



FORTRESS PAPER LTD.

Q2 2008

FOR THE THREE AND SIX MONTHS ENDED

JUNE 30, 2008

**FORTRESS PAPER LTD.
SECOND QUARTER 2008
MANAGEMENT'S DISCUSSION AND ANALYSIS**

This Management's Discussion and Analysis ("MD&A") of the financial condition and results of operations of Fortress Paper Ltd ("Fortress" or the "Company") has been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and should be read in conjunction with the unaudited consolidated financial statements and the notes thereto for the three and six month periods ended June 30, 2008 and with the audited consolidated financial statements for the year ended December 31, 2007 (available on SEDAR at www.sedar.com). The MD&A provides a review of the significant developments that have impacted the Company's performance during the quarter ended June 30, 2008 relative to the previous quarter and prior year comparative quarter.

This interim MD&A contains certain forward-looking statements that reflect the current views and/or expectations of the Company with respect to its performance, business and future events. The reader is cautioned that forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements including, without limitation, those relating to damage to our reputation, competition, maintaining our market position, marketability and price of our products, technology and protection of our intellectual property, dependence on our major customers, fluctuations in the price and supply of raw materials, fluctuations in foreign exchange and other risk factors detailed in our filings with Canadian securities regulatory authorities. These risks, as well as others, could cause actual results and events to vary significantly. The Company does not undertake any obligation to release publicly any revisions for updating any voluntary forward-looking statements, except as required by law.

Throughout this discussion, reference is made to EBITDA (defined as net income before interest, income taxes, depreciation, amortization, non-operating income and expenses and stock based compensation), which the Company considers to be an indicative measure of operating performance and a good metric to evaluate profitability. EBITDA is not a generally accepted earnings measure and should not be considered as an alternative to net income or cash flows as determined in accordance with GAAP. As there is no standardized method of calculating EBITDA, the Company's use of the term may not be directly comparable with similarly titled measures used by other companies. A reconciliation of EBITDA to net income reported in accordance with GAAP is included in this MD&A.

The information in this report is as at August 8, 2008.

All financial references are in Canadian dollars unless otherwise noted.

Description of Business

The Company was incorporated on May 30, 2006 under the laws of the Province of British Columbia.

The Company completed its initial public offering ("IPO") on June 28, 2007 by the issuance of 5 million common shares at an offering price of \$8.00 per share for total proceeds of \$40 million. The shares commenced trading on the Toronto Stock Exchange on June 28, 2007 under the symbol "FTP". At the same time IPO proceeds were used to repay a CHF 6.4 million note (CAD 5.6 million). In July 2007, pursuant to an underwriting agreement between the Company and the underwriters, in connection with the initial public offering of the Company, the underwriters exercised their option to purchase an additional 750,000 common shares of the Company at a price of \$8.00 per share, bringing the total gross proceeds from the IPO to \$46 million. Net of issuance costs the Company received proceeds of \$40.6 million.

Second Quarter 2008 Earnings Review

Three Months Ended June 30, 2008

Selected Financial Information and Statistics

(thousands of dollars, except per unit amounts and shipments, unaudited)	Q2 2008	Q1 2008	Q2 2007
Sales	49,138	49,789	35,441
EBITDA ¹	6,184	6,643	4,319
Operating income	5,075	5,527	3,364
Net income	3,401	4,189	1,700
Shipments (tonnes)	14,125	15,004	12,578

¹See net income to EBITDA reconciliation.

Overview

Sales. Sales for the three months ended June 30, 2008 were significantly higher relative to second quarter of 2007 and comparative to the previous quarter primarily due to capacity increases at both our mills which were completed in the third quarter of 2007 and the continued focus at the Dresden mill towards more non-woven wallpaper base.

Landqart produces various security and specialty papers. Security paper production includes banknotes which result in varying degrees of EBITDA margin depending on the complexity of the features included.

Cost of Products Sold. Cost of products sold were \$37.1 million or 75.6% of sales for the three months ended June 30, 2008 compared to \$27.2 million or 76.8% in the prior year comparative period. In the first quarter of 2008, cost of products sold were \$38.2 million or 76.7% of sales. The mills operated at full capacity during the respective periods.

Selling, General and Administrative. Selling, general and administrative expenses were \$5.8 million (second quarter 2007, \$3.9 million and first quarter 2008, \$4.9 million) and were comprised primarily of sales commissions, marketing, corporate and administrative expenses.

Stock-based Compensation. Stock-based compensation expense was \$0.4 million during the period (\$0.5 million and \$0.4 million in the second quarter of 2007 and the first quarter of 2008, respectively) reflecting the grant of 982,675 options issued to directors and officers of the Company in fiscal 2007 and 30,000 issued to an employee in January 2008.

EBITDA. As a result of the foregoing factors, EBITDA was \$6.2 million in the second quarter of 2008 compared to \$4.3 million in the second quarter of 2007 and \$6.6 million in the first quarter of 2008.

Net income to EBITDA reconciliation:

(thousands of dollars, unaudited)	Q2 2008	Q1 2008	Q2 2007
Net income	3,401	4,189	1,700
Income tax	517	2,130	757
Other expense (income)	170	(943)	329
Interest expense	987	151	578
Amortization	733	740	455
Stock based compensation	376	376	500
EBITDA	\$6,184	\$6,643	\$4,319

Operating Results by Business Segment

Landqart Mill

(thousands of dollars, except for shipments, unaudited)	Q2 2008	Q1 2008	Q2 2007
Sales	19,999	20,725	15,731
Operating income	822	750	1,840
Shipments (tonnes)	4,473	4,603	3,841

Dresden Mill

(thousands of dollars, except for shipments, unaudited)	Q2 2008	Q1 2008	Q2 2007
Sales	29,139	29,064	19,710
Operating income	5,245	5,732	2,281
Shipments (tonnes)	9,652	10,401	8,737

Six Months Ended June 30, 2008

Selected Financial Information and Statistics for the Six Months Ended:

<u>(thousands of dollars, except for shipments, unaudited)</u>	<u>June 30, 2008</u>	<u>June 30, 2007</u>
Sales	98,927	73,692
EBITDA ¹	12,827	7,160
Operating income	10,602	5,812
Net income	7,590	2,794
Shipments (tonnes)	29,129	26,048

¹See net income to EBITDA reconciliation.

Overview

Sales. Sales for the six months ended June 30, 2008 were significantly higher relative to prior year comparative period primarily due to capacity increases at both our mills and the continued shift at the Dresden mill towards more non-woven wallpaper base.

Landqart produces various security and specialty papers. Security paper production includes banknotes which result in varying degrees of EBITDA margin depending on the complexity of the features included.

Cost of Products Sold. Cost of products sold were \$75.3 million or 76.1% of sales for the six months ended June 30, 2008. In the six months ended June 30, 2007 cost of products sold were \$57.2 million or 77.7%. The mills operated at full capacity during the respective periods.

Selling, General and Administrative. Selling, general and administrative expenses were \$10.8 million for the six months ended June 30, 2008 and \$9.4 million in the prior year comparative period.

Stock-based Compensation. Stock-based compensation expense was \$0.8 million during the period (prior year comparative period, \$0.5 million) reflecting the grant of 982,675 options issued to directors and officers of the Company in fiscal 2007 and 30,000 issued to an employee in January 2008.

EBITDA. As a result of the foregoing factors, EBITDA was \$12.8 million for the six months ended June 30, 2008 compared to \$7.2 for the six months ended June 30, 2007.

Net income to EBITDA reconciliation:

(thousands of dollars, unaudited)

	June 30, 2008	June 30, 2007
Net income	7,590	2,794
Income tax	2,647	1,602
Other (income) expense	(773)	361
Interest expense	1,138	1,055
Amortization	1,473	848
Stock based compensation	752	500
EBITDA	\$12,827	\$7,160

Operating Results by Business Segment

Landqart Mill

(thousands of dollars, except for shipments, unaudited)

	June 30, 2008	June 30, 2007
Sales	40,724	32,920
Operating income	1,572	2,362
Shipments (tonnes)	9,076	8,266

Dresden Mill

(thousands of dollars, except for shipments, unaudited)

	June 30, 2008	June 30, 2007
Sales	58,203	40,772
Operating income	10,977	4,406
Shipments (tonnes)	20,053	17,782

Liquidity and Capital Resources

The Company has no exposure to asset backed commercial paper or off balance sheet instruments.

The Company has a net positive cash position of \$11.5 million (cash and cash equivalents less debt). EBITDA amounted to \$12.8 million in the six months ended June 30, 2008.

Although there can be no assurances, Fortress believes that cash generated from operations, together with amounts available under its credit facilities and net proceeds from the IPO will be sufficient to meet its debt service requirements, capital expenditure needs and working capital needs for the foreseeable future. Fortress' future operating performance and its ability to service its debt and outstanding convertible note and pay other indebtedness of Fortress will be subject to future economic conditions and the financial success of Fortress' business and other factors, many of which are not within Fortress' control, including changes in market prices for its security and specialty papers and raw material costs.

Operating Activities

Fortress operates in a cyclical industry and its operating cash flows vary accordingly. Fortress' principal operating cash expenditures are for compensation, fibre, chemicals and debt service. Operating activities generated cash of \$11.5 million in the six month ended June 30, 2008 compared to \$3.4 million in the six months ended June 30, 2007. In the second quarter of 2008, operating activities generated \$7.7 million compared to \$2.2 million in the prior year comparative period.

Working capital is subject to cyclical operating needs, the timing of collection of receivables and the payment of payables and expenses.

Investing Activities

Investing activities in the six months ended June 30, 2008 used cash of \$6.4 million related to the purchase of plant and equipment at the mills. In the six months ended June 30, 2007 investing activities used cash of \$1.0 million, \$3.9 million related to the purchase of plant and equipment at the mills which was partially offset by the release of restricted cash of \$3.0 million. Investing activities in the second quarter of 2008 and 2007 used cash of \$4.3 million and \$2.8 million, respectively, primarily related to the purchase of plant and equipment at the mills.

During the six months ended June 30, 2008, the Company received 6,500,000 shares of iDcentrix for licensing of LQard exclusive rights for the United States and Mexico and non-exclusive rights for other countries. Concurrent with this transaction, iDcentrix became a public company. The fair value of the shares initially recorded as an increase in other income was determined to be \$560. The Company recognized \$257 as other expenses for previously unrecorded equity losses relating to 2007. The Company recognized \$303 as other expenses for equity losses relating to the three months ended March 31, 2008 bringing the value of the investment to \$Nil. There are currently unrecognized equity losses relating to the six months ended June 30, 2008. The Company is under no obligation to fund these losses.

The shares of iDcentrix closed at \$0.95 per share at June 30, 2008. The shares held by the Company are subject to certain trading restrictions.

Financing Activities

Financing activities in the six months ended June 30, 2008 used cash of \$12.1 million primarily related to the redemption of the convertible note (\$8.2 million) and repayment of debt and operating loans (\$8.0 million) partially offset by \$4.1 million in additional financing. In the six months ended June 30, 2007, financing activities provided cash of \$28.8 million primarily

related to the \$35.2 million initial public offering funds received net of issuance costs and a \$0.8 million private placement which were partially offset by the net decrease in debt of \$7.2 million.

Financing activities in the second quarter of 2008 used cash of \$7.3 million primarily related to the redemption of the convertible note (\$8.2 million) and repayment of long term debt (\$1.5 million) partially offset by 2.4 million in additional financing. In the prior year comparative period financing activities provided cash of \$30.9 million primarily related to the \$35.2 million initial public offering funds received net of issuance costs and additional loans of \$2.3 million partially offset by the repayment of \$6.6 million debt.

Early Redemption of Convertible Debt

During the quarter ended June 30, 2008, the terms of the convertible debt were amended to allow for redemption by the Company prior to August 1, 2009. On May 22, 2008, the Company redeemed the convertible debt in full. The Company paid \$8,176, representing the full principal amount of the Convertible Note together with the interest accrued up to August 1, 2009, and 105,000 common shares of the Company. On May 22, 2008 the shares of the Company were trading at \$10.74. Of the \$9,304 total consideration provided to Mercer, \$951 was recorded as interest expense and \$742 was recorded as a decrease in retained earnings. The amounts recorded as equity and interest expense were determined using methodology consistent with the original valuation of the components of the Convertible Note. The expense portion was calculated using the present value of future cash outflows using a 5% discount rate.

Related Party Transactions

In the six month period ended June 30, 2008, the Company, in the normal course of business, has paid office and administration expenses of \$38 (2007 - \$45) to a company with a common director.

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

Income Taxes

During the quarter the combined tax rate in Landqart, Switzerland was reduced to 18.9% from 29.0%. As a result, a future income tax recovery of \$1,054 was recorded in the current quarter relating to the Company's defined benefit pension plan. The tax rate for Dresden Papier has remained at 29% for the period.

Foreign Currency

The Company is exposed to foreign exchange risk primarily in Euros, Swiss Francs, and Canadian dollars. The Company's products are sold globally with prices denominated primarily in Euros and Swiss Francs. The majority of the Company's expenditures are denominated in Euros and Swiss Francs. In addition the Company holds financial assets and liabilities in the local operating currencies. At June 30, 2008 the Company held \$17.4 million in Canadian dollar cash and cash equivalents (December 31, 2007 - \$32.8 million).

For the six month periods ending June 30, 2007 and 2008, the Company has not used derivative instruments to reduce its exposure to currency risk.

Fluctuations of 1% in the exchange rates for Euros and Swiss Francs, when compared to the Canadian dollar, are not expected to have a material impact on the Company's results of operations due to both the sales and expenditures being primarily denominated in local currencies.

Outstanding Shares

The number of common shares outstanding at June 30, 2008 and the date of this report was 10,308,300. The number of options outstanding at June 30, 2008 and the date of this report was 1,012,675.

Critical Accounting Estimates

The preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates are used for, but not limited to, the accounting for doubtful accounts, depreciation and amortization, asset impairments, valuation of equity investment, derivative financial instruments, allocation of purchase price of acquisitions, stock based compensation, pensions and post-retirement obligations, income taxes and contingencies. Actual results could differ from these estimates.

Changes in Accounting Policies

Effective January 1, 2008, the Company adopted the Canadian Institute of Chartered Accountants' new Handbook Sections; 1535 "Capital Disclosures", 3031 "Inventories", 3862 "Financial Instruments – Disclosures" and 3863 "Financial Instruments – Presentation". Handbook Sections 3862 and 3863 replace Section 3861 "Financial Instruments – Disclosure and Presentation". These recommendations have been incorporated into the unaudited interim consolidated financial statements.

Section 1535 – Capital Disclosures

This Section establishes standards for disclosing information about an entity's capital and how it is managed. Under this standard the Company is required to disclose qualitative and quantitative information that enables users of the financial statements to evaluate the Company's objectives, policies and processes for managing capital (see note 7 to the interim consolidated financial statements).

Section 3031 – Inventories

This Section replaces Section 3030 and prescribes the accounting treatment for inventories and provides guidance on the determination of costs and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on assigning costs to inventories and in conjunction with Section 3061 "Property Plant and Equipment", provides guidance on classification of major spare parts. The adoption of this Section did not have a significant impact on the Company.

Section 3862 – Financial Instruments – Disclosures

This Section requires entities to provide disclosure of quantitative and qualitative information in their financial statements that enable users to evaluate (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and management's objectives, policies and procedures for managing such risks (see note 12 to the interim consolidated financial statements).

Section 3863 – Financial Instruments – Presentation

This Section establishes standards for presentation of financial instruments and non-financial derivatives.

International financial reporting standards (IFRS)

In 2006, the Canadian Accounting Standards Board ("AcSB") published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with IFRS over an expected five year transitional period. In February 2008 the AcSB announced that 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canada's own GAAP. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011 and will be applicable to the Company commencing with its fiscal year beginning January 1, 2011. The transition date of January 1, 2011 for the Company will require the restatement for comparative purposes of amounts reported by the Company for the year ended June 30, 2011. While the Company has begun assessing the adoption of IFRS for 2011, the financial reporting impact of the transition to IFRS cannot be reasonably estimated at this time.

Internal Controls Over Financial Reporting

During the quarter ended June 30, 2008, there were no changes in the Company's internal controls over financial reporting that materially affected, or would be reasonably likely to materially affect, such controls.

Management's Outlook

The market for security papers remains strong with the driving forces continuing to be innovation to stay ahead of counterfeiters, quality of the end products, and the confidence in and reputation of suppliers. The wallpaper base market's trend of displacing traditional paper-based products with the improved non-woven wallpaper bases continues to be a major factor in the industry with positive implications for the Company. The Company has a very strong balance sheet and continues to selectively evaluate both organic opportunities to further increase capacity and external acquisitions to take advantage of strong industry fundamentals for our portfolio of products.

Risks and Uncertainties

A comprehensive discussion of Risk Factors is included in the Company's 2007 annual information form available on SEDAR at www.sedar.com.

Selected Quarterly Information

(thousands of dollars, except per unit amounts, earnings per share ("EPS"), exchange rates and shares outstanding, unaudited)	Q2 2008	Q1 2008	Q4 2007	Q3 2007	Q2 2007	Q1 2007
Sales	49,138	49,789	37,537	34,065	35,441	38,251
Operating income	5,075	5,527	3,380	1,406	3,364	2,448
EBITDA	6,184	6,643	4,255	2,196	4,319	2,841
Net income	3,401	4,189	2,279	211	1,700	1,094
Basic EPS	\$0.33	\$0.41	\$0.22	\$0.02	\$0.40	\$0.35
Diluted EPS	\$0.33	\$0.38	\$0.22	\$0.02	\$0.38	\$0.20
Weighted average shares outstanding						
Basic (thousands)	10,248	10,203	10,204	10,049	4,275	3,102
Weighted average shares outstanding						
Diluted (thousands)	10,423	11,141	11,141	10,986	5,212	6,227
Average Swiss/Canadian exchange rate ⁽¹⁾	0.9797	0.9405	0.8563	0.8720	0.8982	0.9501
Average Euro/Canadian exchange rate ⁽¹⁾	1.5778	1.5046	1.4213	1.4370	1.4801	1.5355

(1) Source – Bank of Canada (average noon rate for the period)

FORTRESS PAPER LTD.
CONSOLIDATED BALANCE SHEETS
(Canadian dollars, amounts in thousands - unaudited)

	<u>As at</u> <u>June 30, 2008</u>	<u>As at</u> <u>December 31, 2007</u>
ASSETS		
Current		
Cash and cash equivalents	\$ 38,329	\$ 45,307
Trade accounts receivable	15,409	11,778
Other accounts receivable	2,457	2,899
Inventories	25,618	23,808
Prepaid expenses	283	420
	82,096	84,212
Restricted cash	47	44
Property, plant and equipment	35,721	30,626
Employee future benefits	9,759	8,303
	\$ 127,623	\$ 123,185
Total assets		
 LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Operating loans (<i>note 4</i>)	\$ -	\$ 5,854
Accounts payable and accrued liabilities	21,374	20,319
Income taxes payable	6,754	3,241
Other current liabilities	2,939	3,037
Current portion of long-term debt (<i>note 4</i>)	5,043	4,813
	36,110	37,264
Long-term debt (<i>note 4</i>)	21,828	23,799
Future income taxes	1,845	2,408
Total liabilities	\$ 59,783	\$ 63,471
Shareholders' equity (<i>note 5</i>)		
Share capital	59,555	58,428
Contributed surplus	1,659	1,508
Retained earnings (deficit)	6,626	(222)
Total shareholders' equity	67,840	59,714
Total liabilities and shareholders' equity	\$ 127,623	\$ 123,185

(See accompanying notes)

(Signed) *Chadwick Wasilenkoff*

(Signed) *Richard Whittall*

Chadwick Wasilenkoff
Director

Richard Whittall
Director

FORTRESS PAPER LTD.
CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE INCOME AND RETAINED
EARNINGS (DEFICIT)
(Canadian dollars, amounts in thousands - unaudited)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Sales	\$ 49,138	\$ 35,441	\$ 98,927	\$ 73,692
Costs and expenses				
Cost of products sold	(37,125)	(27,193)	(75,325)	(57,181)
Amortization	(733)	(455)	(1,473)	(848)
Selling, general and administration	(5,829)	(3,929)	(10,775)	(9,351)
Stock-based compensation (note 6)	(376)	(500)	(752)	(500)
Operating income	<u>5,075</u>	<u>3,364</u>	<u>10,602</u>	<u>5,812</u>
Other				
Interest, net (note 4)	(987)	(578)	(1,138)	(1,055)
Other expense, net	-	10	-	30
Foreign exchange (loss) gain	(170)	(339)	773	(391)
Net income before income taxes	<u>3,918</u>	<u>2,457</u>	<u>10,237</u>	<u>4,396</u>
Income tax expense (note 11)	(517)	(757)	(2,647)	(1,602)
Net income and comprehensive income	<u>\$ 3,401</u>	<u>\$ 1,700</u>	<u>\$ 7,590</u>	<u>\$ 2,794</u>
Earnings per share				
Basic	\$ 0.33	\$ 0.40	\$ 0.74	\$ 0.76
Diluted	\$ 0.33	\$ 0.38	\$ 0.74	\$ 0.69
Weighted average number of shares outstanding				
Basic	10,248,300	4,274,929	10,226,000	3,691,735
Diluted	10,422,741	5,212,492	10,263,907	4,629,235
	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Retained earnings (deficit)				
Balance — beginning of period	\$ 3,967	\$ (4,412)	\$ (222)	\$ (5,506)
Redemption of Convertible Note (note 4)	(742)	-	(742)	-
Earnings	3,401	1,700	7,590	2,794
Balance — end of period	<u>\$ 6,626</u>	<u>\$ (2,712)</u>	<u>\$ 6,626</u>	<u>\$ (2,712)</u>

(See accompanying notes)

FORTRESS PAPER LTD.
CONSOLIDATED STATEMENTS OF CASHFLOWS
(figures are in thousands of Canadian dollars except where indicated - unaudited)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Cash flows from (used by) operating activities				
Net income	\$ 3,401	\$ 1,700	\$ 7,590	\$ 2,794
Items not affecting cash:				
Amortization	733	455	1,473	848
Future income taxes	(1,054)	(145)	(563)	(149)
Foreign exchange loss (gain) on long term debt	(898)	(1,651)	3,115	(1,732)
Foreign exchange loss on operating loan	-	-	256	-
Stock based compensation	376	500	752	500
	2,558	859	12,623	2,261
Non-operating interest penalty (<i>note 4</i>)	951	-	951	-
Change in non-cash working capital items				
Accounts receivable	2,676	465	(3,189)	468
Inventories	(679)	190	(1,810)	91
Prepaid expenses	87	133	137	(152)
Other assets	236	1,377	(1,457)	568
Accounts payable and other	1,881	(792)	4,244	117
	7,710	2,232	11,499	3,353
Cash flows from (used by) financing activities				
Issuance of common shares, net of issue costs (<i>note 5</i>)	-	35,220	-	36,034
Shares repurchased	-	-	(1)	-
Redemption of Convertible Note, including penalties (<i>note 4</i>)	(8,176)	-	(8,176)	-
Repayment of long-term debt	(1,520)	(6,649)	(1,944)	(6,894)
Proceeds from long-term debt	2,365	1,994	4,124	2,250
Repayment of operating loans	-	-	(6,110)	-
Proceeds from operating loans	-	333	-	458
Repayment of note payable	-	-	-	(2,999)
	(7,331)	30,898	(12,107)	28,849
Cash flows from (used by) investing activities				
Additions to property, plant and equipment	(4,334)	(2,882)	(6,367)	(3,946)
Restricted cash	-	46	(3)	2,972
	(4,334)	(2,836)	(6,370)	(974)
(Decrease) increase in cash position	(3,955)	30,294	(6,978)	31,228
Cash and cash equivalents, beginning of period	42,284	8,254	45,307	7,320
Cash and cash equivalents, end of period	38,329	38,548	38,329	38,548

Supplementary cash flow information (*note 10*)

(*See accompanying notes*)

FORTRESS PAPER LTD.
NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(unaudited, Canadian dollars, amounts in thousands except share and per share data)

1. THE COMPANY AND BASIS OF PRESENTATION

Fortress Paper Ltd. (the “Company”) was incorporated on May 30, 2006 under the laws of the Province of British Columbia. From the date of incorporation to July 31, 2006 the Company was inactive. The Company’s fiscal year end is December 31.

The Company completed its initial public offering on June 28, 2007 by the issuance of 5,000,000 common shares at an offering price of \$8.00 per share for total proceeds of \$40,000. The shares commenced trading on the Toronto Stock Exchange under the symbol “FTP”. On July 19, 2007, pursuant to an underwriting agreement between the Company and the Underwriters dated June 20, 2007, in connection with the initial public offering of the Company, the Underwriters exercised their option to purchase an additional 750,000 Common shares of the Company issued at a price of \$8.00 per share, bringing the total gross proceeds from the initial public offering of Fortress Paper Ltd. to \$46,000.

These unaudited interim financial statements do not include all of the disclosures required by Canadian generally accepted accounting principles for annual financial statements and, accordingly, should be read in conjunction with the consolidated financial statements and notes as at and for the year ended December 31, 2007 (available on SEDAR at www.sedar.com). These unaudited interim financial statements follow the same accounting policies and methods of their application as December 31, 2007 consolidated financial statements except as disclosed in note 2.

2. CHANGES IN ACCOUNTING POLICIES

Effective January 1, 2008, the Company adopted the Canadian Institute of Chartered Accountants’ new Handbook Sections; 1535 “Capital Disclosures”, 3031 “Inventories”, 3862 “Financial Instruments – Disclosures” and 3863 “Financial Instruments – Presentation”. Handbook Sections 3862 and 3863 replace Section 3861 “Financial Instruments – Disclosure and Presentation”. These recommendations have been incorporated into these unaudited interim consolidated financial statements.

Section 1535 – Capital Disclosures

This Section establishes standards for disclosing information about an entity's capital and how it is managed. Under this standard the Company is required to disclose qualitative and quantitative information that enables users of the financial statements to evaluate the Company’s objectives, policies and processes for managing capital (note 7).

Section 3031 – Inventories

This Section replaces Section 3030 and prescribes the accounting treatment for inventories and provides guidance on the determination of costs and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on assigning costs to inventories and in conjunction with Section 3061 “Property Plant and Equipment”, provides guidance on classification of major spare parts. The adoption of this Section did not have a significant impact on the Company.

Section 3862 – Financial Instruments – Disclosures

This Section requires entities to provide disclosure of quantitative and qualitative information in their financial statements that enable users to evaluate (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and management’s objectives, policies and procedures for managing such risks (note 12).

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Section 3863 – Financial Instruments – Presentation

This Section establishes standards for presentation of financial instruments and non-financial derivatives.

3. INVESTMENTS

During the year ended December 31, 2007, the Company received 3,500,000 shares of a private company, namely iDcentrix Inc. (“iDcentrix”), for licensing of LQard Canadian rights. The initial fair value of the shares was determined to be \$Nil. The Company is deemed to exert significant influence over iDcentrix through its share ownership and accounts for its investment in iDcentrix using the equity method.

During January of 2008, the Company received 6,500,000 shares of iDcentrix for licensing of LQard exclusive rights for the United States and Mexico and non-exclusive rights for other countries. Concurrent with this transaction, iDcentrix became a public company. The fair value of the shares initially recorded as an increase in other income was determined to be \$560. During the quarter ended March 31, 2008, the Company recognized \$257 as other expenses for previously unrecorded equity losses relating to 2007. During the quarter ended March 31, 2008, the Company recognized \$303 as other expenses for equity losses relating to 2008. There are currently unrecognized equity losses relating to the six months ended June 30, 2008. The Company is under no obligation to fund these losses.

The shares of iDcentrix closed at \$0.95 per share at June 30, 2008. The shares held by the Company are subject to certain trading restrictions.

4. LONG-TERM DEBT AND OPERATING LOANS

Long-term debt

	<u>June 30, 2008</u>	<u>December 31, 2007</u>
Convertible debt due 2011; interest at prime +2% (a)	\$ -	\$ 7,500
Credit agreement with bank maturing 2009 and 2013; interest at 2.65% secured by current assets (2008 - EUR 1,154 and 2007 - EUR 1,346)	1,851	1,943
Credit agreement with bank maturing 2009, and 2011; interest at 4.5%, 3.8% and 4.0% secured by mortgage (2008 - CHF 4,150 and 2007- EUR 4,350)	4,143	3,793
Credit agreement with bank maturing 2009 and 2012; interest at 4.8% and Libor + 2.0% unsecured (2008 - CHF 7,115 and 2007 - CHF 7,850)	7,103	6,845
Credit agreement with bank maturing 2008, 2011, 2017 and 2018; interest up to Libor + 2%, 5.8%, and 4.8% secured by fixed assets (2008 - CHF 12,680 and 2007 - CHF 8,566)	12,659	7,470
Capital leases; interest at 4.7% (2008 - CHF 169 and 2007 - CHF 629)	169	548
Capital leases; interest at 4.2% (2008 - EUR 589 and 2007 - EUR 678)	946	978
	<hr/>	<hr/>
	26,871	29,077
Less: Convertible debt allocated to contributed surplus, net of accretion (a)	-	(465)
Less: Current portion	(5,043)	(4,813)
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	\$ 21,828	\$ 23,799

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- (a) The convertible debt ("Convertible Note") is a senior secured convertible note of the Company in the principal amount of \$7,500 that matures in August, 2011. The Convertible Note bears interest at an annual rate equal to the prime rate of a national Canadian bank, plus 2%. The Convertible Note is secured by a first security lien upon all or substantially all of the Company's assets.

Commencing August 1, 2007, any holder of the Convertible Note (a "Holder") may, at its option, convert the Convertible Note into common shares at any time until the close of business on the last business day prior to maturity. The conversion price shall be at the IPO offering price of \$8.00 per share. Notwithstanding the foregoing, the maximum number of Shares issuable to Mercer upon a conversion shall be the number that results in Mercer holding, as close as possible without exceeding, 49.9% of the issued and outstanding shares as of the date of the applicable conversion.

The Company has initially recorded a liability portion of \$6,900 and an equity portion of \$600 in contributed surplus. The liability portion has been calculated using present value of future cash outflows using a 10% discount rate.

The Company may redeem the Convertible Note on or after August 1, 2009, in whole or in part, at 100% of the principal amount to be redeemed together with interest accrued thereon up to but not including the redemption date.

During the quarter ended June 30, 2008, the terms of the Convertible Note were amended to allow for redemption by the Company prior to August 1, 2009. On May 22, 2008 the Company redeemed the Convertible Note in full. The Company paid \$8,176, representing the full principal amount of the Convertible Note together with the interest accrued up to August 1, 2009, and 105,000 common shares of the Company. On May 22, 2008 the shares of the Company were trading at \$10.74. Of the \$9,304 total consideration provided to Mercer, \$951 was recorded as interest expense and \$742 was recorded as a decrease in retained earnings. The amounts recorded as equity and interest expense were determined using methodology consistent with the original valuation of the components of the Convertible Note. The expense portion was calculated using the present value of future cash outflows using a 5% discount rate.

Operating loans

At December 31, 2007, the Company had approximately \$6,659 in operating lines of credit available secured by inventory and accounts receivable, of which \$5,854 was drawn down. Interest was payable at rates from 5.25% to 6.0%.

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5. SHAREHOLDERS' EQUITY

(a) **Authorized:**

Unlimited number of common shares without par value
Unlimited number of preferred shares with par value \$1,000

(b) **Issued and fully paid — common shares:**

	Number of Shares	Share Capital	Contributed Surplus
Balance, December 31, 2006	3,000,000	\$ 12,000	\$ 5,600
Private placements	203,500	814	—
Performance based compensation	1,250,000	5,000	(5,000)
Initial public offering	5,750,000	46,000	—
Share issue costs	—	(5,386)	—
Stock compensation	—	—	908
Balance, December 31, 2007	10,203,500	\$ 58,428	\$ 1,508
Stock compensation	—	—	752
Share repurchase	(200)	(1)	(1)
Shares issued on redemption of Convertible Note (note 4)	105,000	1,128	—
Contributed surplus on Convertible Note (note 4)	—	—	(600)
Balance, June 30, 2008	10,308,300	\$ 59,555	\$ 1,659

Share capital reorganization

Effective June 20, 2007, the Company consolidated its outstanding common shares on the basis of one new common share for every two existing common shares. The impact of the share capital consolidation has been reflected in these consolidated financial statements and the accompanying notes.

Private Placements

On July 19, 2007, pursuant to an underwriting agreement between the Company and the Underwriters dated June 20, 2007, entered into in connections with the initial public offering of the Company, the Underwriters exercised their option to purchase an additional 750,000 Common shares of the Company issued at a price of \$8.00 per share, bringing the total gross proceeds from the initial public offering of Fortress Paper Ltd. to \$46,000.

On June 28, 2007, the Company completed its initial public offering of 5,000,000 Common shares at an offering price of \$8.00 per share for total proceeds of \$40,000.

On February 22, 2007 the Company raised \$400 by the issuance of 100,000 shares through a private placement.

On February 6, 2007 the Company raised \$414 by the issuance of 103,500 shares through a private placement.

6. STOCK OPTIONS

During 2006 the Company adopted a stock incentive plan. The exercise price of options granted under the stock incentive plan shall be as determined by the Board of Directors when such options are granted, subject to any

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limitations imposed by any relevant stock exchange or regulatory authority. The maximum number of options that may be granted must not exceed 10% of the common shares outstanding at the time of the grant.

On April 5, 2007 and May 2, 2007 two tranches of options were granted for 320,350 and 122,325 shares, respectively to directors and officers of the Company with an exercise price equivalent to the IPO price with expiry 10 years from the IPO date (June 20, 2007). On November 1, 2007 a further two tranches of options were granted for 240,000 and 300,000 shares to directors of the Company with expiry 10 years from the grant date. On January 1, 2008 a further tranche of options was granted for 30,000 shares to an employee of the company with expiry 10 years from the grant date.

The stock options vest from one year to three years from the IPO or grant dates.

The estimated fair value for the 30,000 options granted during the three months ended March 31, 2008 was \$77. Prorating the total amount based on the vesting schedule \$376 has been expensed during the three months ended March 31, 2008 as stock-based compensation in the statement of operations with a corresponding amount recorded as contributed surplus in shareholders' equity.

The weighted average fair value of the options, being \$3.09 per option, has been estimated at the grant dates using the Black-Scholes option pricing model. Option pricing models require the input of highly subjective assumptions including the expected volatility. Changes in the assumptions can materially affect the fair value estimate, and, therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company's stock options. Assumptions used in the pricing model are as follows:

Risk-free interest rate	4%
Expected life of options	5 years
Annualized volatility	40%
Dividend rate	Nil

Stock option transactions and the number of stock options outstanding are summarised as follows:

	<u>Number of options</u>	<u>Exercise Price</u>
Granted April 5, 2007	320,350	\$ 8.00
Granted May 2, 2007	122,325	8.00
Granted November 1, 2007	540,000	8.00
Balance, December 31, 2007	982,675	\$ 8.00
Granted January 1, 2008	30,000	\$ 8.00
Balance, June 30, 2008	1,012,675	\$ 8.00

At June 30, 2008, 295,116 stock options were exercisable (December 31, 2007 – 147,558). No stock options were exercised during the six month period ended June 30, 2008 or the year ended December 31, 2007.

7. CAPITAL DISCLOSURES

The Company's objectives when managing capital are to safeguard its assets and maintain a globally competitive cost structure while looking for growth opportunities to provide returns to its shareholders. In addition, the Company works with all relevant stakeholders to ensure the safety of its operations and employees, and remain in compliance with all environmental regulations and enhance the communities in which it operates.

The Company constantly monitors and assesses its financial performance in order to ensure that its net debt levels are prudent taking into account the anticipated direction of the business cycle. The company continuously monitors the public and private debt markets and the public equity markets in order to assure that its capital

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structure is appropriately balanced. The Company is currently in a net cash position and can be materially influenced by changes in the relative value of the Canadian dollar, Swiss Franc, and Euro.

The Company's capital is comprised of net cash and shareholders' equity:

	<u>June 30, 2008</u>	<u>December 31, 2007</u>
Cash and cash equivalents	\$ 38,329	\$ 45,307
Less total debt	(26,871)	(34,466)
Net cash	<u>11,458</u>	<u>10,841</u>
Shareholders' equity	<u>67,840</u>	<u>59,714</u>

During the six months ended June 30, 2008 the Company was in compliance with all external capital requirements and covenants related to its debt facilities.

8. RELATED PARTY TRANSACTIONS

In the six month period ended June 30, 2008, the Company, in the normal course of business, has paid office and administration expenses of \$38 (2007 - \$45) to a company with a common director.

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

9. EMPLOYEE FUTURE BENEFITS

Pension expenses of \$257 were recorded for the six months ended June 30, 2008. No pension expense was recorded for the six months ended June 30, 2007 due to the overfunded pension.

10. SUPPLEMENTARY CASH FLOW INFORMATION

	<u>Three Months Ended June 30, 2008</u>	<u>Three Months Ended June 30, 2007</u>	<u>Six Months Ended June 30, 2008</u>	<u>Six Months Ended June 30, 2007</u>
Interest paid	\$ 979	\$ 482	\$ 1,366	\$ 1,065
Income taxes paid	51	-	100	-

Non-cash items

Change in non-cash property, plant and equipment purchases included in accounts payable was \$988 for the six months ended June 30, 2008 and \$640 for the three months ended June 30, 2008 (2007 - \$Nil).

During the three months ended June 30, 2008 there were 105,000 common shares of the Company issued as part of the redemption of the Convertible Note.

During the three months ended March 31, 2008 the Company received 6,500,000 shares of iDcentrix for licensing of LQard North American rights.

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During the three months ended June 30, 2007, the Company received 3,500,000 shares of iDcentrix for licensing of LQard Canadian rights.

11. INCOME TAXES

During the quarter the combined tax rate in Landqart, Switzerland was reduced to 18.9% from 29.0%. As a result, a future income tax recovery of \$1,054 was recorded in the current quarter relating to the Company's defined benefit pension plan. The tax rate for Dresden Papier has remained at 29% for the period.

12. FINANCIAL INSTRUMENTS

Classification of Financial Instruments

The Company has classified its cash and cash equivalents as held-for-trading. Accounts receivable are classified as loans and receivables and are measured at amortized cost. Accounts payable and accrued liabilities, other liabilities, and long-term debt, including interest payable, are classified as other liabilities, all of which are measured at amortized cost. The Company has no derivatives embedded in its financial or non-financial contracts that are not closely related to the host contract.

Financial Risk Management

The Company is exposed to a number of risks as a result of holding financial instruments. These risks include credit risk, liquidity risk and market risk.

I. Credit risk:

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligations. Financial instruments that potentially subject the Company to credit risk include cash and cash equivalents and accounts receivable.

Cash and cash equivalents includes cash on deposit with an original maturity date of 90 days or less. In order to mitigate the risk of financial loss, cash on deposit is held with major financial institutions. The cash and cash equivalents balance at June 30, 2008 was \$38.3 million (December 31, 2007 - \$45.3 million).

The Company utilizes a combination of credit insurance and self-insurance to manage the risk associated with trade receivables. Approximately 80% of the outstanding trade receivables are covered under credit insurance. The majority of the balance is with large and financially sound customers. Accounts receivable aged greater than 90 days is 1.1 million CHF and is considered collectable. The Company's trade receivable balance at June 30, 2008 was \$15.4 million (December 31, 2007 - \$11.8 million).

II. Liquidity risk:

Liquidity risk is the risk that the Company will be unable to meet its financial obligations as they fall due. The Company manages liquidity risk through management of its capital structure in conjunction with cash flow forecasting including anticipated investing and financing activities.

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At June 30, 2008, the Company's accounts payable and accrued liabilities totalled \$21.4 million (December 31, 2007 - \$20.3), all of which fall due for payment within one year of the balance sheet date.

At June 30, 2008, and December 31, 2007, the Company was in a positive net cash position (cash and cash equivalents less total debt).

III. Market risk:

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in interest rates and foreign currency.

a. Interest rate risk:

The Company is exposed to interest rate risk through its financial assets and financial obligations bearing variable interest rate. The Company's cash and cash equivalents include term deposits with an original maturity date of 90 days or less.

The Company manages interest rate risk by maximizing the interest earned on excess funds while maintaining the liquidity necessary to meet day-to-day operating cash flow requirements.

Reasonable fluctuations of 50 bps in the applicable market interest rates are not expected to have a material impact on the Company's results of operations.

The Company currently does not use derivative instruments to reduce its exposure to interest rate risk.

b. Currency risk:

The Company is exposed to foreign exchange risk primarily in Euros, Swiss Francs, and Canadian dollars. The Company's products are sold globally with prices denominated primarily in Euros and Swiss Francs. The majority of the Company's expenditures are denominated in Euros and Swiss Francs. In addition the Company holds financial assets and liabilities in the local operating currencies. At June 30, 2008 the Company held \$17.4 million in Canadian dollar cash and cash equivalents (December 31, 2007 - \$32.8 million).

For the six month periods ending June 30, 2007 and 2008, the Company has not used derivative instruments to reduce its exposure to currency risk.

Fluctuations of 1% in the exchange rates for Euros and Swiss Francs, when compared to the Canadian dollar, are not expected to have a material impact on the Company's results of operations due to both the sales and expenditures being primarily denominated in local currencies.

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13. SEGMENTED INFORMATION

The segmentation of the Company's manufacturing operations by mill is based on a number of factors, including production, production processes, and economic characteristics. No single customer accounted for 10% or more of the Company's total sales.

	Three Months Ended June 30, 2008			
	Dresden Papier (Germany)	Landqart (Switzerland)	Corporate (Canada)	Fortress Paper Consolidated
Sales	\$ 29,139	19,999	-	\$ 49,138
Operating earnings (loss)	\$ 5,245	822	(992)	\$ 5,075
Amortization	\$ (359)	(374)	-	\$ (733)
Stock-based compensation	\$ -	-	(376)	\$ (376)
Property, plant and equipment	\$ 12,201	23,519	-	\$ 35,720
Capital expenditures	\$ 2,080	2,107	-	\$ 4,187
Sales by geographic area	%	%		%
Germany	49.6	24.0		39.2
Switzerland	-	19.9		8.1
Other Western Europe	26.0	31.7		28.3
Eastern Europe	23.1	12.4		18.7
Other	1.3	12.0		5.7
Total	100.0	100.0	-	100.0

	Three Months Ended June 30, 2007			
	Dresden Papier (Germany)	Landqart (Switzerland)	Corporate (Canada)	Fortress Paper Consolidated
Sales	\$ 19,710	15,731	-	\$ 35,441
Operating earnings (loss)	\$ 2,281	1,840	(757)	\$ 3,364
Amortization	\$ (278)	(177)	-	\$ (455)
Stock-based compensation	\$ -	-	(500)	\$ (500)
Property, plant and equipment	\$ 9,269	12,870	-	\$ 22,139
Capital expenditures	\$ 584	3,255	-	\$ 3,839
Sales by geographic area	%	%		%
Germany	49.5	15.0		33.8
Switzerland	-	29.8		13.6
Other Western Europe	23.6	31.4		27.2
Eastern Europe	23.5	15.5		19.9
Other	3.4	8.3		5.5
Total	100.0	100.0	-	100.0

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Six Months Ended June 30, 2008

	Dresden Papier (Germany)	Landqart (Switzerland)	Corporate (Canada)	Fortress Paper Consolidated
Sales	\$ 58,203	40,724	-	\$ 98,927
Operating earnings (loss)	\$ 10,977	1,572	(1,947)	\$ 10,602
Amortization	\$ (742)	(731)	-	\$ (1,473)
Stock-based compensation	\$ -	-	(752)	\$ (752)
Property, plant and equipment	\$ 12,201	23,519	-	\$ 35,720
Capital expenditures	\$ 2,438	4,129	-	\$ 6,567
Sales by geographic area	%	%		%
Germany	51.2	15.4		39.2
Switzerland	-	20.4		8.1
Other Western Europe	24.9	38.5		28.3
Eastern Europe	21.4	13.0		18.7
Other	2.5	12.7		5.7
Total	100.0	100.0		100.0

Six Months Ended June 30, 2007

	Dresden Papier (Germany)	Landqart (Switzerland)	Corporate (Canada)	Fortress Paper Consolidated
Sales	\$ 40,772	32,920	-	\$ 73,692
Operating earnings (loss)	\$ 4,406	2,362	(956)	\$ 5,812
Amortization	\$ (545)	(303)	-	\$ (848)
Stock-based compensation	\$ -	-	(500)	\$ (500)
Property, plant and equipment	\$ 9,269	12,870	-	\$ 22,139
Capital expenditures	\$ 892	5,669	-	\$ 6,561
Sales by geographic area	%	%		%
Germany	51.0	12.1		33.4
Switzerland	-	27.5		12.4
Other Western Europe	24.1	35.2		29.1
Eastern Europe	22.9	13.5		18.6
Other	2.0	11.7		6.5
Total	100.0	100.0		100.0