4,197	7,820	12,017	14,753	19,645	AUG/2002
- ICMS	—	—	—	15,992	—	
- INFRAERO - Airport Taxes (c)	9,923	49,203	59,126	63,065	60,540	NOV/2002
- Instituto Aerus de Seguridade Social (d)	4,792	186,883	191,675	155,388	191,675	SEP/2007
	47,852	436,843	484,695	454,478	510,549	

(a) Payment in 96 monthly installments and bearing interest at 1% per month;

(b) Payable in installments over a maximum of 80 months and bearing interest at 1% per month;

(c) Airport taxes due up to June 1994; to be paid in installments over a 96-month period and bearing interest at 1% per month;

(d) Contributions due to AERUS will be divided into installments to be consolidated in September, 1997 and then be payable as from October 1997 in 120 monthly installments and bearing interest at 1% per month.

9. LEASE AGREEMENTS

	R$ thousand		
	Parent Company		Consolidated
	12.31.96	12.31.95	12.31.96
Flight Equipment	1,015,428	1,238,996	1,015,428
Ground/Training Equipment	4,236	6,903	27,049
Refinancings	171,638	150,430	171,638
	1,191,302	1,396,329	1,214,115
Analyzed between:			
Short-Term	184,470	187,020	188,918
Long-Term	1,006,832	1,209,309	1,025,197

Interest incurred and not due is reported under Current Liabilities as "Accrued Interest".

9.1. Flight Equipment

	R$ thousand				
	12.31.96			12.31.95	
	Short Term	Long Term	Total	Total	Final Maturity
- Orient Leasing Co. and Others - Japan	—	—	—	178,501	
- Nissho Iwai Corp. and Others - Japan (JYE$ 20.4 billion)	44,546	136,350	180,896	190,658	SEP/2002
- Nissho Iwai Corp. - Japan (US$ 119.9 million)	6,277	118,398	124,675	122,198	NOV/2005
- Citibank - USA (US$ 25.3 million)	10,351	15,913	26,264	33,318	OCT/99
- Wilmington Trust Co. - USA (US$ 376.0 million)	35,873	355,059	390,932	403,005	JAN/2006
- G.P.A. Group - Ireland (US$ 52.2 million)	13,918	40,355	54,273	62,647	APR/2002
- Harrington Ltd. - USA (US$ 73.8 million)	9,429	67,327	76,756	80,514	FEB/2001
- General Electric Capital Corp.-USA (US$ 12.6 million)	1,194	11,979	13,173	12,934	NOV/2004
- Bavaria Flug Gesellschaft - Germany (US$ 47.0 million)	7,914	40,920	48,834	49,992	JUN/2002
- Mitsui Corp. - Japan (US$ 47.0 million)	3,167	45,675	48,842	48,410	DEC/2006
- Orix Ouro Corp. - Cayman (US$ 25.1 million)	2,953	23,063	26,016	25,177	JUL/2001
- SL VRG Ltd. - Cayman (US$ 23.8 million)	2,692	22,075	24,767	25,702	JUL/2001
- BCN Leasing - Brazil	—	—	—	4,011	
- Pontual Leasing - Brazil	—	—	—	1,313	
- Safra Leasing - Brazil	—	—	—	616	
	138,314	877,114	1,015,428	1,238,996	

- Interest is calculated based on the LIBOR plus a spread which varies from 1.125% to 4% p.a.

9.2. Refinancings

	R$ thousand				
	12.31.96			12.31.95	
	Short Term	Long Term	Total	Total	Final Maturity
- Financial Lease					
(a) -Wilmington Trust Co. -USA (US$ 34.1 million)	—	35,443	35,443	33,196	JAN/2006
(b) -Wilmington Trust Co. -USA (US$ 16.4 million)	16,067	1,065	17,132	29,910	OCT/97
(c) -First Security Bank of Utah -USA (US$ 26.7 million)	4,053	23,682	27,735	27,230	NOV/2004
(d) -G.P.A. Group -USA (US$ 9.6 million)	5,924	4,099	10.023	12.901	SEP/98
(e) -McDonnell Douglas -USA (US$ 26.8 million)	—	27.898	27,898	120	JAN/2002
	26,044	92,187	118,231	103,357	
- Operating Lease					
(f)-Pegasus Capital Corp. - USA (US$ 2.9 million)	1,490	1,537	3,027	3,825	OCT/98
(f)-Global Aircraft Leasing Ltd. - Cayman (US$ 4.1 million)	1,920	2,428	4,348	4,579	JAN/99
(f)-PK Airfinance - USA (US$ 3.7 million)	1,539	2,288	3,827	4,665	JAN/99
(f)-Ansett Worldwide Aviation - USA (US$ 3.6 million)	1,458	2,252	3,710	3,647	OCT/99
(f)-Bavaria Flug Gesellschaft - Germany (US$ 7.0 million)	3,704	3,573	7.277	7,421	SEP/99
(f)-International Lease Finance Corp.-USA (US$ 21.2 million)	2.833	19,184	22,017	22,936	MAY/2003
(f)-Mitsui (US$ 3.9 million)	3,060	1,026	4,086	—	JAN/99
(f)-Aircraft 46941 - (Nib) (US$ 4.9 million)	1,888	3,227	5,115	—	MAY/99
	17,892	35,515	53,407	47,073	
	43,936	127,702	171,638	150,430	

a. Outstanding balance of debt (US$ 34.1 million) related to the contracts for four MD-11 aircraft, borne by the guarantor of the operation (McDonnell Douglas), US$ 17.4 million to be amortized in January, 2005 and US$ 16.7 million in January, 2006. Interest of 4% p.a. above LIBOR will be due on the outstanding balance of debt, payable quarterly;

b. Outstanding balance of debt (US$ 16.4 million) in 4 installments; interest is at 4% p.a. above LIBOR and paid quarterly;

c. Payments of principal and interest are due monthly based on a rate of 4% p.a. above LIBOR;

d. Installments of the principal and interest due on lease contracts from March to June 1994, which were refinanced with the lessor over 54 monthly payments. Interest will also be paid monthly based on a fixed rate of 8% p.a. and variable in accordance with LIBOR;

e. Amounts of financial leases that were not paid and were refinanced by McDonnell Douglas in relation to four MD-11 aircraft, maintained with Wilmington Trust for a period of 11 years. Amortization as from April, 1998 and interest at 4% p.a. above LIBOR are due quarterly.

f. Monthly amortization and interest calculated on the basis of LIBOR plus a spread of 4% p.a.

10. OPERATING LEASES

The Company has operating lease commitments for the following aircraft:

Equipment		Contract	
Quant.	Type	Beginning	End
11	B-737/200	SEP/1996	NOV/2001
11	B-737/300	MAY/1990	OCT/1999
3	B-747/300	JUL/1994	JUL/1999
6	B-767/200	NOV/1994	DEC/2009
2	B-767/300	SEP/1994	MAR/1998
5	DC-10/30	SEP/1990	JUN/1999
3	MD-11	NOV/1991	DEC/2001

The operating lease contracts involve operations without purchase options, they are neither recorded in the Company's accounting records nor shown under Current and Long-Term Liabilities. The volume of commitments assumed by VARIG as a result of these contracts, corresponding to the amount of RS 708,209 thousand, which is recognized in income for the year as Flight Operating Costs due to use of the respective equipment, which in 1996 corresponded to RS 150,101 thousand.

11. DEBENTURES

11.1.The Extraordinary Stockholders Meeting held on November 17, 1994 approved the issue of 130,000 debentures (4th issue) with par value of RS 1,000.000, divided in three series with the following characteristics as of December 31, 1995:

		RS thousand			
	Quantity	Short Term	Long Term	12.31.96 Total	Renegotiated Interest
- 1st series	21,845 (a)	9,163	21,380	30,543	582
- 2nd series	68,101 (b)	28,565	66,652	95,217	1,816
- 3rd series	33,498 (c)	14,051	32,785	46,836	893
	123,444	51,779	120,817	172,596	3,291 (d)

(a) Debentures convertible into common shares;

(b) Debentures convertible into preferred shares;

(c) Debentures convertible into preferred shares;

(d) Interest are classified as Current Liabilities under "Accrued Interest".

As from July 1, 1995, with the termination of Real Consumer Price Index (IPC-r), the monetary restatement of debentures started to be carried out based on the INPC, with a remuneration of 12% p.a. and premium calculated according to the issue register, and paid annually. The amortization will be carried out in 3 annual successive installments as from November 1997 or, at the choice of the debenture-holder, through conversion into shares of Company capital stock, which can be made at any time until the final maturity, according to the following ratios:

Date	Quantity of Shares per Debenture
until 10/31/95	385
from 11/1/95 to 10/31/96	308
from 11/1/96 to 10/31/97	254
from 11/1/97 to 10/31/98	178
from 11/1/98 to 11/1/99	102

As of December 31, 1996, 6,556 debentures were converted, as follows:

	Quantity
- 1st series	3,155
- 2nd series	2,899
- 3rd series	502

Debentures of the 1st and 2nd series are being guaranteed by the Company's creditor banks, as per private deed, and the value of the subscription of such debentures was used in the settlement of loans with those institutions in January of 1995.

12. STOCKHOLDERS' EQUITY

12.1. Paid-in Capital Stock

The Company's paid-in capital stock, totaling R$ 272,022,528.00, is comprised of 64,380,189 shares without par value. Of this total number of shares, 36,663,468 are common voting shares and the remaining 27,716,721 preferred non-voting shares. Authorized capital stock is 85,843,855 common shares and 63,948,793 preferred shares.

The principal corporate acts during the year were as follows:

a. Annual and Extraordinary General Stockholders Meetings were held on April 29, 1996 and, among other decisions, approved an increase in the Company's capital stock from R$ 190,653,863.32 to R$ 272,022,528.00 through incorporation of monetary restatement reserves into capital stock in the amount of R$81,368,664.68, without issue of new shares.

12.2. Dividends

In light of the loss for the year and the absence of retained earnings and revenue reserves, no dividends will be distributed.

13. FINANCIAL STATEMENTS IN CURRENCY OF CONSTANT PURCHASING POWER

As described in Note 2, the financial statements have been prepared in accordance with accounting principles generally accepted in Brazil on the basis of Corporate Legislation. Had the statements been prepared in accordance with fundamental accounting principles, the following adjustments would have been made:

- Monetary Restatement of Permanent Assets and Stockholders' Equity, calculated based on the variation in the General Price Index - Domestic Demand (IGP-DI);

- Calculation of gains and losses on non-indexed monetary items by the IGP-DI variation and allocation thereof to the respective income statement accounts:

- Indexation of income statement accounts according to the IGP-DI;

A summary of Balance Sheet and Income Statement accounts prepared in accordance with fundamental accounting principles is shown as follows:

13.1. Balance Sheets
(Constant Purchasing Power)
(Amounts in December 1996 currency)

ASSETS

	R$ thousand	
	12.31.96	12.31.95
CURRENT ASSETS		
Cash and Cash Equivalents	59,988	103,184
Accounts Receivable	436,384	519,445
Maintenance and Operating Supplies	108,196	140,371
Taxes Recoverable	110,050	—
Others	150,499	159,908
CURRENT ASSETS	865,118	922,908
NONCURRENT ASSETS		
Special Deposits	96,162	57,802
Taxes Recoverable	122,970	2,193
Others	27,598	33,202
NONCURRENT ASSETS	246,730	93,197
PERMANENT ASSETS		
Investments	232,469	196,865
Property and Equipment	2,027,390	2,273,141
Deferred Charges	6,914	8,712
PERMANENT ASSETS	2,266,773	2,478,718
TOTAL ASSETS	3,378,621	3,494,823

(Constant Purchasing Power)
(Amounts in December 1996 currency)

LIABILITIES AND STOCKHOLDERS' EQUITY

	R$ thousand	
	12.31.96	12.31.95
CURRENT LIABILITIES		
Suppliers	67,726	66,134
Loans and Financings - Working Capital	162,657	376,410
Lease Agreements	184,470	204,465
Unearned Transportation Revenues	246,572	215,346
Accounts Payable	343,195	285,532
CURRENT LIABILITIES	**1,004,620**	**1,147,887**
LONG-TERM LIABILITIES		
Loans and Financings - Working Capital	699,504	431,302
Lease Agreements	1,006,832	1,322,111
Accounts Payable	236,063	259,064
LONG-TERM LIABILITIES	**1,942,399**	**2,012,477**
STOCKHOLDERS' EQUITY		
Restated Paid-in Capital Stock	297,396	297,396
Revaluation Reserves	24,690	38,781
Retained Earnings (Deficit)	109,516	(1,718)
STOCKHOLDER'S EQUITY	431,602	334,459
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	3,378,621	3,494,823

13.2. Statement of Income

	R$ thousands	
	12.31.96	12.31.95
Net Operating Revenues	3,135,307	3,441,511
Operating Costs	(2,140,318)	(2,214,995)
GROSS PROFIT	**994,989**	**1,226,516**
Commercial Expenses	(820,111)	(770,144)
Administrative Expenses	(151,278)	(205,862)
FLIGHT OPERATING PROFIT	**23,600**	**250,510**
Net Financial Income (Expenses)	(217,951)	(265,917)
Gains /(Losses) on Foreign Currency Assets and Liabilities	52,790	111,841
Income from Investments	25,508	7,452
Gains /(Losses) on Non-Interest Monetary Items	(11,519)	(709)
OPERATING INCOME (LOSS)	**(127,572)**	**103,177**
Non-Operating Income (Loss)	224,715	(110,675)
NET INCOME (LOSS) FOR THE YEAR	97,143	(7,498)
NET INCOME (LOSS) PER SHARE - R$	1.51	(0.12)

13.3. Reconciliation between stockholders' equity and income for the year - December 31, 1996.

	Stockholders' Equity	Income for the Year
According to Corporate Legislation	241,959	(63;964)
- Monetary restatement of Corporate Legislation balances	186,300	157,764
- Equity adjustment	3,343	3,343
In currency of Constant Purchasing Power	431,602	97,143

Consolidated financial statements have not been presented in currency of constant purchasing power, due to the immateriality of the balances of subsidiaries in relation to the parent company's financial statements as a whole.

14. NON-OPERATING INCOME (LOSS)

We highlight the following net results of the main events which occurred in 1996 with respect to the Parent Company:

	RS thousand
-Write-off of Sale/Lease-Back of 10 B-737/200 aircraft	35,758
-Taxes recoverable	225,928
-Result of write-off of accessories and spare parts	(22,192)
-Provision for contingent liabilities	(15,723)
-Depreciation of grounded aircraft	(5,782)
-Other non-operating results	7,789
	225,778

15. TAXES

15.1. ICMS (value-added tax on circulation of goods and transportation and communications services)

In view of the changes instituted by the Federal Constitution in October of 1988, the States of the Brazilian Federation approved collection of ICMS on domestic air passenger and cargo transport as from May, 1989, on the basis of the National Tax Conference (CONFAZ 66/88). The Special Presumed Credit rate is 9% (8% for the states of São Paulo, Rio Grande do Sul and Paraná).

Collection of such value-added tax was suspended under a restraining order as from July, 1994. This resulted from a preliminary injunction granted in that month by the Federal Supreme Court in response to a Direct Unconstitutionality Suit filed by the nation's Attorney General. This suit in turn was based on a suit of the same nature filed by the Brazilian Airline Companies Association (SNEA). In a decision handed down on September 12, 1996, collection of this tax was ruled unconstitutional. A law enacted subsequent to the Supreme Court decision determined collection of the ICMS as from January 1, 1997. Given the above, and based on the opinion of VARIG's legal advisors, the Company considered the amounts paid to the states in the period from May, 1989 to July, 1994, monetarily restated, as tax credits recoverable under current assets in the amounts of R$ 110,050 thousand at the Parent Company and R$ 140,352 thousand at the Consolidated level, as well as under noncurrent assets in the amount of R$ 110,051 thousand at the Parent Company and Consolidated level. Moreover, as they will be offset by future tax debts of the same nature, they are shown at their estimated realizable amounts. The net credit in income for the year is R$ 220,101 thousand at the Parent Company level and R$ 250.403 thousand at the Consolidated level, recognized under non-operating income under the heading Taxes Recoverable.

15.2. Income Tax and Social Contribution

At the Parent Company this year, in light of the deficit, neither Income Tax nor Social Contribution are due. Accumulated tax losses (NOLs) - minus deferred inflation profit - as of December 31, 1996, in the amount of approximately R$ 412 million, will be offset against future taxable income.

16. CONTINGENT CREDITS

Through its legal counsel, VARIG filed suit — won at the first court level — for reimbursement by the government of an insufficiency of domestic fare tariffs in effect from 1986 to 1991. The total updated amount filed for as of March 1995, according to calculations made by the accounting experts, is R$ 2,236,654 thousand. The Company has chosen not to record such contingent credits in its financial statements. This will be done when a final decision is reached on the Company's lawsuit.

17. AERUS EMPLOYEE PENSION FUND

The Instituto Aerus de Seguridade Social (Aerus Social Security Institute) is an employee pension fund that provides supplementary retirement benefits to airline employees in Brazil.

In order to finance the activities of AERUS, on the basis of actuarial calculations contributions are paid by employees and sponsoring entities based on individual salaries. In 1996, Company contributions totaled R$ 43,002 thousand.

According to the financial statements of the pension fund, the mathematical reserves representing liabilities for benefits granted or to be granted, correspond to R$ 1,205,924 thousand, which is R$ 43,072 thousand higher than the fund's assets.

18. INSURANCE

The Company maintains insurance policies in amounts considered sufficient to cover potential risks to its assets and/or liabilities, broken down as follows as of December 31, 1996:

Type	Object	Insured Amount R$ thousand
- Aviation	-Aircraft (engines, airframe), flight simulators, spare parts	3,493,151
-Fire	-Buildings and contents.	392,510
-Ground liability	-Comprehensive (cargo, passengers and other)	1,299,250
	-Vehicle liability	26
-Vehicles	-Company vehicles	592
-Sundry risks	-Valuables and equipment	154
-Group life and personal accident	-All employees	25

BOARD OF DIRECTORS

Walterson Fontoura Caravajal
Chairman

Carlos Willy Engels
Vice-Chairman

Aguinaldo de M. Junqueira Filho

Fernando Tigre de Barros Rodrigues

Ingo Ploger

Joaquim Fernandes dos Santos

Lino Pereira

Nelson de Sampaio Bastos

Paulo Pavarini

OFFICERS

Fernando Abs da Cruz Souza Pinto
President and Chief Executive Officer

Carlos Ebner Neto
Chief Financial Officer and Investor Relations Director

Claudio Affonso Junqueira
Engineering and Maintenance Director

Eloy Jorge Binder
Flight Operations Director

Gilson Gomes Novo
Commercial Director

Luiz da Gama Mor
Operational Logistics Director

Manoel José Fontes Torres
Planning Director

Odilon Cesar Nogueira Junqueira
Administration and Human Resources Director

Oscar Luiz de Britto Guerra
Marketing Director

Manuel Eduardo Domingues Guedes
Accountant
CRC-SP - 145.685/S/RS
CPF 013.901.588-45

REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders and Directors
"VARIG", S.A. (Viação Aérea Rio-Grandense)

1. We have audited the accompanying balance sheets of **"VARIG", S.A. (Viação Aérea Rio-Grandense)** (Parent Company) as of December 31, 1996 and 1995 and of **"VARIG", S.A. (Viação Aérea Rio-Grandense)** and its Subsidiaries (Consolidated) as of December 31, 1996, and the related statements of income, changes in stockholders' equity (Parent Company) and changes in financial position for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

2. We conducted our audits in accordance with auditing standards generally accepted in Brazil. Those standards require that we: a) plan our work considering the materiality of balances, volume of transactions and the Companies' system of internal accounting control; b) examine, on a test basis, evidence supporting the amounts and disclosures in the financial statements; and c) assess the accounting principles used and significant estimates made by management, as well as evaluate the overall financial statement presentation.

3. In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of **"VARIG", S.A. (Viação Aérea Rio-Grandense)** (Parent Company) as of December 31, 1996 and 1995, and of **"VARIG", S.A. (Viação Aérea Rio-Grandense)** and its subsidiaries (Consolidated) as of December 31, 1996, and the results of their operations, the changes in its stockholders' equity (Parent Company) and changes in their financial position, respectively, for the years then ended, in accordance with accounting principles generally accepted in Brazil on the basis of Corporate Legislation (Law No. 6404/76), which do not provide for recognition of the effects of inflation as required by Brazilian fundamental accounting principles, as disclosed in Note 13 for information purposes.

São Paulo, March 26, 1997

Coopers & Lybrand

Coopers & Lybrand
Biedermann, Bordasch

accountants
CRC 2SP 008599/S/RS

REPORT OF STATUTORY AUDIT COMMITTEE
(FREE TRANSLATION FROM THE PORTUGUESE LANGUAGE ORIGINAL)

In the manner provided by currently effective legislation and the Corporate Charter, the Statutory Audit Committee of **"VARIG" S.A. (Viação Aérea Rio-Grandense)** met to examine and issue an opinion on the Company's Balance Sheet as of December 31, 1996 and the respective Statements of Income and of Changes in Stockholders' Equity and Changes in Financial Position for the year then ended.

Considering the monthly checks that it made on the Company's interim balance sheets and further considering the unqualified Report of Independent Accountants, the Statutory Audit Committee approved the said financial statements and considered them suitable for submission to the Stockholders, according to the terms of the said Report of Independent Auditors.

Committee Member Paulo Henrique Silveira Fernandes Nonato submitted a separate qualification recorded in the minutes of the meeting of the Statutory Audit Committee held on this date.

Rio de Janeiro, March 26, 1997.

Committee Members:
Celso Lima Araújo
Horst Gunter Axthelm
Paulo Henrique Silveira Fernandes Nonato

Alternates:
Izidoro Polacow
Roberto Bier da Silva
Ernani Ferreira Lima