



# **FORTRESS PAPER LTD.**

## **TSX: FTP**

- **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**
- **CONSOLIDATED FINANCIAL STATEMENTS AS AT AND FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND FIVE MONTHS ENDED DECEMBER 31, 2006**
- **PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS For the year ended December 31, 2006 (Canadian dollars, amounts in thousands, unaudited)**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This management's discussion and analysis of the financial condition and results of operations of Fortress has been prepared in accordance with GAAP and should be read in conjunction with the accompanying audited financial statements and the notes thereto for the three months ended March 31, 2007 and five months ended December 31, 2006, and the unaudited pro forma consolidated statement of earnings for the year ended December 31, 2006. See "Index to Financial Statements". The results of the Mills reflect predecessor operations and may not be indicative of the results of operations had the business been managed by Fortress during that time. The unaudited pro forma consolidated statement of earnings for the year ended December 31, 2006 has been prepared on a pro forma basis as if the acquisition of Landqart and the Dresden Mill had occurred on January 1, 2006 and is based on available information and certain estimates and assumptions. No comparative financial information has been presented because the transfer of the Mills by Mercer to the Company occurred effective August 1, 2006.

### **Overview**

Fortress is an international producer of security and other specialty papers. Fortress' security papers include banknote, passport and visa papers. Its specialty papers include non-woven wallpaper base products, and other high value niche papers. As an extension of its security papers business, Fortress has been actively developing and marketing innovative paper-based security products. Fortress operates two paper mills, the Landqart Mill located in Switzerland and the Dresden Mill located in Germany. In 2006, approximately 94.5% of Fortress' sales revenue was derived from Europe. The Landqart Mill's annual production capacity ranges from 12,000 tonnes to 22,000 tonnes depending on the product mix of security and specialty papers produced. The production of high security papers tends to occur in small production runs. When the Landqart Mill is manufacturing a large proportion of high security papers, this effectively reduces the capacity of the paper machines. The Dresden Mill has an annual production capacity of 36,000 tonnes.

The financial performance of Fortress depends on a number of variables that impact sales and production costs. Sales are driven largely by the mix of security and specialty papers produced and foreign exchange rates. Fortress' product mix is important because value-added and higher value security papers, non-woven wallpaper base and other specialty niche papers generate higher prices. The foreign exchange rate between the Euro and Canadian dollar, and the Swiss Franc and the Canadian dollar also impacts Fortress' financial results as approximately 82% of its sales are made in Euros and Swiss Francs, while a significant portion of its indebtedness and corporate office costs are in Canadian dollars.

Fortress' production costs are driven largely by raw material prices, the mix of its production and other operating costs. Fortress' main raw materials are wood pulp and synthetic fibres, the costs of which are primarily affected by supply and demand for paper, wood pulp and petroleum products. Finally, production costs are also affected by other operating costs such as labour.

Sales in security papers are expected to remain static in 2007, as Fortress has initiated several high return capital expenditure programs and continues to develop new security features which will require several planned shut-downs during fiscal 2007. The benefits derived from these capital investments at the Landqart Mill should be reflected in Fortress' results of operations in 2008 and 2009. Fortress' sales in non-woven wallpaper base are expected to remain strong in 2007. The overall shift in market demand from traditional paper wallpaper base to non-woven wallpaper base is expected to continue. Fortress has initiated a capital expenditure program which will increase capacity and continue to improve the quality of the non-woven wallpaper base. These capital investments at the Dresden Mill will be made in 2007 and 2008 and should have an immediate impact on Fortress' results of operations upon completion.

### **Three Months Ended March 31, 2007**

*Sales.* Sales for the three months ended March 31, 2007 totaled \$38.3 million. The Landqart Mill and the Dresden Mill contributed \$17.2 million and \$21.1 million of sales revenue, respectively. Total shipments during the period were 13,470 tonnes, comprised of 4,425 tonnes of security and specialty papers from the Landqart

Mill and 9,045 tonnes of wallpaper base from the Dresden Mill. The average sales revenue per tonne at the Landqart Mill and Dresden Mill was \$3,885 per tonne and \$2,329 per tonne, respectively, during the period.

The results reflected a one-time 380 tonne sale of security papers to a new customer at below manufacturing cost which was committed to by prior management and had a negative impact of approximately \$0.4 million on net earnings.

*Cost of Products Sold.* Cost of products sold were \$31.5 million or 82.4% of sales for the three months ended March 31, 2007, and reflected a \$0.3 million over-funded pension adjustment which decreased cost of products sold by the corresponding amount and Fortress' increased production of security papers and non-woven coated wallpaper base. The Mills operated at capacity during the period.

*Selling, General and Administrative.* Selling, general and administrative expenses were \$3.9 million and were comprised primarily of sales commissions and marketing, corporate and administrative expenses.

*EBITDA.* As a result of the foregoing factors, EBITDA was \$2.8 million for the three months ended March 31, 2007.

Net earnings to EBITDA reconciliation:

	<b>Three Months Ended March 31, 2007</b>
	<b>(thousands of dollars)</b>
Net earnings .....	\$1,094
Income tax .....	845
Other expense .....	32
Interest expense .....	477
Amortization .....	393
EBITDA .....	<u>\$2,841</u>

#### **Five Months Ended December 31, 2006**

*Sales.* Sales for the five months ended December 31, 2006 totaled \$53.3 million. The Landqart Mill and the Dresden Mill contributed \$23.5 million and \$29.8 million of sales revenue, respectively. Total shipments during the period were 21,518 tonnes, comprised of 5,328 tonnes of security and specialty papers from the Landqart Mill and 16,190 tonnes of wallpaper base from the Dresden Mill. The average sales revenue per tonne at the Landqart Mill and Dresden Mill was \$4,415 per tonne and \$1,836 per tonne, respectively, during the period.

The results reflected Fortress' increased production of security papers and non-woven coated wallpaper base.

Fortress' sales revenue was adversely affected by the appreciating Canadian dollar relative to the Euro and Swiss Franc during the period, with the average value of the Canadian dollar increasing by 3.8% versus the Euro and 6.2% versus the Swiss Franc over the period.

*Cost of Products Sold.* Cost of products sold were \$44.0 million or 82.6% of sales for the five months ended December 31, 2006, and reflected a \$0.5 million over-funded pension adjustment which decreased cost of products sold by the corresponding amount and Fortress' increased production of security papers and non-woven coated wallpaper base. The Mills operated at capacity during the period.

*Selling, General and Administrative.* Selling, general and administrative expenses were \$4.2 million and were comprised primarily of sales commissions and marketing, corporate and administrative expenses.

*Stock-based Compensation.* Stock-based compensation expense was \$8.0 million during the period reflecting a grant of 1,000,000 Options and 1,000,000 restricted Shares issued to a director and officer of the

Company as a performance incentive for Fortress achieving certain milestone events and obtaining a public listing. See “Prior Sales”.

*EBITDA.* As a result of the foregoing factors, EBITDA was \$5.0 million for the five months ended December 31, 2006.

Net earnings to EBITDA reconciliation:

	<u>Five Months Ended</u> <u>December 31, 2006</u> (thousands of dollars)
Net loss . . . . .	\$(5,506)
Income tax . . . . .	1,035
Other income . . . . .	(139)
Interest expense . . . . .	769
Amortization . . . . .	855
Stock-based compensation . . . . .	<u>7,999</u>
EBITDA . . . . .	<u>\$ 5,013</u>

**Year Ended December 31, 2006 Pro Forma (Unaudited)**

*Sales.* Sales for the year ended December 31, 2006 totaled \$123.1 million. The Landqart Mill and the Dresden Mill contributed \$59.9 million and \$63.2 million of sales revenue, respectively. Total shipments during the period were 50,613 tonnes, comprised of 14,592 tonnes of security and specialty papers from the Landqart Mill and 36,021 tonnes of wallpaper base from the Dresden Mill. The average sales revenue per tonne at the Landqart Mill and Dresden Mill was \$4,103 per tonne and \$1,755 per tonne, respectively, during the period.

The results reflected Fortress’ increased production of security papers and non-woven coated wallpaper base.

Fortress’ sales revenue was adversely affected by the appreciating Canadian dollar relative to the Euro and Swiss Franc during the period, with the average value of the Canadian dollar increasing by 5.7% versus the Euro and 7.1% versus the Swiss Franc over the period.

*Cost of Products Sold.* Cost of products sold were \$100.8 million or 81.9% of sales for the year ended December 31, 2006, and reflected a \$1.1 million over-funded pension adjustment which decreased cost of products sold by the corresponding amount and Fortress’ increased production of security papers and non-woven coated wallpaper base. The Mills operated at capacity during the period.

*Selling, General and Administrative.* Selling, general and administrative expenses were \$11.0 million and were comprised primarily of sales commissions and marketing, corporate and administrative expenses.

*Stock-based Compensation.* Stock-based compensation expense was \$8.0 million during the period reflecting the grant of 1,000,000 Options and 1,000,000 restricted Shares issued to a director and officer of the Company as a performance incentive for Fortress achieving certain milestone events and obtaining a public listing. See “Prior Sales”.

*EBITDA.* As a result of the foregoing factors, EBITDA was \$11.4 million for the year ended December 31, 2006.

Net earnings to EBITDA reconciliation:

	<b>Pro Forma Year Ended December 31, 2006</b> <b>(unaudited)</b> <b>(thousands of dollars)</b>
Net loss . . . . .	\$(3,503)
Income tax . . . . .	2,387
Other expense . . . . .	612
Interest expense . . . . .	1,959
Amortization . . . . .	1,931
Stock-based compensation . . . . .	7,999
EBITDA . . . . .	<u>\$11,385</u>

### **Liquidity and Capital Resources**

Following the transfer of the Mills by Mercer to the Company, Fortress' principal liquidity requirements were for working capital, debt service under the Convertible Note in the principal amount of \$7.5 million, the Landqart Note in the principal amount of CHF6.4 million and the funding of capital expenditures. These requirements have been met from cash flow from operations and equity financings by the Company. The net proceeds of the Offering will be used to finance 2007 and 2008 capital programs, repay the Landqart Note and for general corporate purposes.

EBITDA amounted to \$2.8 million in the three months ended March 31, 2007, \$5.0 million in the five months ended December 31, 2006 and \$11.4 million for the year ended December 31, 2006 on a pro forma basis.

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 Offering 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 the 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 in the five months ended December 31, 2006 provided cash of \$9.1 million. 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 five months ended December 31, 2006 used cash of \$3.1 million related to the purchase of property, plant and equipment at the Mills of \$5.0 million and restricted cash of \$3.0 million, which was partially offset by the cash acquired by the Company on the acquisition of the Mills of \$4.9 million.

Fortress anticipates its total capital expenditures for 2007 and 2008 to be approximately \$15.5 million and \$18.0 million, respectively, and primarily relate to machinery and equipment upgrades, selective cost reduction and efficiency improvement projects to enhance its competitive position. This level of capital expenditures could increase or decrease as a result of a number of factors, including Fortress' financial results and future economic conditions. See "Description of the Business — Capital Expenditures".

### **Financing Activities**

Financing activities in the five months ended December 31, 2006 provided cash of \$1.3 million primarily related to the \$7.5 million redemption of preferred shares of the Company and the \$1.8 million repayment of operating loans, which was partially offset by the issuance of Shares of the Company for proceeds of \$9.0 million and a net increase in long-term debt of \$1.6 million.

Fortress has no commitments to acquire assets or operating businesses. Fortress anticipates that there will be acquisitions of businesses or commitments to capital projects in the future. To achieve its long-term goals of expanding its assets and earnings base through the acquisition of interests in complimentary businesses and operating facilities, and organically through high return capital expenditures at the Mills, Fortress will require substantial capital resources. The required necessary resources for such long-term goals will be financed from cash flow from operations, cash on hand, incurrence of additional indebtedness and future equity financings.

### **Earnings Sensitivities**

Fortress' earnings are sensitive to fluctuations in pulp prices and currency exchange rates. Fortress earns approximately 64% of its sales revenue in Euros. Based on pro forma production and sales for the year ended December 31, 2006, changes in pulp prices and exchange rates affect EBITDA as follows:

	<u>Approximate Annual Effect on EBITDA</u> (thousands of dollars)
Pulp price sensitivity — 1% price decrease . . . . .	\$240
Synthetic fibre price sensitivity — 1% price decrease . . . . .	\$120
	<u>Approximate Annual Effect on EBITDA</u> (thousands of dollars)
Exchange rate sensitivity <sup>(1)</sup>	
Canadian dollar/Euro — increase of \$0.01 per Euro . . . . .	\$ 40
Canadian dollar/Swiss Franc — increase of \$0.01 per Swiss Franc . . . . .	\$ 60

(1) Assumes no foreign currency hedges.

## **AUDITORS' REPORT TO THE DIRECTORS OF FORTRESS PAPER LTD.**

We have audited the consolidated balance sheets of Fortress Paper Ltd. as at March 31, 2007 and December 31, 2006 and the consolidated statements of operations and comprehensive income, deficit and accumulated other comprehensive income, and cash flows for the three and five month periods 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.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at March 31, 2007 and December 31, 2006 and the results of its operations and its cash flows for the three and five month periods then ended in accordance with Canadian generally accepted accounting principles.

(Signed) PRICEWATERHOUSECOOPERS LLP  
Chartered Accountants

Vancouver, British Columbia  
May 18, 2007 (except as to note 16  
which is as of June 20, 2007)

**FORTRESS PAPER LTD.**  
**CONSOLIDATED BALANCE SHEETS**  
**As at March 31, 2007 and December 31, 2006**  
**(Canadian dollars, amounts in thousands)**

	<b>2007</b>	<b>2006</b>
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents . . . . .	\$ 8,254	\$ 7,320
Trade accounts receivable . . . . .	13,287	13,620
Other accounts receivable . . . . .	2,059	1,729
Inventories ( <i>note 4</i> ) . . . . .	18,820	18,721
Prepaid expenses . . . . .	534	249
	42,954	41,639
Restricted cash ( <i>note 8</i> ) . . . . .	46	2,972
Property, plant and equipment ( <i>note 5</i> ) . . . . .	18,755	16,426
Other assets ( <i>note 6</i> ) . . . . .	9,045	8,236
<b>Total assets</b> . . . . .	<b>\$70,800</b>	<b>\$69,273</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Operating loans ( <i>note 7</i> ) . . . . .	\$ 4,368	\$ 4,253
Accounts payable and accrued liabilities . . . . .	20,494	18,777
Income taxes payable . . . . .	1,439	584
Other current liabilities ( <i>note 8</i> ) . . . . .	2,490	5,494
Current portion of long-term debt ( <i>note 7</i> ) . . . . .	4,003	3,595
	32,794	32,703
Long-term debt ( <i>note 7</i> ) . . . . .	21,634	22,102
Future income taxes ( <i>note 14</i> ) . . . . .	2,370	2,374
<b>Total liabilities</b> . . . . .	<b>\$56,798</b>	<b>\$57,179</b>
<b>Shareholders' equity</b>		
Share capital . . . . .	12,814	12,000
Contributed surplus . . . . .	5,600	5,600
Deficit . . . . .	(4,412)	(5,506)
<b>Total shareholders' equity</b> ( <i>note 9</i> ) . . . . .	<b>14,002</b>	<b>12,094</b>
<b>Total liabilities and shareholders' equity</b> . . . . .	<b>\$70,800</b>	<b>\$69,273</b>

**Subsequent events** (*note 16*)

**Commitments** (*note 11*)

Approved by the Board of Directors:

(Signed) CHADWICK WASILENKOFF  
 Director

(Signed) RICHARD O'C. WHITTALL  
 Director



**FORTRESS PAPER LTD.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME**  
**Three months ended March 31, 2007 and five months ended December 31, 2006**  
**(Canadian dollars, amounts in thousands)**

	<u>2007</u>	<u>2006</u>
<b>Sales</b> .....	\$ 38,251	\$ 53,254
<b>Costs and expenses</b>		
Cost of products sold .....	(31,513)	(43,997)
Amortization .....	(393)	(855)
Selling, general and administration .....	(3,897)	(4,244)
Stock-based compensation ( <i>note 9</i> ) .....	—	(7,999)
<b>Operating income (loss)</b> .....	<u>2,448</u>	<u>(3,841)</u>
<b>Other</b>		
Interest, net ( <i>note 13</i> ) .....	(477)	(769)
Other income (expenses), net .....	20	1
Foreign exchange gain (loss) .....	<u>(52)</u>	<u>138</u>
<b>Net Income (loss) before income taxes</b> .....	1,939	(4,471)
Income tax expense ( <i>note 14</i> ) .....	<u>(845)</u>	<u>(1,035)</u>
<b>Net income (loss) and Comprehensive Income</b> .....	<u>\$ 1,094</u>	<u>\$ (5,506)</u>
<b>Earning (loss) per share</b>		
<b>Basic</b> .....	\$ 0.35	\$ —
<b>Diluted</b> .....	\$ 0.20	\$ —
<b>Basic and diluted</b> .....	\$ —	\$ (2.76)
<b>Weighted average number of shares outstanding</b>		
<b>Basic</b> .....	3,102,061	—
<b>Diluted</b> .....	6,227,061	—
<b>Basic and diluted</b> .....	—	1,991,861

**FORTRESS PAPER LTD.**  
**CONSOLIDATED STATEMENTS OF DEFICIT AND ACCUMULATED**  
**OTHER COMPREHENSIVE EARNINGS**

**Three months ended March 31, 2007 and five months ended December 31, 2006**  
**(Canadian dollars, amounts in thousands)**

	<b>2007</b>	<b>2006</b>
<b>Retained Earnings (Deficit)</b>		
Balance — beginning of period . . . . .	\$(5,506)	\$ —
Earnings (Loss) . . . . .	1,094	(5,506)
<b>Balance — end of period</b> . . . . .	<u><u>\$(4,412)</u></u>	<u><u>\$(5,506)</u></u>
 <b>Accumulated Other Comprehensive Earnings</b>		
Balance — beginning and end of period . . . . .	<u><u>\$ —</u></u>	<u><u>\$ —</u></u>

**FORTRESS PAPER LTD.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Three months ended March 31, 2007 and five months ended December 31, 2006**  
**(Canadian dollars, amounts in thousands)**

	<b>2007</b>	<b>2006</b>
<b>Cash flows from operating activities</b>		
Net income (loss) . . . . .	\$ 1,094	\$(5,506)
Items not affecting cash:		
Amortization . . . . .	393	855
Future income taxes . . . . .	(4)	607
Foreign exchange (gain) loss on long term debt . . . . .	(71)	801
Other foreign exchange (gain) . . . . .	(10)	206
Stock based compensation . . . . .	—	7,999
	1,402	4,962
Change in non-cash working capital items		
Accounts receivable . . . . .	3	(4,395)
Inventory . . . . .	(99)	(39)
Prepays . . . . .	(285)	(249)
Other assets . . . . .	(809)	(901)
Accounts payable and other . . . . .	909	9,753
	1,121	9,131
<b>Cash flows from financing activities</b>		
Issuance of common shares ( <i>note 9</i> ) . . . . .	814	9,000
Repayment of long-term debt . . . . .	(245)	(461)
Proceeds from long-term debt . . . . .	256	2,038
Proceeds from (repayment of) operating loans . . . . .	125	(1,807)
Repayment of note payable ( <i>note 8</i> ) . . . . .	(2,999)	—
Redemption of preferred shares . . . . .	—	(7,500)
	(2,049)	1,270
<b>Cash flows from investing activities</b>		
Additions to property, plant and equipment . . . . .	(1,064)	(5,050)
Cash acquired on acquisition ( <i>note 3</i> ) . . . . .	—	4,941
Restricted cash . . . . .	2,926	(2,972)
	1,862	(3,081)
<b>Increase in cash position</b> . . . . .	934	7,320
Cash and cash equivalents, beginning of period . . . . .	7,320	—
<b>Cash and cash equivalents, end of period</b> . . . . .	\$ 8,254	\$ 7,320
<b>Supplemental information</b>		
Interest paid . . . . .	\$ 583	\$ 634
Income taxes paid . . . . .	\$ —	\$ 14

**Non cash financing and investing activities**

During the 5 month period ended December 31, 2006, the Company issued \$7,500 preferred shares and \$7,500 in convertible debt in exchange for the Landqart and Dresden Papier mills. (*note 3*)

(*See accompanying notes*)

**FORTRESS PAPER LTD.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**for the three months ended March 31, 2007 and the five months ended December 31, 2006**  
**(Canadian dollars, amounts in thousands except share and per share data)**

**1. THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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 was initially established as a wholly owned subsidiary of Mercer International Inc. (“Mercer”). As part of its strategy to focus exclusively on its pulp business, Mercer determined in 2006 to sell certain of its non-core paper assets. In connection with the transaction, on August 1, 2006, Mercer indirectly transferred two paper mills, Dresden Papier in Germany and Landqart in Switzerland, to the Company in consideration for a secured convertible note, in the principal amount of \$7,500 and preferred shares with a redemption value of \$7,500. On August 1, 2006, certain private equity investors subscribed for \$8,000 of Shares of the Company. Upon receipt of the initial subscription proceeds, the Company utilized \$7,500 of such proceeds to redeem all of the preferred shares and shares owned by Mercer and reorganized the Board and management of the Company.

*Basis of Presentation*

The consolidated financial statements include the accounts of the Company and, from their respective dates of acquisition of control or formation, its wholly owned subsidiaries.

All significant intercompany transactions and balances have been eliminated.

*Revenue and Related Cost Recognition*

The Company recognizes revenue from product sales when persuasive evidence of an arrangement exists, the sales price is fixed or determinable, title of ownership and risk of loss have passed to the customer and collectability is reasonably assured. Sales are reported net of discounts and allowances. Amounts charged to customers for shipping and handling are recognized as revenue. Shipping and handling costs incurred by the Company are included in cost of sales.

*Estimates*

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in Canada 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, derivative financial instruments, allocation of purchase price of acquisitions, pensions and post-retirement obligations, income taxes and contingencies. Actual results could differ from these estimates.

*Foreign Currency Translation*

All foreign currencies are translated into Canadian dollars using average rates for the period for items included in the consolidated statements of loss, the rate in effect at the balance sheet date for monetary assets and liabilities, and historical rates for other assets included in the consolidated balance sheet. Translation gains or losses are included in the determination of income.

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006  
(Canadian dollars, amounts in thousands except share and per share data)**

**1. THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

*Cash and Cash Equivalents*

The Company considers cash, cash in banks, commercial paper, and deposits with financial institutions with original maturities of three months or less and that can be liquidated without prior notice or penalty, to be cash or cash equivalent.

*Inventories*

Finished goods and work in process inventories are valued at the lower of average cost and net realizable value. Raw materials and supplies inventory are valued at the lower of average cost and replacement cost.

*Property, Plant and Equipment*

Property, plant and equipment are stated at cost less accumulated amortization.

No amortization is charged on major improvements or expansions until construction is completed. Betterments and replacements, including leasehold and other improvements that extend the assets' useful life or productive capabilities of major units of property and equipment are capitalized. Maintenance, repairs and minor replacements are expensed as incurred.

Property, plant and equipment are principally amortized on a straight-line basis over their estimated useful lives as follows:

Buildings . . . . .	10-50 years
Manufacturing equipment and machinery . . . . .	5-20 years
Fixtures and other equipment . . . . .	3-10 years

*Impairment of long-lived assets*

The Company reviews property, plant, and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Recoverability is assessed by comparing the carrying amount to the projected future net undiscounted cash flows the long-lived assets are expected to generate. If an impairment is discovered the amount of write down would be based on discounted future cash flows.

*Stock-based compensation*

The Company follows the fair value method for accounting for share options granted to directors, officers and employees. Under the fair value method, compensation expense is recorded for share options over the vesting period based on the estimated fair market value of the option at the date of the grant. Performance option and share awards based on certain conditions are recognized when it is considered likely that the performance condition will be achieved.

*Employee future benefits*

The Company accrues for its obligations under employee benefit plans and the related costs net of plan assets.

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006  
(Canadian dollars, amounts in thousands except share and per share data)**

**1. THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

The Company has adopted the following principles:

- The measurement date used for accounting purposes is December 31, 2006;
- The cost of pensions earned by employees is actuarially determined using the projected benefit method pro-rated on service and management's estimate of expected plan investment performance, salary escalation and retirement ages of employees;
- For the purpose of calculating the expected return on plan assets, those assets are valued at fair value.
- The excess of the net actuarial gain (loss) over 10% of the greater of the benefit obligations and the fair value of plan assets is amortized over the average remaining service period of the active employees which is 9.0 years.

*Income taxes*

Future income taxes are provided for using the liability method. Under the liability method, future income taxes are recognised for temporary differences between the tax and financial statement bases of assets, liabilities and certain carry-forward items.

Future income tax assets are recognised only to the extent that it is more likely than not that they will be realised. Future income tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of substantive enactment.

*Other Assets*

Deferred share issuance costs represent costs incurred in connection with the initial public offering (the "IPO") process and consist of professional, agency and related fees. Upon completion of the IPO, these costs will be offset against the proceeds raised.

*Earnings (loss) per share*

Basic earnings (loss) per share are computed using the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share amounts are calculated giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares using the treasury stock method. The treasury stock method assumes that proceeds received from the exercise of stock options and warrants are used to repurchase to repurchase common shares at the prevailing market rate.

As the Company incurred net losses in the period ended December 31, 2006, the stock options and performance options and share awards, as disclosed in note 9, were not included in the computation of loss per share as their inclusion would be anti-dilutive.

**2. FINANCIAL INSTRUMENTS**

Effective January 1, 2007, the Company adopted the Canadian Institute of Chartered Accountants' new Handbook Sections 3855 "Financial Instruments—recognition and measurement" and Section 1530 "Comprehensive Income".

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006  
(Canadian dollars, amounts in thousands except share and per share data)**

**2. FINANCIAL INSTRUMENTS (Continued)**

Section 3855 prescribes when a financial instrument should be recognized on the balance sheet and at what amount. It also specifies how to present financial instrument gains and losses. Under Section 3855, all financial instruments are classified into one of these five categories: held-for-trading, held-to-maturity investments, loans and receivables, available-for-sale financial assets or other financial liabilities. All financial instruments and derivatives are measured in the Consolidated Balance Sheet at fair value on initial recognition. Subsequent measurement depends on the initial classification of the instrument. Loans and receivables, held-to-maturity investments and other financial liabilities are measured at amortized cost. All derivative instruments, including embedded derivatives, are recorded in the Consolidated Balance Sheet at fair value unless they qualify for the normal sales and purchases exemption. Changes in the fair value of derivatives that are not exempt are recorded in income.

Section 1530 introduces new requirements for situations when certain gains and losses (“other comprehensive income”) must be temporarily presented outside of net income in a new Statement of Comprehensive Income. Comprehensive income is the change in the Company’s net assets that results from transactions, events and circumstances from sources other than the Company’s shareholders and includes items that would not normally be included in net earnings such as unrealized gains or losses on available for sale investments. Other comprehensive income includes the holding gains and losses from available for sale securities which are not included in net income (loss) until realized.

The adoption of the new recommendations did not materially impact the Company’s financial statements.

*Fair values*

The fair value of cash and cash equivalents, restricted cash, accounts receivable, operating loans, accounts payable and accrued liabilities, and deposits approximate their carrying values given the short term maturity of these instruments. The estimated fair value of the bank debt incurred is estimated by reference to current market rates for debt securities with similar term and characteristics and is not materially different from the book value.

*Credit risk*

The financial instruments that potentially expose the Company to a concentration of credit risk are cash and short term investments and accounts receivables. The Company limits its exposure to credit loss by depositing cash with qualified financial institutions. Management regularly monitors the credit worthiness of its debtors and believes that it has adequately provided any exposure to potential credit loss.

*Currency risk*

A significant portion of the Company’s earnings is generated from sales denominated in Euro and Swiss francs. The Company does not use forward exchange contracts to reduce its exposure to exchange rate movements, however, the Company has a significant portion of its long-term debt denominated in both Euro and Swiss francs.

**3. ACQUISITION OF MILLS**

The Company was initially established as a wholly owned subsidiary of Mercer International Inc. As part of its strategy to focus exclusively on its pulp business, Mercer determined in 2006 to sell certain of its non-core paper assets. In connection with the transaction on August 1, 2006, Mercer indirectly transferred

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006  
(Canadian dollars, amounts in thousands except share and per share data)**

**3. ACQUISITION OF MILLS (Continued)**

two mills, Dresden Papier in Germany and Landqart in Switzerland, to the Company in consideration for a secured convertible note, in the principal amount of \$7,500, and preferred shares with a redemption value of \$7,500.

In connection with the transaction, on August 1, 2006, certain private equity investors subscribed for \$8,000 of Shares of the Company. Upon receipt of the initial subscription proceeds, the Company utilized \$7,500 of such proceeds to redeem all of the preferred shares and Shares owned by Mercer and reorganized the Board and management of the Company.

After giving effect to the redemption, Mercer's interest in the Company is comprised of the Convertible Note, particulars of which are more fully set out under (note 7).

The acquisition has been accounted for using the purchase method, in which the purchase consideration was allocated to the estimated fair values of assets and liabilities on the date of acquisition. The preliminary allocation of the purchase cost of the acquisition is as follows:

Net Assets acquired at fair values:

Cash . . . . .	\$ 4,941
Accounts receivable and other . . . . .	11,103
Inventory . . . . .	18,682
Property, plant and equipment . . . . .	12,239
Employee future benefit plan . . . . .	7,185
	54,150
 Liabilities assumed:	
Current liabilities . . . . .	21,278
Future income taxes . . . . .	1,767
Long term debt . . . . .	16,055
	39,100
Net assets acquired: . . . . .	\$15,050
 Consideration paid:	
Cash paid on closing . . . . .	\$ 7,500
Convertible debt . . . . .	7,500
Closing fees . . . . .	50
	\$15,050

**4. INVENTORIES**

	<b>2007</b>	<b>2006</b>
Raw materials . . . . .	\$ 7,798	\$ 7,447
Work in progress . . . . .	1,467	1,328
Finished goods . . . . .	9,556	9,946
	\$18,820	\$18,721



**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006**  
**(Canadian dollars, amounts in thousands except share and per share data)**

**5. PROPERTY, PLANT AND EQUIPMENT**

	2007		
	Cost	Accumulated Amortization	Net Book Value
Land and building . . . . .	\$ 5,817	\$ 100	\$ 5,717
Production and other equipment . . . . .	9,515	1,148	8,367
Construction-in-progress . . . . .	4,671	—	4,671
	\$20,003	\$1,248	\$18,755
	2006		
	Cost	Accumulated Amortization	Net Book Value
Land and building . . . . .	\$ 5,789	\$ 78	\$ 5,711
Production and other equipment . . . . .	8,940	777	8,163
Construction-in-progress . . . . .	2,552	—	2,552
	\$17,281	\$855	\$16,426

The net book value and accumulated amortization of capital leases included in production and other equipment was \$578 and \$42 respectively at March 31, 2007 and \$593 and \$26 respectively at December 31, 2006.

**6. OTHER ASSETS**

	2007	2006
Employee future benefits ( <i>note 12</i> ) . . . . .	\$8,172	\$7,953
Deferred share issuance costs . . . . .	873	283
	\$9,045	\$8,236

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006  
(Canadian dollars, amounts in thousands except share and per share data)**

**7. LONG-TERM DEBT AND OPERATING LOANS**

*Long-term debt*

	2007	2006
Convertible debt due 2011; interest at 8% (a) . . . . .	\$ 7,500	\$ 7,500
Credit agreement with bank maturing 2009 and 2013; interest at 2.65% secured by current assets (EUR 1,731) . . . . .	2,669	2,663
Credit agreement with bank secured by mortgage maturing 2007, 2009, and 2011; interest at 4.8%, 3.8% and 4.0% (CHF 4,750) . . . . .	4,516	4,538
Credit agreement with bank unsecured maturing 2012; interest at Libor + 2.0% (CHF 1,632) . . . . .	1,552	1,559
Credit agreement with bank secured by fixed assets maturing 2011 and 2019; interest at Libor + 2.5% (CHF 2,641 and 2,372) . . . . .	2,511	2,265
Note payable to Stendal Pulp unsecured maturing 2011; interest at Eurobor +3.0% (CHF 6,400) (b) . . . . .	6,085	6,115
Capital leases maturing in 2007; interest at 4.5% (CHF 1,476 and 1,735) . . . . .	1,403	1,657
	26,237	26,297
Less: Convertible debt allocated to contributed surplus (a) . . . . .	(600)	(600)
Less: Current portion . . . . .	(4,003)	(3,595)
	\$21,634	\$22,102

Principal repayments as at March 31, 2007 are required as follows:

	Long term debt	Capital lease	Total
2007 . . . . .	\$ 2,600	\$1,403	\$ 4,003
2008 . . . . .	2,457	—	2,457
2009 . . . . .	1,958	—	1,958
2010 . . . . .	1,686	—	1,686
2011 . . . . .	15,688	—	15,688
Thereafter . . . . .	445	—	445
	\$24,834	\$1,403	\$26,237

(a) The 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 Shares at any time until the close of business on the last business day prior to maturity, unless previously redeemed or purchased, at the conversion price of \$4.00 per Share, if such conversion is carried out prior to the occurrence of a public listing of the Shares through an initial public offering, a distribution of Mercer's interest in the Company to Mercer's shareholders, a merger of the Company with an existing listed corporation, a plan of arrangement or similar corporate reorganization resulting in the shares of the Company becoming publicly listed or any other

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006**

**(Canadian dollars, amounts in thousands except share and per share data)**

**7. LONG-TERM DEBT AND OPERATING LOANS (Continued)**

transaction, reorganization or event resulting in the Company achieving a public listing (each a "Liquidity Event"). If such conversion takes place upon or following a Liquidity Event, the conversion price shall be the lowest price per Share issued or resulting from a Liquidity Event at the time of the Liquidity Event. 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 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.

The Convertible Note also contains positive and negative covenants of the Company customary for secured financings of this nature, including limitations in respect of the granting of security, dispositions of material assets, ceasing to carry on business, consolidation, amalgamation or mergers and the incurrence of indebtedness. In addition, the Company has covenanted to permit Mercer to appoint up to one third of the directors of the Company so long as there remains any outstanding obligations under the Convertible Note.

- (b) The note payable to Stendal Pulp, a subsidiary of Mercer, is unsecured, non-convertible and, unless earlier redeemed, matures on August 1, 2011. The note bears interest at an annual rate which is equal to the Euribor rate, plus 3%. The note contains positive and negative covenants customary for financings of this nature, including limitations in respect of the granting of security, dispositions of material assets, ceasing to carry on business, consolidation, amalgamation or mergers and the incurrence of indebtedness.

*Operating loans*

At March 31, 2007, the Company has approximately \$7,164 in operating lines of credit available, of which \$4,368 was drawn down. The loans are secured by inventory and accounts receivable. Interest is payable at rates from 5.25% to 5.5%.

At December 31, 2006, the Company had approximately \$7,188 in operating lines of credit available secured by inventory and accounts receivable, of which \$4,253 was drawn down. Interest is payable at rates from 5.25% to 5.5%.

**8. OTHER CURRENT LIABILITIES**

	<b>2007</b>	<b>2006</b>
Promissory note to Mercer Darlehen (EUR 1,950) . . . . .	\$ —	\$2,999
Other . . . . .	2,490	2,495
	<b>\$2,490</b>	<b>\$5,494</b>

The promissory note bearing interest at 4% was due and repaid January 28, 2007. Restricted cash of EUR 1,950 was put aside to offset the note.

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006  
(Canadian dollars, amounts in thousands except share and per share data)**

**9. 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:**

	<b>Number of Shares</b>	<b>Share Capital</b>	<b>Contributed Surplus</b>
Private placements . . . . .	2,250,000	\$ 9,000	\$ —
Convertible debt . . . . .	—	—	600
Stock compensation . . . . .	750,000	3,000	—
Performance based compensation . . . . .	—	—	5,000
<b>Balance, December 31, 2006</b> . . . . .	<b>3,000,000</b>	<b>\$12,000</b>	<b>\$5,600</b>
Private placements . . . . .	203,500	\$ 814	\$ —
<b>Balance, March 31, 2007</b> . . . . .	<b>3,203,500</b>	<b>\$12,814</b>	<b>\$5,600</b>

Subsequent to March 31, 2007, the Company proposed to effect a consolidation of its outstanding common shares on the basis of one new common share for every two existing common shares (note 16). These financial statements reflect the proposed share capital consolidation on a retroactive basis. Accordingly, the number of common shares, options and earnings per share calculations reflect the impact of the share capital consolidation.

*Private Placements*

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

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

On November 20, 2006 the Company raised \$1,000 by the issuance of 250,000 shares.

On August 1, 2006 the Company completed its initial private placement of \$8,000 by the issuance of 2,000,000 shares.

*Stock compensation*

During the period the Company recognized stock based compensation of \$7,999 for the grant or contingent grant of 1,000,000 options and 1,000,000 restricted shares. Stock compensation has been determined at \$4.00 per option and restricted share, equivalent to the private placement share price, less the exercise price. On August 1, 2006 the Company granted a total of 1,000,000 stock options with an exercise price of \$0.002 per option to a director of the Company. Upon the close of the initial private placement 750,000 options became vested and were exercised for \$1.50. The remaining 250,000 options shall vest and become exercisable on the date that the Company and / or Landqart enters into a licensing agreement, on terms approved by the Company, with an entity which is at arm's length to both the Company and Landqart, for the licensing of the LQard security card technology and shall expire five days thereafter, provided that if the licensing arrangement is not completed prior to June 1, 2007, the option shall be null and void. The

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006  
(Canadian dollars, amounts in thousands except share and per share data)**

**9. SHAREHOLDERS' EQUITY (Continued)**

option agreement provides that upon the recipient exercising the options in its entirety, the Company shall enter into a restricted share agreement to grant 1,000,000 restricted shares to the recipient.

**10. RELATED PARTY TRANSACTIONS**

In the three month period ended March 31, 2007, the Company, in the normal course of business, has paid or accrued office and administration expenses of \$23 to a company with a common director and accrued director fees of \$12.

In the five month period ended December 31, 2006, the Company, in the normal course of business, had paid or accrued office and administration expenses of \$39 to a company with a common director.

**11. COMMITMENTS**

The minimum lease commitment and purchase obligations over the next 5 years and thereafter is as follows:

	<u>2007</u>
2007 . . . . .	\$1,873
2008 . . . . .	133
2009 . . . . .	109
2010 . . . . .	105
2011 . . . . .	74
Thereafter . . . . .	<u>102</u>
	<u>\$2,396</u>

In previous years, the Dresden Papier mill had received state and federal grants totalling EUR 5,963. As of December 31, 2006 and March 31, 2007 the Company has accrued EUR 900 as a repayment obligation under the terms of the grants. There are no additional repayment obligations as of December 31, 2006 and March 31, 2007.

**FORTRESS PAPER LTD.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**for the three months ended March 31, 2007 and the five months ended December 31, 2006**  
**(Canadian dollars, amounts in thousands except share and per share data)**

**12. EMPLOYEE FUTURE BENEFITS**

The Company maintains a defined benefit pension plan providing pension benefits based on either length of service or earnings and length of service.

The status of the Company's defined benefit pension plans, in aggregate, is as follows:

	<u>2007</u>	<u>2006</u>
<b>Accrued benefit obligation</b>		
Beginning of period . . . . .	\$ 49,664	\$ 46,542
Service cost . . . . .	316	476
Interest cost on accrued obligation . . . . .	366	506
Benefit payments . . . . .	(622)	(997)
Contributions by plan participants . . . . .	539	863
Actuarial loss and other . . . . .	—	345
Foreign exchange . . . . .	(239)	1,929
End of period . . . . .	<u>\$ 50,023</u>	<u>\$ 49,664</u>
<b>Plan assets</b>		
Fair value, beginning of period . . . . .	\$ 57,015	\$ 53,727
Actual return on plan assets . . . . .	720	857
Employer contributions . . . . .	219	352
Employee contributions . . . . .	539	863
Benefit payments . . . . .	(622)	(998)
Foreign exchange . . . . .	(274)	2,214
End of period . . . . .	<u>\$ 57,597</u>	<u>\$ 57,015</u>
<b>Funded status — plan surplus</b>	<u>\$ 7,574</u>	<u>\$ 7,351</u>
Unamortized net actuarial loss . . . . .	598	602
Accrued benefit asset . . . . .	<u>\$ 8,172</u>	<u>\$ 7,953</u>
<b>Expense</b>		
Current service cost . . . . .	\$ 316	\$ 476
Interest cost . . . . .	366	507
Actual return on plan assets . . . . .	(720)	(857)
Actual actuarial loss on benefit obligations . . . . .	—	345
Expenses before adjustments . . . . .	(38)	471
Difference between expected return and actual return on plan assets . . . . .	—	(231)
Difference between net actuarial (gain) loss recognized and actual (gain) loss on benefit obligations . . . . .	—	(345)
Net expense . . . . .	<u>\$ (38)</u>	<u>\$ (105)</u>
<b>Significant actuarial assumptions used are as follows</b>	<u>%</u>	<u>%</u>
Discount rate . . . . .	2.9	2.9
Expected rate of return on plan assets . . . . .	5.0	5.0
Rate of increase in future compensation . . . . .	1.5	1.5
<b>Plan assets at fair value at the end of the year</b>	<u>%</u>	<u>%</u>
Liquid assets . . . . .	4.0	4.0
Bonds . . . . .	52.0	52.0
Equity — World . . . . .	25.0	25.0
Real estate . . . . .	19.0	19.0
	<u>100.0</u>	<u>100.0</u>

**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006**  
**(Canadian dollars, amounts in thousands except share and per share data)**

**13. INTEREST, NET**

	<b>2007</b>	<b>2006</b>
Interest expense . . . . .	\$ (492)	\$ (785)
Interest income . . . . .	15	16
	\$ (477)	\$ (769)

**14. INCOME TAXES**

The components of the future income tax liability are as follows:

	<b>2007</b>	<b>2006</b>
Future income tax assets (liabilities)		
Pension benefit . . . . .	\$ (2,370)	\$ (2,307)
Other . . . . .	—	(67)
Non-capital loss carryforward . . . . .	5,300	5,486
Property, plant and equipment . . . . .	4,740	4,747
	7,863	7,859
Valuation allowance . . . . .	(10,040)	(10,233)
Net future income tax liability . . . . .	\$ (2,370)	\$ (2,374)

Non-capital loss carryforward expire beginning in 2007 through 2011.

The components of income tax expense are as follows:

	<b>2007</b>	<b>2006</b>
Current . . . . .	\$ (782)	\$ (495)
Future . . . . .	(63)	(540)
	\$ (845)	\$ (1,035)

The reconciliation of income taxes calculated at the statutory rate of 34.12% to the actual income tax provision is as follows:

	<b>2007</b>	<b>2006</b>
Net income (loss) before income taxes . . . . .	\$ 1,939	\$ (4,471)
Income tax recovery at statutory rates . . . . .	662	(1,526)
Stock compensation and other non deductible expenses . . . . .	—	2,823
Rate differences in foreign jurisdictions . . . . .	80	(13)
Tax loss carryforward used . . . . .	—	(317)
Other . . . . .	103	68
Income tax expense . . . . .	\$ 845	\$ 1,035





**FORTRESS PAPER LTD.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**for the three months ended March 31, 2007 and the five months ended December 31, 2006  
(Canadian dollars, amounts in thousands except share and per share data)**

**16. SUBSEQUENT EVENTS**

*Option granted and restricted shares awarded*

On April 25, 2007, pursuant to the option and restricted share agreement described in note 9, the remaining 250,000 options and 1,000,000 restricted shares have been granted or awarded. The restricted shares are subject to various voting, trading and ownership restrictions, which will terminate upon the Company completing its initial public offering.

On April 5, 2007 and May 2, 2007 two tranches of options were granted for 320,350 and 122,325 shares, respectively. These options were granted to directors and officers of the Company with an exercise price equivalent to the initial public offering price with expiry 10 years from the date of grant.

*License agreement*

On April 25, 2007, the Company has licensed the exclusive rights to use and exploit identification card technology in Canada to an arm's length party.

*Initial public offering*

The Company entered into an underwriting agreement dated June 20, 2007 relating to the proposed initial public offering of common shares to be issued at a price of \$8.00 per share for total proceeds of \$40,000.

*Proposed 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 proposed share capital consolidation has been reflected in these consolidated financial statements and the accompanying notes.

## COMPILATION REPORT ON PRO FORMA FINANCIAL STATEMENTS

To the Directors of Fortress Papers Ltd.

We have read the accompanying unaudited pro forma consolidated statement of operations of Fortress Papers Ltd. (the company) for the year ended December 31, 2006 and have performed the following procedures.

1. Compared the figures in the column captioned "Fortress Papers Ltd." to the audited consolidated financial statements of the company for the period ended December 31, 2006 and found them to be in agreement.
2. Made enquiries of certain officials of the company who have responsibility for financial and accounting matters about:
  - (a) the basis for determination of the pro forma adjustments; and
  - (b) whether the pro forma financial statements comply as to form in all material respects with the requirements of the applicable securities regulatory authorities in Canada.

The officials:

- (a) described to us the basis for determination of the pro forma adjustments; and
  - (b) stated that the pro forma statements comply as to form in all material respects with the applicable securities regulatory authorities in Canada.
3. Read the notes to the pro forma statements, and found them to be consistent with the basis described to us for determination of the pro forma adjustments.
4. Recalculated the application of the pro forma adjustments to the aggregate of the amounts in the column captioned "Fortress Paper Ltd." for the year ended December 31, 2006, and found the amounts in the column captioned "Pro forma Fortress Paper Ltd." to be arithmetically correct.

A pro forma financial statement is based on management assumptions and adjustments which are inherently subjective. The foregoing procedures are substantially less than either an audit or a review, the objective of which is the expression of assurance with respect to management's assumptions, the pro forma adjustments, and the application of the adjustments to the historical financial information. Accordingly, we express no such assurance. The foregoing procedures would not necessarily reveal matters of significance to the pro forma financial statements, and we therefore make no representation about the sufficiency of the procedures for the purposes of a reader of such statements.

(Signed) PricewaterhouseCoopers LLP  
Chartered Accountants  
Vancouver, British Columbia  
June 20, 2007

**FORTRESS PAPER LTD.**  
**PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS**  
**For the year ended December 31, 2006**  
**(Canadian dollars, amounts in thousands)**  
**(unaudited)**

	<u>Fortress Paper Ltd.</u>	<u>Pro forma adjustments</u>	<u>Note 3</u>	<u>Pro forma Fortress Paper Ltd.</u>
<b>Sales</b> . . . . .	\$53,254	\$69,838	a	\$123,092
<b>Costs and expense</b>				
Cost of products sold . . . . .	43,997	56,756	a	100,753
Amortization . . . . .	855	1,076	b	1,931
Selling, general and administration . . . . .	4,244	6,332	a	
		378	b	10,954
Stock-based compensation . . . . .	<u>7,999</u>	<u>—</u>	c	<u>7,999</u>
<b>Operating earnings (loss)</b> . . . . .	(3,841)	5,296		1,455
<b>Other</b>				
Interest, net . . . . .	(769)	(462)	d	
		(728)	b	(1,959)
Other income (expenses), net . . . . .	1	(751)	d	(750)
Foreign exchange gain . . . . .	<u>138</u>	<u>—</u>	g	<u>138</u>
<b>Earnings before income taxes</b> . . . . .	(4,471)	3,355		(1,116)
(Provision for) recovery of income tax . . . . .	(1,035)	(597)	e	
		(755)	f	(2,387)
<b>Net earnings (loss) for the year</b> . . . . .	<u>\$ (5,506)</u>	<u>\$ 2,003</u>		<u>\$ (3,503)</u>

**FORTRESS PAPER LTD.**  
**NOTES TO PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS**  
**for the year ended December 31, 2006**  
**(Canadian dollars, amounts in thousands except share and per share data)**  
**(unaudited)**

**1. BASIS OF PRESENTATION**

The unaudited pro forma consolidated statement of operations of Fortress Paper Ltd. for the year ended December 31, 2006 has been prepared as if the acquisition described in Note 2 was completed on January 1, 2006. The pro forma combined results are not necessarily indicative of the actual results that would have occurred had the acquisition been consummated on those dates, or of the future operations of the combined entities

The unaudited pro forma consolidated statement of operations of Fortress Paper Ltd. for the year ended December 31, 2006 has been prepared by isolating the statement of earnings on a carve out basis for Dresden Papier, the statement of earnings from Landqart and an extrapolation of head office expenses and other consolidated figures from 5 months to 12 months.

The unaudited pro forma consolidated statement of earnings should be read in conjunction with the financial statements of Fortress Paper Ltd. for the five month period ended December 31, 2006 as presented in the information circular.

The pro forma adjustments are tentative and are based on available information and certain estimates and assumptions, as presented in note 3. The Company believes that the assumptions are reasonable and present the effects of the transaction as if from the beginning of the year, and that the pro forma adjustments are properly applied in the pro forma statement of operations.

**2. ACQUISITION**

The Company was initially established as a wholly owned subsidiary of Mercer International Inc. Mercer is one of the world's largest market softwood kraft pulp producers. As part of its strategy to focus exclusively on its pulp business, Mercer determined in 2006 to sell certain of its non-core paper assets. In connection with the transaction on August 1, 2006, Mercer indirectly transferred two mills, Heidenau in Germany and Landqart in Switzerland, to the Company in consideration for a secured convertible note, in the principal amount of \$7,500 and preferred shares with a redemption value of \$7,500.

In connection with the transaction, on August 1, 2006, certain private equity investors subscribed for \$8,000 of Shares of the Company. Upon receipt of the initial subscription proceeds, the Company utilized \$7,500 of such proceeds to redeem all of the preferred shares and Shares owned by Mercer and reorganized the Board and management of the Company.

After giving effect to the redemption, Mercer's interest in the Company is comprised of the Convertible Note.

The acquisition has been accounted for by the purchase method, whereby the purchase consideration has been allocated to the assets and liabilities acquired based on the fair values on August 1, 2006.

**3. PRO FORMA ADJUSTMENTS AND ASSUMPTIONS**

The following assumptions and adjustments have been made to the unaudited pro forma income statement assuming that the following transaction had been effected January 1, 2006 for the unaudited pro forma consolidated statement of operations.

- a) Figures are compiled from audited mill results for the period January 1, 2006 through July 31, 2006.

**FORTRESS PAPER LTD.**  
**NOTES TO PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS (Continued)**  
**for the year ended December 31, 2006**  
**(Canadian dollars, amounts in thousands except share and per share data)**  
**(unaudited)**

**3. PRO FORMA ADJUSTMENTS AND ASSUMPTIONS (Continued)**

- b) Figures are extrapolated for the full year based on the audited results from August 1, 2006 to December 31, 2006.
- c) It is assumed that no further stock compensation occurred in the year other than that in the audited period August 1, 2006 to December 31, 2006.
- d) Figure is compiled from Landqart audited results.
- e) Figures are extrapolated for the full year based on the current tax results from August 1, 2006 to December 31, 2006.
- f) Figures are extrapolated for the full year based on the future tax results from August 1, 2006 to December 31, 2006.
- g) The foreign exchange represents the audited figure for the period August 1, 2006 to December 31, 2006 and is assumed to remain constant for the duration of the year.