

Affidavit #3 of William A. Sharkey
sworn June 19, 2012

No. S120712
Vancouver Registry

IN THE SUPREME COURT OF BRITISH COLUMBIA
IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,
R.S.C. 1985, c. C-36, AS AMENDED

AND

IN THE MATTER OF THE *CANADA BUSINESS CORPORATIONS ACT*,
R.S.C. 1985, c. C-44

AND

IN THE MATTER OF THE *BUSINESS CORPORATIONS ACT*,
S.B.C. 2002, c. 57

AND

IN THE MATTER OF CATALYST PAPER CORPORATION
AND THE PETITIONERS LISTED IN SCHEDULE "A"

PETITIONERS

AFFIDAVIT #3 OF WILLIAM A. SHARKEY

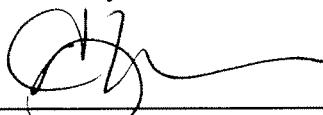
I, William A. Sharkey, retiree, of 4878 3rd Avenue, Delta, British Columbia, SOLEMNLY
AFFIRM AND SAY THAT:

1. I am a former employee of Crown Zellerbach Canada Ltd. and Fletcher Challenge Canada Ltd., which are predecessor companies to Catalyst Paper Corporation and/or its affiliated companies (collectively, "Catalyst" or the "Company"). I retired from the Company in 1994 after approximately thirty years of service.

2. I am also the President (until the Annual General Meeting on June 5, 2012) and a director of the Catalyst-TimberWest Retired Salaried Employees' Association ("RSEA"), an association that was described in detail in the Affidavit #1 of Alan L. Statham, sworn on February 21, 2012. As such, I have personal knowledge of the facts to which I hereinafter depose, except where stated to be on information and belief, in which case I verily believe them to be true.

3. As a former senior salaried employee with Catalyst, and its predecessor companies, I am familiar with the consolidated financial statements and associated documents of Catalyst and recognize the document attached hereto and marked as Exhibit "A" as a true copy of the Company's Consolidated Financial Statements as excerpted from its 2005 Annual Report, and the document attached hereto and marked as Exhibit "B" is a true copy of the Company's Consolidated Financial Statement as excerpted from its 2007 Annual Report.

AFFIRMED BEFORE ME at the City of
Vancouver, Province of British Columbia,
this 19TH day of June, 2012.



A Commissioner for taking Affidavits
in British Columbia



WILLIAM A. SHARKEY

Caily A. DiPuma
Hunter Litigation Chambers
Suite 2100 - 1040 West Georgia Street
Vancouver, BC V6E 4H1

EX-99.2 3 exhibit2.htm AUDITED CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEAR ENDED
DECEMBER 31, 2005

1

MANAGEMENT'S RESPONSIBILITY

The management of Catalyst Paper Corporation is responsible for the preparation, integrity and fair presentation of the accompanying consolidated financial statements and other information contained in this Annual Report. The consolidated financial statements and related notes were prepared in accordance with accounting principles generally accepted in Canada and reflect management's best judgments and estimates. Financial information provided elsewhere in this Annual Report is consistent with that in the consolidated financial statements.

Management maintains a system of internal controls over financial reporting which encompasses policies, procedures and controls to provide reasonable assurance that assets are safeguarded against loss or unauthorized use, transactions are executed and recorded in accordance with management's authorization, and financial records are accurate and reliable.

The Board of Directors is responsible for satisfying itself that management fulfills its responsibilities for financial reporting and internal control. The Audit Committee, which is comprised of seven non-management members of the Board of Directors, provides oversight to the financial reporting process. The Audit Committee meets periodically with management, the internal auditors and the external auditors to review the consolidated financial statements, the adequacy of financial reporting, accounting systems and controls and internal and external auditing functions.

The consolidated financial statements have been reviewed by the Audit Committee, which has recommended their approval by the Board of Directors. These consolidated financial statements have been audited by KPMG LLP, the external auditors, whose report follows.

Russell J. Horner
President and
Chief Executive Officer

Ralph Leverton
Vice-President, Finance
and Chief Financial Officer

Vancouver, Canada
January 24, 2006

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Catalyst Paper Corporation as at December 31, 2005 and 2004 and the consolidated statements of earnings, retained earnings and cash flows for each of the years in the three-year period ended December 31, 2005. 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 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.

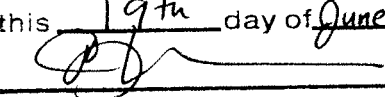
In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2005 in accordance with Canadian generally accepted accounting principles.

Chartered Accountants
Vancouver, Canada

January 24, 2006

This is Exhibit "A" referred to in the
affidavit of William A Sharkey
sworn before me at Vancouver, BC
this 19th day of June 2012

2


A Commissioner for taking Affidavits
within British Columbia

CONSOLIDATED STATEMENTS OF EARNINGS*(In millions of dollars, except where otherwise stated)*

	<i>Years ended December 31,</i>		
	<i>2005</i>	<i>2004</i>	<i>2003</i>
Sales	\$ 1,823.9	\$ 1,878.2	\$ 1,820.5
Operating expenses			
Cost of sales	1,611.0	1,674.9	1,687.5
Selling, general and administrative	57.7	50.5	54.7
Amortization	180.3	184.1	189.9
	<u>1,849.0</u>	<u>1,909.5</u>	<u>1,932.1</u>
Operating earnings (loss)	(25.1)	(31.3)	(111.6)
Foreign exchange gain on translation of long-term debt	24.7	53.5	58.2
Loss on repayment of long-term debt (note 12)	—	(5.2)	—
Write-down of property, plant and equipment (note 9)	—	—	(14.2)
Other income (expense), net	4.5	1.2	(3.9)
Interest expense, net (note 5)	(75.7)	(74.9)	(75.0)
Earnings (loss) before income taxes and non-controlling interest	(71.6)	(56.7)	(146.5)
Income tax recovery (note 6)	(46.6)	(28.1)	(62.0)
Net earnings (loss) before non-controlling interest	(25.0)	(28.6)	(84.5)
Non-controlling interest (note 3(a))	(0.6)	—	—
Net earnings (loss)	\$ (25.6)	\$ (28.6)	\$ (84.5)
Basic and diluted earnings (loss) per share (note 7) (in dollars)	\$ (0.12)	\$ (0.13)	\$ (0.41)
Weighted average common shares outstanding (in millions)	<u>214.6</u>	<u>214.6</u>	<u>206.6</u>

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS*(In millions of dollars)*

	<i>Years ended December 31,</i>		
	<i>2005</i>	<i>2004</i>	<i>2003</i>
Retained earnings, beginning of year			
— as previously reported	\$ 124.4	\$ 155.6	\$ 240.1
Effect of change in accounting policy (note 3(c))	—	(2.6)	—
Retained earnings, beginning of year, restated	124.4	153.0	240.1
Net earnings (loss)	(25.6)	(28.6)	(84.5)
Retained earnings, end of year	<u>\$ 98.8</u>	<u>\$ 124.4</u>	<u>\$ 155.6</u>

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEETS*(In millions of dollars)***4**

	<i>As at December 31,</i>	
	<i>2005</i>	<i>2004</i>
ASSETS		
Current assets		
Cash and cash equivalents	\$ —	\$ 26.0
Accounts receivable	246.7	236.8
Inventories (note 8)	245.7	258.1
Prepays and other	24.1	24.6
	516.5	545.5
Property, plant and equipment (note 9)	2,139.3	2,172.9
Other assets (note 10)	40.1	27.5
	\$ 2,695.9	\$ 2,745.9
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities (note 11)	\$ 279.4	\$ 285.5
Long-term debt (note 12)	861.9	823.6
Other long-term obligations (note 13)	209.7	233.6
Future income taxes (note 6)	300.9	332.9
Deferred credits (note 14)	24.3	27.5
	1,676.2	1,703.1
SHAREHOLDERS' EQUITY		
Share capital (note 15)	913.6	913.6
Contributed surplus (note 3(c))	7.3	4.8
Retained earnings	98.8	124.4
	1,019.7	1,042.8
	\$ 2,695.9	\$ 2,745.9
Commitments and Guarantees and Indemnities (notes 21 and 22)		
Contingent liabilities (note 23)		

The accompanying notes are an integral part of the consolidated financial statements.

ON BEHALF OF THE BOARD:

 Russell J. Horner
 Director

 Thomas S. Chambers
 Director

CONSOLIDATED STATEMENTS OF CASH FLOWS (In millions of dollars)

5

	<i>Years ended December 31,</i>		
	<i>2005</i>	<i>2004</i>	<i>2003</i>
Cash flows provided (used) by:			
Operations			
Net earnings (loss)	\$ (25.6)	\$ (28.6)	\$ (84.5)
Items not requiring (providing) cash			
Amortization	180.3	184.1	189.9
Future income taxes	(51.6)	(31.3)	(67.9)
Increase in other long-term obligations	24.7	23.5	17.5
Foreign exchange gain on translation of long-term debt	(24.7)	(53.5)	(58.2)
Non-controlling interest (note 3(a))	0.6	—	—
Loss on repayment of long-term debt (note 12)	—	5.2	—
Write-down of property, plant and equipment (note 9)	—	—	14.2
Other	0.8	(10.5)	(10.9)
	<u>104.5</u>	<u>88.9</u>	<u>0.1</u>
Changes in non-cash working capital			
Accounts receivable	(9.1)	(18.1)	57.5
Inventories	12.4	(22.2)	10.2
Prepays and other	(6.7)	(0.9)	2.6
Accounts payable and accrued liabilities	(8.1)	16.8	(47.9)
	<u>(11.5)</u>	<u>(24.4)</u>	<u>22.4</u>
Cash flows provided by operations	<u>93.0</u>	<u>64.5</u>	<u>22.5</u>
Investing			
Acquisition of paper recycling business (note 4)	—	—	(32.1)
Additions to property, plant and equipment	(95.2)	(68.0)	(81.4)
Proceeds from sale of property, plant and equipment	3.5	0.5	0.4
Proceeds from termination of interest rate swaps	—	—	15.9
Purchase price adjustment (note 19)	—	26.6	—
Decrease (increase) in other assets	(1.3)	(0.9)	1.1
Cash flows used by investing activities	<u>(93.0)</u>	<u>(41.8)</u>	<u>(96.1)</u>
Financing			
Share issue costs	—	—	(0.1)
Increase (decrease) in revolving loan (note 12)	6.4	(12.5)	(105.7)
Issue of long-term debt (note 12)	—	333.1	212.7
Repayment of long-term debt (note 12)	—	(266.1)	—
Premium and expenses on repayment of long-term debt	—	(15.0)	—
Deferred financing costs	0.1	(6.2)	(5.6)
Decrease in other long-term obligations	(32.5)	(30.0)	(27.7)
Cash flows provided (used) by financing activities	<u>(26.0)</u>	<u>3.3</u>	<u>73.6</u>
Cash and cash equivalents, increase (decrease) during year	<u>(26.0)</u>	<u>26.0</u>	<u>—</u>
Cash and cash equivalents, beginning of year	<u>26.0</u>	<u>—</u>	<u>—</u>
Cash and cash equivalents, end of year	<u>\$ —</u>	<u>\$ 26.0</u>	<u>\$ —</u>
Supplemental information:			
Income taxes paid	\$ 3.9	\$ 4.3	\$ 7.1
Net interest paid	75.3	79.0	79.1
Common shares issued for acquisition of paper recycling business (note 4)	—	—	29.1

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BUSINESS SEGMENTS*(In millions of dollars)*

	Year ended December 31, 2005				
	Specialty Papers	Newsprint	Pulp	Corporate Adjustments	Consolidated
Sales to external customers	\$ 994.7	\$ 529.1	\$ 300.1	\$ -	\$ 1,823.9
Inter-segment sales	-	-	83.3	(83.3)	-
Amortization	97.8	45.8	36.7	-	180.3
Operating earnings (loss)	21.4	12.3	(58.8)	-	(25.1)
Total assets	1,416.8	736.4	524.2	18.5	2,695.9
Additions to property, plant and equipment	50.1	23.6	21.5	-	95.2

	Year ended December 31, 2004				
	Specialty Papers	Newsprint	Pulp	Corporate Adjustments	Consolidated
Sales to external customers	\$ 1,037.2	\$ 553.1	\$ 287.9	\$ -	\$ 1,878.2
Inter-segment sales	-	-	127.2	(127.2)	-
Amortization	101.5	49.5	33.1	-	184.1
Operating earnings (loss)	1.9	(4.3)	(28.9)	-	(31.3)
Total assets	1,406.0	741.3	576.9	21.7	2,745.9
Additions to property, plant and equipment	28.5	10.1	29.4	-	68.0

	Year ended December 31, 2003				
	Specialty Papers	Newsprint	Pulp	Corporate Adjustments	Consolidated
Sales to external customers	\$ 1,002.7	\$ 539.2	\$ 278.6	\$ -	\$ 1,820.5
Inter-segment sales	-	-	171.5	(171.5)	-
Amortization	98.5	61.7	29.7	-	189.9
Operating earnings (loss)	(32.5)	(56.6)	(22.5)	-	(111.6)
Total assets	1,441.8	773.4	575.8	25.4	2,816.4
Additions to property, plant and equipment	28.1	25.6	27.7	-	81.4

See accompanying note 20 to the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

1. NATURE OF OPERATIONS

On October 3, 2005, the shareholders authorized Norske Skog Canada Limited to change its name to Catalyst Paper Corporation.

Catalyst Paper Corporation, together with its subsidiaries (collectively, the "Company") is a significant newsprint and specialty groundwood paper producer in North America. The Company operates four manufacturing divisions, and one paper recycling division in British Columbia, Canada. The Company operates in three business segments.

Specialty Papers	– Manufacture and sale of groundwood specialty printing paper and kraft paper.
Newsprint	– Manufacture and sale of newsprint.
Pulp	– Manufacture and sale of softwood pulps.

The primary markets for the Company's paper products are North America, Latin America and the Pacific Rim. The primary markets for the Company's pulp products are Europe and the Pacific Rim.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company are expressed in millions of Canadian dollars and are prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). These financial statements differ in certain respects from those prepared in accordance with United States generally accepted accounting principles ("U.S. GAAP"). These measurement differences are described in note 24 "Differences between United States and Canadian generally accepted accounting principles".

(a) Basis of consolidation

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 and partnership. All inter-company transactions and amounts have been eliminated on consolidation. In addition, the consolidated financial statements include the accounts of variable interest entities from the date it is determined that the Company is the primary beneficiary (note 3(a)).

(b) Use of estimates

The consolidated financial statements have been prepared in conformity with Canadian GAAP, which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the year. On an ongoing basis, management reviews its estimates, including those related to environmental and legal liabilities, impairment of long-lived assets, pension and post-retirement benefits, bad debt and doubtful accounts and income taxes, based on currently available information. Actual amounts could differ from those estimates.

(c) Revenue recognition

The Company recognizes revenues upon shipment when the significant risks and rewards of ownership are transferred to the customer. Title of the products is typically transferred to the customers at the time of shipment, and payment is based on agreed prices and credit terms contained in sales invoices. Customers have no contractual right of return.

(d) Translation of foreign currencies

The majority of the Company's sales are denominated in foreign currencies, principally the U.S. dollar. Revenue and expense items denominated in foreign currencies are translated at exchange rates prevailing during the period. Monetary assets and liabilities of the Company's operations denominated in foreign currencies are translated at the period-end exchange rates. Non-monetary assets and liabilities are translated at exchange rates in effect when the assets are acquired or the obligations are incurred. Foreign exchange gains and losses are reflected in net earnings (loss) for the period.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

9

(e) Derivative financial instruments

The Company uses derivative financial instruments in the management of foreign currency, interest rate and commodity price exposures. The Company's policy is to use derivatives for managing existing financial exposures and not for trading or speculative purposes. The Company uses hedge accounting to account for the derivative financial instruments designated as hedging instruments, and the fair value method to account for derivative financial instruments not designated as hedging instruments. In order for a derivative to qualify for hedge accounting, the Company designates the hedge relationship and formally documents at its inception, the particular risk management objective and strategy, the specific asset, liability or cash flow being hedged, as well as how effectiveness is assessed. Risk management strategies and relationships are assessed on an on-going basis to ensure each derivative instrument is effective in accomplishing the objective of offsetting either changes in the fair value or cash flow attributable to the exposure being hedged both at inception and over the term of the hedging relationship.

Realized and unrealized gains or losses associated with hedging instruments are recognized in earnings in the same period the hedged item is recognized. Realized and unrealized gains or losses when hedging instruments have ended or ceased to be effective prior to their maturity are deferred and recognized in earnings concurrently with the recognition of the item being hedged.

Foreign exchange exposure to foreign currency revenue and related receivables, primarily in U.S. currency, is managed through the use of foreign exchange forward contracts and options to sell foreign currencies. Realized foreign exchange translation gains and losses from transactions formally designated as hedges are recognized concurrently with the hedged revenue in "Sales". Instruments that are not designated as hedges are included in "Prepays and other" or "Accounts payable and accrued liabilities" on the consolidated balance sheet at their fair value. Gains and losses, both realized and unrealized, from such instruments that are not designated as hedges are also recorded in "Sales".

Price risk associated with the sale of products or purchase of certain inputs, primarily oil and gas, is managed from time to time through the use of commodity swaps. Realized gains and losses from transactions formally designated as hedges are recognized concurrently with the hedged item in "Cost of sales". Instruments that are not designated as hedges are included in "Prepays and other" or "Accounts payable and accrued liabilities" on the consolidated balance sheet at their fair value. Changes in fair value are recognized in "Cost of sales".

Foreign currency exposure on long-term debt denominated in U.S. currency is managed through the use of forward contracts and options to purchase U.S. dollars. These instruments are reported under "Other assets" or "Other long-term obligations" on the consolidated balance sheet at their fair value with changes in fair value recognized in "Foreign exchange gain on translation of long-term debt", offsetting the respective translation gains and losses on the underlying foreign currency long-term debt.

Exposure to interest rates on long-term debt is managed through the use of interest swaps. These swap agreements require the periodic exchange of payments without the exchange of the notional principal amount on which the payments are based. Settlement amounts under interest swap agreements formally designated as hedges are recognized in "Interest expense, net", offsetting the interest expense otherwise incurred.

Cash flows from derivative financial instruments that are designated as hedges are classified in "Operations" on the consolidated statement of cash flows consistent with the hedged transaction. Derivatives not designated as hedges are also classified in "Operations".

(f) Cash and cash equivalents

Cash and cash equivalents include cash and short-term investments with original maturities of less than three months and are presented at cost, which approximates market value.

(g) Inventories

Inventories, other than supplies which are valued at cost, are valued at the lower of average cost and net realizable value.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

(h) Property, plant and equipment

Property, plant and equipment are stated at cost, which includes capitalized interest during construction, less accumulated amortization, including asset impairment charges.

Buildings, machinery and equipment are amortized on a straight-line basis at rates that reflect estimates of the economic lives of the assets. The rates for major classes of assets are:

Buildings	2.5 – 5.0%
Pulp and paper machinery and equipment	5.0%

During periods of major production interruption, an obsolescence amount of 10% of normal amortization is charged on manufacturing equipment.

No amortization is charged on capital projects during the period of construction. Start-up costs incurred in achieving normal operating capacity on major capital projects are deferred and amortized over a five-year period.

(i) Impairment of long-lived assets

Long-lived assets are tested for recoverability when events or changes in circumstances indicate their carrying value may not be recoverable. A long-lived asset is potentially not recoverable when its carrying value is greater than the sum of its undiscounted cash flows expected to result from its use and eventual disposition. The impairment loss, if any, is measured as the amount by which the long-lived asset's carrying amount exceeds its fair value.

(j) Environmental costs

Environmental expenditures are expensed or capitalized depending upon their future economic benefit. Expenditures that prevent future environmental contamination are capitalized as part of "Property, plant and equipment", and amortization is subsequently charged to income over the estimated future benefit period of the assets. Expenditures that relate to an existing condition caused by past operations are expensed. Liabilities are recorded on an undiscounted basis when rehabilitation efforts are likely to occur and the costs can be reasonably estimated.

(k) Asset retirement obligations

Asset retirement obligations are recognized, at fair value, in the period in which the Company incurs a legal obligation associated with the retirement of an asset. The associated costs are capitalized as part of the carrying value of the related asset and depreciated over its remaining useful life. The liability is accreted using a credit adjusted risk-free interest rate.

(l) Deferred financing costs

Deferred financing costs are included in "Other assets" on the consolidated balance sheet and represent the issuance costs of the Company's long-term debt. Related amortization is included in "Interest expense, net" on a straight-line basis over the term of the debt.

(m) Share issue costs

Direct costs of issuing shares, net of income tax recoveries thereon, are applied to reduce the value of consideration assigned to such shares.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

(n) Stock-based compensation and other stock-based payments after January 1, 2004

The Company uses the fair-value based method of accounting for stock-based payments to key officers, directors and for stock options granted to its employees. Under the fair-value based method, compensation cost is measured at fair value at the date of grant, and is expensed over the award's vesting period. Any consideration paid by plan participants on the exercise of share options or the purchase of shares is credited to "Share capital" together with any related stock-based compensation expense.

Deferred share units ("DSU") settleable in cash are amortized over their vesting periods and remeasured at each reporting period, until settlement, using the quoted market value. DSUs are accounted for as compensation expense and recorded in "Accounts payable and accrued liabilities".

(o) Income taxes

Income taxes are accounted for using the liability method. Future income tax assets and liabilities are based on temporary differences (differences between the accounting basis and the tax basis of the assets and liabilities) and non-capital loss carry-forwards and are measured using the enacted or substantively enacted tax rates and laws expected to apply when these differences reverse. Future tax benefits, including non-capital loss carry-forwards, are recognized to the extent that realization of such benefits is considered more likely than not. The effect on future tax assets and liabilities of a change in tax rates is recognized in earnings in the period that substantive enactment occurs.

(p) Deferred credits

Deferred credits represent the excess of amounts assigned to future income tax assets for tax losses acquired in other than business combinations over the consideration paid. Deferred credits are amortized to "Income tax recovery" in the consolidated statement of earnings over the period that the acquired tax asset is utilized.

(q) Employee future benefits

Pensions and other employee future benefits

The estimated cost for pensions and other employee future benefits provided to employees by the Company is accrued using actuarial techniques and assumptions during the employees' active years of service. These plans include funded and unfunded defined benefit plans and defined contribution plans. The net periodic benefit cost includes:

- the cost of benefits provided in exchange for employees' services rendered during the year,
- the interest cost of benefit obligations,
- the expected long-term return on pension fund assets based on the fair value for all asset classes,
- gains or losses on settlements or curtailments,
- the straight-line amortization of past service costs and plan amendments over the average remaining service period of the active employee group covered by the plans, unless the period is less than five years, in which case such costs are amortized over five years, and
- the amortization of cumulative unrecognized net actuarial gains and losses in excess of 10% of the greater of the accrued benefit obligation and the fair value of plan assets at the beginning of year over the average remaining service period of the active employee group covered by the plans, unless the period is less than five years, in which case such costs are amortized over five years.

The plan obligations are determined in accordance with the projected benefit method prorated on services.

(r) Earnings per share

Basic earnings (loss) per share are computed by dividing net earnings (loss) for the period by the weighted average shares outstanding during the reporting period. Diluted earnings (loss) per share are computed using the treasury stock method. When the effect of options and other securities convertible into common shares is anti-dilutive, including when the Company has incurred a loss for the period, basic and diluted loss per share are the same.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

14

(s) Comparative figures

Certain comparative figures disclosed in the consolidated financial statements have been reclassified to conform with the presentation adopted for the current year.

3. CHANGE IN ACCOUNTING POLICIES**(a) Variable interest entities**

Effective January 1, 2005, the Company adopted the Canadian Institute of Chartered Accountants ("CICA") Accounting Guideline 15, "Consolidation of Variable Interest Entities" ("AcG-15") on a prospective basis. AcG-15 prescribes the application of consolidation principles for entities that meet the definition of a variable interest entity ("VIE"). AcG-15 requires that an enterprise holding other than a voting interest in a VIE could, subject to certain conditions, be required to consolidate the VIE if the enterprise is considered its primary beneficiary whereby it would absorb the majority of the VIE's expected losses, receive the majority of its expected residual returns, or both.

The adoption of AcG-15 resulted in the consolidation of 100% of Powell River Energy Inc. ("PREI"). PREI commenced operations February 2001, and consists of an integrated hydroelectric power generating, transmission and distribution system which includes two hydroelectric generating stations that provide power to the Company. The Company purchases 100% of the power generated by PREI. The Company's 50.0% interest in PREI was previously accounted for using the proportionate consolidation method.

The Company has limited access to PREI's assets, which generally takes the form of interest on loans, management fees and earnings distributions based on the Company's interest in PREI. In addition, creditors of PREI have recourse limited to the assets in PREI. The change in consolidation method does not change the Company's obligations with regard to PREI.

Upon adoption of AcG-15, the Company measured the assets, liabilities, and non-controlling interest of PREI at their carrying amounts and the consolidation of the additional 50.0% of PREI resulted in the following adjustments at January 1, 2005:

Current assets	\$	2.5
Property, plant and equipment		56.9
Other assets ¹		15.7
Current liabilities		(3.3)
Long-term debt		(56.9)
Future income taxes		(14.9)

¹ "Other assets" includes \$16.3 million of non-controlling interest, representing PREI's deficit.

The adoption of AcG-15 is not expected to have a material impact on consolidated net earnings (loss) going forward. The following summarizes the impact the adoption of AcG-15 had on the Company's consolidated statement of earnings in the year ended December 31, 2005:

	Year ended, December 31, 2005
Cost of sales recovery	\$ 7.0
Amortization expense	(1.4)
Interest expense	(5.9)
Income tax recovery – current	0.1
Income tax recovery – future	0.8
Non-controlling interest	(0.6)
Net earnings (loss)	\$ —

The Company has identified two other potential VIEs, but has not been able to obtain the financial information necessary to evaluate whether the entities are VIEs, or if the entities are VIEs, whether the Company is the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

primary beneficiary. The two potential VIEs are private entities and, as such, are unwilling to share financial information with the Company. The potential VIEs are related to each other, and together they provide the Company with warehousing services for a large portion of the Company's paper products. The Company first contracted with these entities in 1999. The amounts paid to these entities are not significant relative to the Company's total distribution costs.

The Company has entered into a building lease agreement with one of the potential VIEs whereby it has agreed to continue making the prescribed lease payments directly to the financial institution holding the mortgage on the building in the event the lessor is no longer able to meet its contractual obligations. As at December 31, 2005, the principal amount of the mortgage was approximately \$13.0 million. This agreement does not increase the Company's liability beyond the obligation under the building lease.

(b) Asset retirement obligations

On December 6, 2005, the CICA's Emerging Issues Committee issued Abstract Number 159, "Conditional Asset Retirement Obligations," ("EIC-159") effective for interim and annual reporting periods ending after March 31, 2006. Effective December 31, 2005, the Company early adopted EIC-159.

EIC-159 clarifies that the term, "conditional asset retirement obligation," as used in CICA Handbook ("the Handbook") Section 3110, "Asset Retirement Obligations," refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. EIC-159 also clarifies what constitutes sufficient information to reasonably estimate the fair value of a conditional asset retirement obligation, and that if sufficient information is not available to reasonably estimate a conditional asset retirement obligation at the time the liability is incurred that the obligation should be recognized initially in the period in which sufficient information becomes available to estimate its fair value.

As a result of the adoption of EIC-159, the Company concluded that the obligations for the proper removal and disposal of asbestos products in the Company's mills meet the definition of a conditional asset retirement obligation. That is, the Company is subject to regulations that are in place to ensure that asbestos fibres do not become friable, or loose. The regulations require that friable asbestos be repaired or removed in accordance with the regulations.

The Company's asbestos can generally be found on steam and condensate piping systems throughout its facilities, as well as in transite cladding on buildings and in building insulation. As a result of the longevity of the Company's mills, due in part to the Company's maintenance procedures, and the fact that the Company does not have plans for major changes that would require the removal of asbestos, the timing of the removal of asbestos in the Company's mills is indeterminate as at December 31, 2005. As a result, the Company is currently unable to estimate the fair value of its asbestos removal and disposal obligation. Consequently, the adoption of EIC-159 did not have an impact on the consolidated financial statements for the year ended December 31, 2005.

(c) Stock-based compensation

Effective January 1, 2004, the Company adopted the CICA amended recommendation of Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments". These recommendations require the use of a fair-value based approach for the accounting of stock-based compensation awards granted to employees. Under the fair-value based method, compensation cost is measured at fair value at the date of grant, and is expensed over the award's vesting period. The standard was applied retroactively without restatement of prior periods, and resulted in an adjustment of \$2.6 million to the contributed surplus and the opening balance of retained earnings of the year ended December 31, 2004, to reflect the cumulative effect of applying the fair-value based method to all employee stock options granted on or after January 1, 2002. For the years ended December 31, 2004 and 2005, the Company recorded \$2.2 million and \$2.5 million, respectively, as an expense for the stock-based compensation plans. During fiscal 2003, the Company accounted for stock-based payments to non-employees, and employee awards of stock, that call for settlement in cash or other assets, or stock appreciation rights that call for net settlement by the issuance of equity instruments, granted on or after January 1, 2002, using the fair value method. No compensation cost was recorded for all other stock-based employee

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

compensation awards. The pro forma disclosures with respect to the years ended December 31, 2003 are provided in note 16 of the consolidated financial statements.

4. BUSINESS ACQUISITION

On December 1, 2003, the Company completed the acquisition of a paper recycling business from Newstech Recycling Partnership (the "Acquisition") for a total purchase price of \$61.1 million, including working capital. The Company's consideration was comprised of \$31.5 million in cash, \$29.0 million in equity and \$0.6 million in transaction costs. The value of the 8,693,988 common shares issued was determined by the weighted average trading price of the Company's common shares over the two-day period before December 1, 2003, which was the date the terms of the Acquisition were agreed to and announced.

The Acquisition has been accounted for using the purchase method of accounting and the results of the operations of the business have been consolidated from the date of acquisition.

5. INTEREST EXPENSE, NET

The components of interest expense, net, for the years ended December 31 were as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Interest on long-term debt	\$ 77.7	\$ 79.0	\$ 80.7
Fixed-to-floating interest rate swaps	(3.9)	(6.8)	(8.5)
Amortization of deferred financing costs	3.0	3.7	4.3
Capitalized interest	—	(0.3)	(0.9)
Interest income	(0.9)	(0.4)	(0.5)
Other	(0.2)	(0.3)	(0.1)
	<u>\$ 75.7</u>	<u>\$ 74.9</u>	<u>\$ 75.0</u>

6. INCOME TAXES

The components of income tax recovery for the years ended December 31 were as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Current	\$ 5.0	\$ 3.2	\$ 5.9
Future	(37.4)	(31.3)	(67.9)
Release of future taxes related to reduction in provincial corporate income tax rate	(14.2)	—	—
	<u>\$ (46.6)</u>	<u>\$ (28.1)</u>	<u>\$ (62.0)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

The reconciliation of income taxes calculated at the statutory rate to the actual income tax provision for the years ended December 31 was as follows:

	<u>2005</u>		<u>2004</u>		<u>2003</u>	
Income tax recovery at Canadian statutory income tax rates	\$	(24.9)	34.8%	\$	(20.1)	35.5%
Increase (decrease) in income taxes for:						
Non-taxable income and expenses		(2.5)	3.5%		(8.1)	14.3
Difference in foreign tax rate		(2.0)	2.8%		(2.3)	4.0
Release of future income taxes related to reduction in provincial corporate income tax rate		(14.2)	19.8%		—	—
Release of deferred credits		(5.0)	7.0%		—	(5.3)
Large corporations tax		3.5	(4.9)%		4.3	(7.6)
Other		(1.5)	2.1%		(1.9)	3.3
Income tax recovery	\$	(46.6)	65.1%	\$	(28.1)	49.5%
					\$	(62.0)
						42.3%

The tax effects of temporary differences that give rise to significant future tax liabilities (assets) at December 31 were as follows:

	<u>2005</u>		<u>2004</u>	
Future income tax liabilities				
Property, plant and equipment	\$	486.0	\$	535.9
Other		90.4		86.8
		576.4		622.7
Future income tax assets				
Non-capital loss carry-forwards		(203.2)		(206.5)
Employee future benefits		(64.3)		(67.3)
Other		(13.9)		(22.3)
		(281.4)		(296.1)
Valuation allowance		5.9		6.3
		(275.5)		(289.8)
Net future income tax liability	\$	300.9	\$	332.9

7. EARNINGS PER SHARE

The following table provides the reconciliation between basic and diluted earnings (loss) per share:

	<u>2005</u>		<u>2004</u>		<u>2003</u>	
Net earnings (loss) reported	\$	(25.6)	\$	(28.6)	\$	(84.5)
Weighted average shares used in computation of basic earnings per share (in millions)		214.6		214.6		206.6
Weighted average shares from assumed conversion of dilutive options (in millions)		—		—		—
Weighted average shares used in computation of diluted earnings per share (in millions)		214.6		214.6		206.6
Basic and diluted earnings (loss) per share (in dollars)	\$	(0.12)	\$	(0.13)	\$	(0.41)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

20

8. INVENTORIES

The components of inventories at December 31 were as follows:

	<u>2005</u>	<u>2004</u>
Specialty papers	\$ 54.4	\$ 53.7
Newsprint	23.5	28.5
Pulp	19.5	25.3
Total finished goods and work in progress	97.4	107.5
Wood chips, pulp logs and other raw materials	36.1	56.1
Operating and maintenance supplies	112.2	94.5
	<u>\$ 245.7</u>	<u>\$ 258.1</u>

9. PROPERTY, PLANT AND EQUIPMENT

The components of property, plant and equipment at December 31 were as follows:

	<u>2005</u>		
	<i>Cost</i>	<i>Accumulated Amortization</i>	<i>Net Book Value</i>
Buildings and land			
Specialty papers and newsprint	\$ 482.3	\$ 156.1	\$ 326.2
Pulp	107.8	44.0	63.8
Machinery and equipment			
Specialty papers and newsprint	\$ 2,475.6	\$ 1,067.4	\$ 1,408.2
Pulp	844.3	503.2	341.1
	<u>\$ 3,910.0</u>	<u>\$ 1,770.7</u>	<u>\$ 2,139.3</u>
	<u>2004</u>		
	<i>Cost</i>	<i>Accumulated Amortization</i>	<i>Net Book Value</i>
Buildings and land			
Specialty papers and newsprint	\$ 406.6	\$ 135.3	\$ 271.3
Pulp	105.0	42.0	63.0
Machinery and equipment			
Specialty papers and newsprint	\$ 2,432.7	\$ 966.5	\$ 1,466.2
Pulp	850.4	478.0	372.4
	<u>\$ 3,794.7</u>	<u>\$ 1,621.8</u>	<u>\$ 2,172.9</u>

In December 2003, the Company recorded a property, plant and equipment write-down of \$14.2 million relating to the permanent closure of a portion of its pulp producing capacity at its Elk Falls mill in early 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

21

10. OTHER ASSETS

The components of other assets at December 31 were as follows:

	2005	2004
Deferred financing costs	\$ 18.3	\$ 21.5
Non-controlling interest (note 3(a))	16.4	—
Deferred charges and other	5.4	6.0
	<u>\$ 40.1</u>	<u>\$ 27.5</u>

11. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

The components of accounts payable and accrued liabilities at December 31 were as follows:

	2005	2004
Trade accounts payable	\$ 142.9	\$ 141.8
Accrued payroll and related liabilities	82.5	86.4
Pension plans (note 17)	11.6	18.1
Post-retirement benefit plans (note 17)	5.5	5.6
Accrued interest	10.8	10.6
Other	26.1	23.0
	<u>\$ 279.4</u>	<u>\$ 285.5</u>

12. LONG-TERM DEBT

The Company's long-term debt, all of which matures beyond one year, at December 31 was as follows:

	2005	2004
Recourse		
Senior notes, 8.625% due June 2011 (US\$400.0 million)	\$ 469.4	\$ 485.1
Senior notes, 7.375% due March 2014 (US\$250.0 million)	291.5	300.9
	760.9	786.0
Revolving operating facility of up to \$350.0 million due July 2008	6.5	—
	767.4	786.0
Non-recourse (PREI) (note 3(a))		
First Mortgage Bonds, 6.387% due July 2009	75.0	37.6
Subordinated promissory notes	19.5	—
	94.5	37.6
	<u>\$ 861.9</u>	<u>\$ 823.6</u>

During the year ended December 31, 2005, the maturity of the \$350.0 million revolving operating facility (the "Facility") was extended by one year, to July 2008. Borrowings under the Facility bear interest at a rate based on Canadian dollar banker's acceptance/prime or U.S. dollar LIBOR/base rates, plus a margin that varies with the Company's credit rating. The interest rates on borrowings under the Facility averaged 5.1% in 2005 (2004 – 5.3%). A commitment fee at a percentage of the margin applies to the undrawn portion of the Facility. Substantially all of the assets of the Company are pledged as security under the Facility. Its availability is determined by a borrowing base, calculated based on accounts receivable and inventory balances, and includes covenants to maintain the funded

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

debt/capitalization ratio below 60%, secured debt/capitalization ratio below 30% and shareholders' equity above \$779.3 million as at December 31, 2005. At December 31, 2005, the Facility had \$6.5 million drawn against it and after outstanding letters of credit of \$22.3 million, \$316.0 million was available to the Company. An interest coverage covenant is applicable in certain circumstances if the Company incurs secured debt other than under the Facility. As of December 31, 2005, no such debt has been incurred.

On March 23, 2004, the Company issued, at par, US\$250.0 million 7.375% senior notes due March 1, 2014 for cash proceeds of \$333.1 million. The net proceeds were used to redeem the 10% senior notes and for general corporate purposes. The Company recorded a loss of \$5.2 million on repayment of the 10% senior notes.

The indentures and agreements governing the Company's senior notes and the Facility contain customary restrictive covenants, including restrictions on the incurrence of additional indebtedness, certain payments including dividends and investments in other persons, the creation of liens, sale and leaseback transactions, certain amalgamations, mergers, consolidations and the use of proceeds arising from certain sales of assets and certain transactions with affiliates. At December 31, 2005 and 2004, the Company was in compliance with the covenants under both its Facility and senior notes. The Company's consolidated fixed charge coverage ratio ("CFCC Ratio") as calculated under the senior note indentures was at 2.0:1 for the last twelve months ended December 31, 2005 (2004 - 2.0:1). If this CFCC Ratio goes below 2.0:1, the Company is limited in the amount of additional debt it may incur beyond drawings under the Facility or other debt as permitted under the senior notes. Also, the Company's restricted payments basket under the senior notes was negative \$69 million as at December 31, 2005 (2004 - negative \$26 million), as a result of accumulated losses in recent years. Under the 8.625% senior notes, the Company cannot pay dividends unless the balance in this basket is positive.

Scheduled long-term debt repayments

	Recourse Debt	Non-recourse Debt
2006	\$ -	\$ -
2007	-	-
2008	6.5	-
2009	-	75.0
2010	-	-
Thereafter	760.9	19.5
	<u>\$ 767.4</u>	<u>\$ 94.5</u>

Fair value of long-term debt

The following estimated fair values of the Company's long-term debt at December 31 have been determined based on management's best estimate of the fair value to refinance debt with similar terms at the respective year-end dates:

	2005	2004
Recourse	\$ 706.1	\$ 830.0
Non-recourse	97.3	39.8
	<u>\$ 803.4</u>	<u>\$ 869.8</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

13. OTHER LONG-TERM OBLIGATIONS

The components of other long-term obligations at December 31 were as follows:

	<u>2005</u>	<u>2004</u>
Pension plans (note 17)	\$ 27.8	\$ 33.2
Other post-retirement benefit plans (note 17)	143.8	132.1
Forward foreign currency contracts hedging long-term debt	25.2	44.1
Deferred gain on termination of interest rate swaps	1.1	4.2
Environmental, remedial and other	11.8	20.0
	<u>\$ 209.7</u>	<u>\$ 233.6</u>

14. DEFERRED CREDITS

Continuity of deferred credits for the years ended December 31 was as follows:

	<u>2005</u>	<u>2004</u>
Beginning of year	\$ 27.5	\$ 21.0
Net price adjustment related to acquired tax losses	2.4	6.5
Adjustment related to utilization of acquired tax losses (note 2(p))	(5.0)	—
Adjustment resulting from reduction in provincial corporate income tax rate	(0.6)	—
End of year	<u>\$ 24.3</u>	<u>\$ 27.5</u>

In prior years, the Company acquired from wholly owned subsidiaries of Fletcher Challenge Limited ("FCL"), a major shareholder up to July 28, 2000, companies with available tax losses. The purchase price of these companies is subject to adjustment under certain conditions. During the year, the Company recorded a downward adjustment of \$2.4 million (net of taxes of \$0.3 million on the interest component), reflecting a reduction to the purchase price (2004 – \$6.5 million).

15. SHARE CAPITAL

(a) Authorized

The Company is authorized to issue 100,000,000 preferred shares and an unlimited number of common shares.

(b) Issued and outstanding

	<u>2005</u>	<u>2004</u>
	<u>Shares</u>	<u>Shares</u>
Issued and outstanding:		
Common shares	<u>214,604,120</u>	<u>214,604,120</u>

16. STOCK-BASED COMPENSATION PLANS

(a) Stock option plans

The Company has an employee share option plan (the "Plan") for its key officers, directors and employees. Options granted prior to January 31, 2003, have a term of five years and the options granted thereafter have a term of ten years. These options are exercisable as to 1/3 on and after the first anniversary date, as to 2/3 on and

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

25

after the second anniversary date and as to all on and after the third anniversary date, unless the market price of the common shares exceeds a specified acceleration price, in which case all of the options are exercisable at that date. Market price is determined by the weighted average price per share for all sales of the shares on the Toronto Stock Exchange ("TSX") during the ten consecutive trading days preceding the date on which a determination of Market Price is required under the Plan. The Plan provides for the issuance of up to a maximum of 10.0 million common shares.

Effective January 1, 2004, the Company applies the fair value method for recording share options granted to directors, officers and employees. The pro forma effect on net earnings (loss) and net earnings (loss) per common share if the fair value method had been used in the year ended December 31, 2003 to determine compensation cost for share options is as follows:

	2003
Net loss	
As reported	\$ (84.5)
Pro forma	(86.5)
Net loss per common share (in dollars)	
As reported	\$ (0.41)
Pro forma	(0.42)

The fair value of share options was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	2005	2004	2003
Risk-free interest rate	3.7%	4.5%	4.9%
Annual dividends per share	Nil	Nil	Nil
Expected stock price volatility	30.3%	28.3%	27.3%
Expected option life (in years)	4.0	4.0	4.0
Average fair value of options granted (in dollars)	\$1.11	\$1.50	\$1.73

Changes during the years ended December 31, in the number of options outstanding, were as follows:

	2005		2004		2003	
	<i>Number of Options</i>	<i>Weighted Average Exercise Price (in dollars)</i>	<i>Number of Options</i>	<i>Weighted Average Exercise Price (in dollars)</i>	<i>Number of Options</i>	<i>Weighted Average Exercise Price (in dollars)</i>
Beginning of year	5,951,333	\$ 5.62	4,495,500	\$ 6.07	4,722,000	\$ 6.08
Granted	2,886,000	3.58	1,637,500	4.39	100,000	5.81
Exercised	—	—	—	—	—	—
Expired or cancelled	(427,833)	4.14	(181,667)	5.67	(326,500)	6.20
End of year	8,409,500	\$ 5.00	5,951,333	\$ 5.62	4,495,500	\$ 6.07

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

The following table summarizes information about stock options outstanding and exercisable at December 31, 2005:

<i>Options Outstanding</i>				<i>Options Exercisable</i>			
<i>Exercise Prices</i>	<i>Number of Options</i>	<i>Weighted Average Remaining Option Life (years)</i>	<i>Weighted Average Exercise Price (in dollars)</i>	<i>Number of Options</i>	<i>Weighted Average Exercise Price (in dollars)</i>	<i>Accelerated Price (in dollars)</i>	
\$ 6.60	1,221,500	0.7	\$ 6.60	1,221,500	\$ 6.60	\$ 9.47	
7.13	1,011,000	1.1	7.13	1,011,000	7.13	10.00	
5.25	1,916,000	1.8	5.25	1,916,000	5.25	7.54	
5.81	50,000	2.1	5.81	33,333	5.81	8.35	
4.39	1,533,333	8.1	4.39	545,833	4.39	6.30	
3.62	2,397,667	9.1	3.62	-	3.62	5.20	
3.18	220,000	9.5	3.18	-	3.18	4.57	
3.31	60,000	9.6	3.31	-	3.31	4.75	
	8,409,500	5.0	\$ 5.00	4,727,666	\$ 5.91	\$ 8.43	

(b) Deferred share unit plan

The Company has established a DSU plan for its directors. Under the terms of this plan, directors may elect to receive their annual remuneration in DSUs, cash or a combination thereof. Each DSU initially has a value equivalent to the Company's weighted average share price on the TSX, during the ten consecutive trading days prior to the issuance date of the DSU. A director's DSU account is credited with dividend equivalents in the form of additional DSUs when dividends are paid on common shares. A director may elect the date of redemption by filing an irrevocable written election with the Company no later than November 15 of the calendar year commencing immediately after the director's termination date. The value shall be paid by the Company as a lump sum in cash, equal to the fair value of the notional underlying common shares plus accrued dividend equivalents at that date, after deduction of applicable taxes and other source deductions required to be withheld. During the year ended December 31, 2005, the Company recognized \$0.6 million in expense (2004 - \$0.5 million) related to DSUs. As at December 31, 2005, 320,982 DSUs are outstanding under this plan (2004 - 225,336 DSUs) and there is approximately \$1.0 million payable (2004 - \$0.8 million).

17. EMPLOYEE FUTURE BENEFITS

Description of benefit plans

The Company maintains pension benefit plans, which include defined benefit and defined contribution segments. Employees hired subsequent to January 1, 1994, enroll in the defined contribution segment.

The defined benefit segment provides a pension based on years of service and earnings. For the defined contribution segment, the Company's contributions are based on a percentage of an employee's earnings with the Company's funding obligations being satisfied upon crediting contributions to an employee's account.

The Company provides other benefit plans consisting of provincial medical plan premiums, extended health care and dental benefits to eligible retired employees and their dependents. Assumed health care trend rates have a significant effect on the amounts reported for the post-retirement medical plans.

Total cash payments

Total cash payments for employee future benefits for the year ending December 31, 2005, consisting of cash contributed by the Company to its funded pension plans, cash payments directly to beneficiaries for its unfunded other benefit plans and cash contributed to its defined contribution plans, was \$32.3 million (2004 - \$29.4 million).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

Defined benefit plan

The Company measures the fair value of plan assets and the accrued benefit obligations for accounting purposes as at December 31 of each year. The most recent actuarial valuation of the majority of pension plans for funding purposes was as of December 31, 2003, and the next required valuation will be as of December 31, 2006.

Change in accrued defined benefit plan obligation

The following table represents the change in the accrued benefit obligation as determined by independent actuaries:

	<i>Pension Benefit Plans</i>		<i>Other Benefit Plans</i>	
	<i>2005</i>	<i>2004</i>	<i>2005</i>	<i>2004</i>
Accrued benefit obligations at beginning of year	\$ 335.4	\$ 327.2	\$ 178.2	\$ 183.6
Service cost for the year	5.4	4.5	4.2	4.3
Interest cost	19.4	19.8	10.7	11.1
Employee contributions	0.4	0.5	—	—
Benefit payments	(26.9)	(26.0)	(5.2)	(5.3)
Actuarial loss (gain) and other adjustments	31.2	9.4	28.9	(15.5)
Accrued benefit obligations balance at end of year	\$ 364.9	\$ 335.4	\$ 216.8	\$ 178.2

Change in fair value of defined benefit plan assets

The following table represents the change in the fair value of assets of defined benefit plans:

	<i>Pension Benefit Plans</i>		<i>Other Benefit Plans</i>	
	<i>2005</i>	<i>2004</i>	<i>2005</i>	<i>2004</i>
Fair value of defined benefit plan assets, beginning of year	\$ 233.3	\$ 214.7	\$ —	\$ —
Actual return on plan assets	21.4	24.0	—	—
Employee contributions	0.4	0.5	—	—
Company contributions	22.3	19.1	5.3	5.5
Other	0.3	1.0	—	—
Benefit payments	(26.9)	(26.0)	(5.1)	(5.5)
Fair value of defined benefit plan assets, end of year	\$ 250.8	\$ 233.3	\$ 0.2	\$ —

The asset allocation for the Company's defined benefit pension plans, by asset category, were as follows:

<i>Plan assets at December 31,</i>	<i>2005</i>	<i>2004</i>
Equity securities	59.3%	57.4%
Fixed income securities	40.7%	42.6%
Total	100.0%	100.0%

Reconciliation of the funded status of the benefit plans to the amounts in the consolidated balance sheets

The following table presents the difference between the fair value of the defined benefit pension assets and the actuarially determined accrued benefit obligations as at December 31, 2005 and 2004. This difference is also referred to as either the deficit or surplus, as the case may be, or the funded status of the plans.

The table also reconciles the amount of the surplus or deficit (funded status) to the accrued benefit obligation in the consolidated balance sheets. This difference between the funded status and the obligation recognized in the

consolidated balance sheets, in accordance with Canadian GAAP, represents the portion of the surplus or deficit not yet recognized for accounting purposes. Deferred recognition is a key element of the Canadian GAAP pension accounting. This approach allows for a gradual recognition of changes in accrued benefit obligations and fund performance over the expected average remaining service life of the employee group covered by the plans.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

As at December 31, 2005, there was a total funding deficit of \$114.1 million (2004 – \$102.1 million) in the Company's various pension plans. Of this amount, \$69.7 million (2004 – \$60.4 million) related to funded defined benefit pension plans and \$44.4 million (2004 – \$41.7 million) to "pay-as-you-go" unfunded defined benefit pension plans. In addition, the Company has other "pay-as-you-go" post-retirement benefit plans, consisting of group health care and life insurance, which had a deficit of \$216.6 million at December 31, 2005 (2004 – \$178.2 million).

	<i>Pension Benefit Plans</i>		<i>Other Benefit Plans</i>	
	<i>2005</i>	<i>2004</i>	<i>2005</i>	<i>2004</i>
Accrued benefit obligation, end of year	\$ 364.9	\$ 335.4	\$ 216.8	\$ 178.2
Fair value of plan assets, end of year	250.8	233.3	0.2	–
Funded status deficit	(114.1)	(102.1)	(216.6)	(178.2)
Unrecognized past service costs	0.2	0.3	(2.1)	(2.3)
Unrecognized actuarial losses	74.7	50.7	69.4	42.8
Accrued benefit obligation recognized in the consolidated balance sheets	\$ (39.2)	\$ (51.1)	\$ (149.3)	\$ (137.7)

Classification of accrued obligations

The accrued benefit obligation is included in the Company's balance sheet as follows:

	<i>Pension Benefit Plans</i>		<i>Other Benefit Plans</i>	
	<i>2005</i>	<i>2004</i>	<i>2005</i>	<i>2004</i>
Other assets	\$ 0.2	\$ 0.2	\$ –	\$ –
Accounts payable and accrued liabilities	(11.6)	(18.1)	(5.5)	(5.6)
Other long-term obligations	(27.8)	(33.2)	(143.8)	(132.1)
	\$ (39.2)	\$ (51.1)	\$ (149.3)	\$ (137.7)

Components of net periodic benefit cost recognized in the year

<i>Pension Benefit Plans</i>	<i>2005</i>	<i>2004</i>	<i>2003</i>
Defined benefit costs			
Service cost for the year	\$ 5.4	\$ 4.5	\$ 4.0
Interest cost	19.4	19.8	20.4
Actual return on assets	(21.4)	(23.9)	11.7
Actuarial (gain)/loss	31.2	9.0	7.5
Prior service costs	–	–	–
Difference between actual and expected return	4.6	7.8	(28.3)
Difference between actual and recognized actuarial (gain)/loss	(28.5)	(5.7)	(4.9)
Difference between actual and recognized prior service costs	0.1	0.2	0.3
Amortization of transitional balance	0.1	(0.3)	(0.7)
	10.9	11.4	10.0
Defined contribution cost			
Service cost for the year	5.1	5.2	4.7
Net periodic benefit cost for pension benefit plans	\$ 16.0	\$ 16.6	\$ 14.7

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

<i>Other Benefit Plans</i>	<i>2005</i>	<i>2004</i>	<i>2003</i>
Defined benefit costs			
Service cost for the year	\$ 4.2	\$ 4.3	\$ 4.3
Interest cost	10.7	11.2	11.2
Actuarial (gain)/loss	28.9	(15.2)	13.0
Prior service costs	—	—	—
Difference between actual and recognized actuarial gain/(loss)	(27.1)	17.8	(10.1)
Difference between actual and recognized prior service costs	(0.2)	(0.2)	(0.2)
Net periodic benefit cost for other benefit plans	\$ 16.5	\$ 17.9	\$ 18.2

Multi-employer pension plans

Unionized employees of the Company are members of industry-wide benefit plans to which the Company contributes a predetermined amount per hour worked by an employee. The pension expense for these plans is equal to the Company's contribution of \$18.3 million for the year end December 31, 2005 (2004 – \$18.4 million; 2003 – \$18.4 million).

Significant assumptions

Actuarial assumptions used in accounting for the Company-maintained benefit plans were:

	<i>2005</i>	<i>2004</i>
Benefit obligations at December 31,		
Discount rate	5.00%	6.00%
Rate of compensation increase	3.00%	3.00%
Net expense for year ended December 31,		
Discount rate	6.00%	6.25%
Rate of compensation increase	3.00%	3.00%
Expected rate of return on plan assets	7.25%	7.50%
Assumed health care cost trend rate at December 31,		
<i>Extended health benefits</i>		
Initial health care cost trend rate	10.00%	11.00%
Annual rate of decline in trend rate	1.00%	1.00%
Ultimate health care cost trend rate	5.00%	5.00%
<i>Dental benefits</i>		
Dental care cost trend rate	5.00%	5.00%
<i>Medical services plan benefits</i>		
Premium trend rate	2.00%	5% until June 30, 2004, 2% thereafter

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

31**Sensitivity analysis**

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1% change in assumed health care cost rates would have the following effects for 2005.

	<i>Other Benefit Plans</i>	
	<i>Increase</i>	<i>Decrease</i>
Total of service and interest cost	\$ 3.2	\$ (2.4)
Accrued benefit obligation	\$ 39.7	\$ (31.4)

18. FINANCIAL INSTRUMENTS**Derivative financial instruments**

The Company uses derivative financial instruments to reduce its exposure to foreign currency and price risk associated with its revenues, energy costs and long-term debt. The Company also uses interest rate swaps to manage its net exposure to interest rate changes.

(a) Revenue risk management instruments

Foreign currency options and forward contracts outstanding to sell U.S. dollars were as follows:

<i>Term</i>	<i>Options</i>				<i>Forward Contracts</i>	
	<i>Purchased Options</i>		<i>Sold Options</i>		<i>Average Rate</i>	
	<i>US\$Millions</i>	<i>Average Rate C\$/US\$</i>	<i>US\$Millions</i>	<i>Average Rate C\$/US\$</i>		
<i>As at December 31, 2005</i>					<i>US\$Millions</i>	<i>C\$/US\$</i>
0 to 12 months	\$ 450	1.1930	\$ 232	1.2899	\$ 60	1.1705
13 to 24 months	50	1.1447	—	—	—	—
	\$ 500	1.1881	\$ 232	1.2899	\$ 60	1.1705
<i>As at December 31, 2004</i>						
0 to 12 months	\$ 422	1.2902	\$ 362	1.3588	\$ 49	1.2798
13 to 24 months	56	1.2882	56	1.3693	—	—
	\$ 478	1.2900	\$ 418	1.3602	\$ 49	1.2798

Foreign exchange translation gains and losses on the above instruments designated as hedges are recognized concurrently with the hedged revenue in "Sales". At December 31, 2005, all of the above contracts are designated as hedging instruments, except for US\$182 million where the associated revenue has been recognized. At period-end exchange rates, the net amount the Company would receive to settle the above contracts and options is \$23.6 million, of which \$13.1 million is included in "Prepays and other", and \$7.7 million has been recognized and included in "Sales".

At December 31, 2005, no price hedging instruments were outstanding in respect of pulp and paper products sold.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

32

(b) Cost risk management instruments

Oil and gas contracts outstanding were as follows:

<i>Term</i>	<i>Oil Contracts</i>		<i>Gas Contracts</i>	
	<i>Barrels ("bbls") (000's)</i>	<i>Average Rate US\$/bbl</i>	<i>MMBTU (millions)</i>	<i>Average Rate US\$/MMBTU</i>
<u><i>As at December 31, 2005</i></u>				
0 to 12 months	20	\$ 23.30	0.2	\$ 6.67
13 to 36 months	30	31.55	—	—
	50	\$ 28.25	0.2	\$ 6.67
<u><i>As at December 31, 2004</i></u>				
0 to 12 months	125	\$ 20.85	0.5	\$ 5.89
13 to 36 months	80	32.34	—	—
	205	\$ 25.33	0.5	\$ 5.89

The above instruments are not designated as hedging instruments for accounting purposes and are reported under "Prepays and other" on the balance sheet at their fair value. Settlements and changes in fair value are recognized in "Cost of sales". At period-end swap rates, the net amount the Company would receive to settle these commodity swaps is \$2.7 million, all of which has been recognized and is included in "Cost of sales" and "Prepays and other".

(c) Long-term debt risk management instruments

The Company has forward foreign currency contracts to acquire U.S. dollars totalling US\$59 million over a two-year period at rates averaging C\$1.5802/US\$. These instruments are not designated as hedging instruments for accounting purposes, and are included in "Other long-term obligations" on the balance sheet at their fair value. Settlements and changes in fair value are recognized in "Foreign exchange gain on translation of long-term debt". At period-end exchange rates, the net amount the Company would pay to settle these contracts is \$24.3 million.

(d) Interest rate swaps

The Company has entered into fixed-to-floating interest rate swaps on US\$40 million, under which it will receive a fixed rate receipt of 7.375%, and pay a floating rate averaging U.S. six month LIBOR plus an average of 2.0%. The swaps mature March 1, 2014, although US\$30 million are cancellable at the counterparties' option between March 1, 2009 and March 1, 2014, for premiums which mirror the call premiums on the 7.375% senior notes. These instruments are designated as fair value hedging instruments, with settlement amounts recognized in interest expense offsetting the interest expense otherwise incurred. At period-end rates, the net amount the Company would receive to settle these contracts is \$0.4 million.

(e) Credit risk

The Company is exposed to credit risk on accounts receivable from its customers who are mainly in the newspaper publishing, commercial printing and paper manufacturing businesses. The Company manages its credit risk, principally through credit policies, which include the analysis of the financial position of its customers and the regular review of their credit limits. The Company also subscribes to credit insurance for a majority of its receivables, and obtains bank letters of credit for some export markets or customers.

The Company is exposed to credit risk with counterparties to the Company's derivative financial instruments. The credit risk arises from the potential for a counterparty to default on its contractual obligations, and is limited to those contracts where the Company would incur a loss in replacing the defaulted transaction. The Company manages this risk by diversifying through counterparties that are of strong credit quality, normally major financial institutions.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

34**(f) Fair value**

Estimated fair-values of financial instruments, which differ from carrying values at December 31, were as follows:

	2005		2004	
	<i>Carrying Value</i>	<i>Fair Value</i>	<i>Carrying Value</i>	<i>Fair Value</i>
Forward contracts and options hedging future U.S. dollar receipts	\$ 13.1	\$ 23.6	\$ 14.2	\$ 50.2
Commodity swaps hedging future oil and gas purchases	2.7	2.7	3.5	3.8
Instruments related to long-term debt risk management				
Forward contracts to buy U.S. dollars	(25.2)	(24.3)	(44.1)	(41.7)
Fixed to floating interest swaps	—	0.4	—	1.4

The fair value of options and forward foreign currency contracts is based on mid-market rates from financial institutions.

19. RELATED PARTY TRANSACTIONS

Related parties include Norske Skogindustrier ASA ("Norske Skog"), a significant shareholder, together with its subsidiaries and affiliates and Norske Skog North America LLC ("NSNALLC"), which was a joint venture between Norske Skog and the Company.

In the second quarter of 2005, the shareholders of NSNALLC announced the dissolution of its U.S. marketing joint venture. The dissolution was effective October 1, 2005, after which the Company returned to marketing its specialty papers directly to North American customers. Transactions or balances with these related parties, not otherwise disclosed in these financial statements, were as follows:

	2005	2004	2003
Norske Skog			
Selling, general and administrative	\$ 0.1	\$ 0.1	\$ 0.1
Accounts receivable	2.4	—	19.3
Norske Skog North America LLC			
Commission expenses	4.4	4.8	4.2
Net loss	0.1	0.1	0.1
Investment (US\$0.5 million)	0.8	0.8	0.8
Accounts payable	—	0.4	0.2

The Company has entered into agency and distribution agreements with affiliates of Norske Skog whereby all sales of the Company's newsprint and specialty papers in certain international markets are affected through affiliates of Norske Skog. During the year, product sales to these affiliates were \$118.1 million (2004 – \$121.7 million; 2003 – \$115.0 million). These transactions are in accordance with normal third party trade practices.

In prior years, the Company acquired, from wholly-owned subsidiaries of FCL (now subsidiaries of Norske Skog), companies with tax losses. The purchase price of these companies is subject to adjustment under certain conditions and \$2.4 million was included in accounts receivable as at December 31, 2005 with respect to such adjustments (2004 – nil; 2003 – \$19.3 million). During 2004, the Company collected \$26.6 million in respect of the adjustment comprised of the \$19.3 million accounts receivable at December 31, 2003 along with a further adjustment and interest totalling \$7.3 million.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

The Company undertakes certain transactions with companies affiliated with a director of the Company. These transactions are in the normal course of business and are on the same terms as those accorded to third parties. During 2005, the Company paid aggregate fees of approximately \$nil (2004 – \$0.4 million; 2003 – \$0.1 million) primarily for legal services to companies affiliated with a director of the Company. The Company charged the costs to “selling, general and administrative expenses”.

The Company has advanced interest-free loans to three officers of the Company. As at December 31, 2005, the balance outstanding was \$0.4 million (December 31, 2004 – \$0.5 million). These loans were issued prior to the enactment of the United States *Sarbanes-Oxley Act of 2002*, which prohibits such loans effective July 30, 2002. The Company has made no loans to any of its directors or officers since that date.

20. SEGMENTED INFORMATION

The Company operates in three business segments:

Specialty papers – Manufacture and sale of groundwood specialty printing paper and kraft paper.
Newsprint – Manufacture and sale of newsprint.
Pulp – Manufacture and sale of softwood pulps.

The accounting policies of the segments are the same as described in the Summary of Significant Accounting Policies in note 2. Segment performance is evaluated based on operating earnings (loss). Inter-segment sales consist of pulp transfers at cost.

2005				
Sales by Shipment Destination	Specialty Papers	Newsprint	Pulp	Total
Canada	\$ 108.7	\$ 85.2	\$ 2.8	\$ 196.7
United States	780.9	269.3	0.2	1,050.4
Asia and Australasia	27.0	108.1	147.6	282.7
Latin America	77.2	66.1	4.6	147.9
Europe and Other	0.9	0.4	144.9	146.2
	<u>\$ 994.7</u>	<u>\$ 529.1</u>	<u>\$ 300.1</u>	<u>\$ 1,823.9</u>

2004				
Sales by Shipment Destination	Specialty Papers	Newsprint	Pulp	Total
Canada	\$ 114.0	\$ 80.7	\$ 3.2	\$ 197.9
United States	750.6	283.0	–	1,033.6
Asia and Australasia	66.3	115.4	160.1	341.8
Latin America	91.5	74.0	1.3	166.8
Europe and Other	14.8	–	123.3	138.1
	<u>\$ 1,037.2</u>	<u>\$ 553.1</u>	<u>\$ 287.9</u>	<u>\$ 1,878.2</u>

2003				
Sales by Shipment Destination	Specialty Papers	Newsprint	Pulp	Total
Canada	\$ 101.1	\$ 77.7	\$ 2.1	\$ 180.9
United States	729.8	311.9	–	1,041.7
Asia and Australasia	95.0	102.7	155.6	353.3
Latin America	71.0	46.9	1.0	118.9
Europe and Other	5.8	–	119.9	125.7
	<u>\$ 1,002.7</u>	<u>\$ 539.2</u>	<u>\$ 278.6</u>	<u>\$ 1,820.5</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

21. COMMITMENTS

The Company has entered into operating leases for property, plant and equipment. The minimum future payments under various operating leases in each of the years ended December 31 are as follows:

2006	\$	12.8
2007		10.2
2008		9.2
2009		7.7
2010		7.2
Subsequent years		46.3
	\$	93.4

The total lease expense amounted to \$13.8 million for the year ended December 31, 2005 (2004 – \$14.5 million; 2003 – \$8.5 million).

22. GUARANTEES AND INDEMNITIES

The Company has, over time, provided various indemnities with respect to tax, environment, and employment liabilities, as well as general representations and warranties on sales of portions of its business, acquisitions, and commodity contracts. Significant existing indemnities are as follows:

- (a) The Company sold a portion of its operations in June 2001. In this regard, the Company provided a 10-year environmental indemnity with a maximum liability to the Company of \$12.5 million. This liability has subsequently been reduced by expenditures related to certain decommissioning projects. The Company provided a tax indemnity, which continues while the relevant tax years of the indemnified parties remain open to audit. The Company also provided a general indemnity, capped at \$5 million, which expired in 2004. The purchaser of the operations has advised the Company that, based on the terms of the purchase and sale agreement, it believes it may be entitled to indemnification under the general indemnity in connection with certain labour matters. The Company is unable to estimate any potential liability under these indemnities as the amounts are dependent upon the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time. As such, no liability has been recorded for these potential obligations.
- (b) In connection with the acquisition of the paper recycling business in December 2003, the Company has provided indemnities with respect to representations and warranties related to general corporate matters and to the shares that have been issued to the vendors. Liability under these indemnities expires in November 2008, except that the indemnity related to title to the shares does not expire. The Company does not expect any significant claims with respect to these indemnities. The Company has also provided indemnities with respect to general environmental matters under its lease of the land and buildings. The Company has agreed to indemnify the landlord for all costs, claims and damages related to any release by the Company of any hazardous substances on the property or the breach by the Company of its environmental covenants under the lease or any environmental laws. This indemnity is indefinite and survives after the lease is terminated. The Company is not liable for pre-existing environmental conditions.
- (c) The Company has entered a building lease agreement whereby it has agreed to continue making the prescribed lease payments directly to the financial institution holding the mortgage on the building in the event the lessor is no longer able to meet its contractual obligations. As at December 31, 2005, the value of the mortgage was approximately \$13 million. This agreement does not increase the Company's liability beyond the obligation under the building lease.

23. CONTINGENT LIABILITIES

In the normal course of its business activities, the Company is subject to a number of claims and legal actions that may be made by customers, suppliers and others. While the final outcome with respect to actions outstanding or pending as at December 31, 2005, cannot be predicted with certainty, the Company believes an adequate provision

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

has been made, or the resolution will not have a material effect on the Company's consolidated financial position, earnings or cash flows.

Class Action Lawsuits

In early 2004, the European Commission began an investigation into possible anti-competitive practices by certain European paper producers. Shortly after the investigation was announced, the Company and certain of its affiliates were named, together with a number of other paper producers in several United States class action lawsuits alleging an ongoing conspiracy to fix prices of magazine and other publication papers. The Company believes there is no merit to the lawsuits, but will nevertheless continue to incur related costs to defend itself.

24. DIFFERENCES BETWEEN UNITED STATES AND CANADIAN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The Company's consolidated financial statements have been prepared in accordance with Canadian GAAP. Significant differences to accounting principles generally accepted in the United States are set forth below:

Earnings adjustments

The following table provides a reconciliation of the net earnings (loss) for the years ended December 31 under Canadian GAAP to U.S. GAAP:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net earnings (loss) in accordance with Canadian GAAP	\$ (25.6)	\$ (28.6)	\$ (84.5)
U.S. dollar revenue hedges (a)	(32.4)	(22.8)	67.5
U.S. dollar long-term debt hedges (b)	(1.5)	(3.0)	(0.6)
Fixed to floating interest swaps (c)	(3.4)	(5.4)	(6.7)
Commodity swaps (d)	(0.3)	(3.3)	3.6
Stock based compensation expense	—	(0.6)	—
Income tax impact of above items	12.8	11.7	(22.8)
Net earnings (loss) in accordance with U.S. GAAP	(50.4)	(52.0)	(43.5)
Other comprehensive income:			
Minimum pension liability adjustment, net of deferred income taxes of \$7.0 million (2004 – \$1.5 million; 2003 – \$1.7 million) (e)	(14.0)	(2.9)	(3.1)
Effective portion of U.S. dollar revenue hedges, net of deferred income taxes of \$2.4 million (a)	4.5	—	—
<u>Comprehensive income (loss) in accordance with U.S. GAAP</u>	<u>\$ (59.9)</u>	<u>\$ (54.9)</u>	<u>\$ (46.6)</u>
Basic and diluted net earnings (loss) per share in accordance with U.S. GAAP (in dollars)	\$ (0.23)	\$ (0.24)	\$ (0.21)
Basic and diluted weighted average number of shares in accordance with U.S. GAAP (in millions)	214.6	214.6	206.6

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

Balance sheet adjustments

The following table provides a reconciliation of the consolidated balance sheet components at December 31 from Canadian GAAP to U.S. GAAP.

	<i>2005</i>	<i>2004</i>
Prepays and other – Canadian GAAP	\$ 24.1	\$ 24.6
U.S. dollar revenue hedges	10.5	36.0
Fixed to floating interest swaps	0.4	1.4
Commodity swaps	–	0.3
Prepaid and other – U.S. GAAP	\$ 35.0	\$ 62.3
 Other assets – Canadian GAAP	 \$ 40.1	 \$ 27.5
Intangible assets related to additional minimum pension liability	–	0.1
Other assets – U.S. GAAP	\$ 40.1	\$ 27.6
 Long-term debt – Canadian GAAP	 \$ 861.9	 \$ 823.6
Adjustment related to fixed to floating interest swaps	0.1	0.8
Long-term debt – U.S. GAAP	\$ 862.0	\$ 824.4
 Other long-term obligations – Canadian GAAP	 \$ 209.7	 \$ 233.6
Additional minimum pension liability adjustment	63.8	42.4
U.S. dollar long-term debt hedges	(0.9)	(2.4)
Cancelled interest rate swaps	(1.1)	(4.2)
Other long-term obligations – U.S. GAAP	\$ 271.5	\$ 269.4
 Future income taxes – Canadian GAAP	 \$ 300.9	 \$ 332.9
Tax effect of pension adjustment	(22.5)	(15.0)
Tax effect of effective portion of U.S. dollar revenue hedges	2.4	–
Tax effect of other adjustments	2.2	15.0
Future income taxes – U.S. GAAP	\$ 283.0	\$ 332.9
 Shareholders' equity – Canadian GAAP	 \$ 1,019.7	 \$ 1,042.8
U.S. dollar revenue hedges	10.5	36.0
U.S. dollar long-term debt hedges	0.9	2.4
Fixed to floating interest swaps	1.4	4.8
Commodity swaps	–	0.3
Additional minimum pension liability adjustment	(63.8)	(42.3)
Tax effect of pension adjustment	22.5	15.0
Tax effect of effective portion of U.S. dollar revenue hedges	(2.4)	–
Tax effect of other adjustments	(2.2)	(15.0)
Shareholders' equity – U.S. GAAP	\$ 986.6	\$ 1,044.0

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts expressed in millions of dollars, except where otherwise stated)

(a) U.S. dollar revenue hedges

Under Canadian GAAP, translation gains and losses on foreign currency options and forward contracts to sell foreign currencies that are designated as hedges are recognized concurrently with the hedged revenue in "Sales". Prior to April 1, 2005, the Company did not designate its revenue contracts as hedges for U.S. GAAP purposes. Effective April 1, 2005, the Company designated certain of its existing revenue contracts as hedges in accordance with criteria under U.S. GAAP and has, prospectively, accounted for them as hedges under U.S. GAAP. For U.S. GAAP purchases, undesignated contracts are recorded at fair value with changes recognized in income. Designated contracts are recorded at fair value with changes in fair value during the period of designation recorded in other comprehensive income, net of tax, until the hedged item is recognized.

(b) U.S. dollar long-term debt hedges

Under Canadian GAAP, prior to January 1, 2004, the Company designated foreign currency contracts related to its U.S. dollar debt as hedges. The forward premium or discount on forward foreign currency contracts used to hedge the U.S. dollar long-term debt was amortized to interest expense over the term of the forward contract. Effective January 1, 2004, foreign currency contracts related to U.S. dollar debt are not designated as hedges. Under U.S. GAAP, the Company does not account for such contracts as hedges of long-term debt and recognizes the foreign currency contracts on a fair value basis at each reporting period.

(c) Fixed to floating interest swaps

Under Canadian GAAP, unrealized gains and losses on interest rate swap contracts designated as hedges are not recognized in the financial statements. Under U.S. GAAP, the ineffectiveness of the hedge is quantified, and the ineffective portion of the changes in fair value is recorded in interest expense.

During 2003, the Company terminated prior to maturity, interest rate swap contracts for cash proceeds of \$15.9 million. Under Canadian GAAP, the net gain is deferred and is being amortized as a reduction of interest expense based on the U.S. swap curve at the time of termination. Under U.S. GAAP, there is no deferred amount as the fluctuations in the fair value and interest payments are recognized in earnings as they arise.

(d) Commodity swaps

Under Canadian GAAP, prior to January 1, 2004, the Company accounted for commodity swaps as hedges. Effective January 1, 2004, commodity swaps are not designated as hedges and are recognized at their fair value at each reporting date with changes in fair value in the year included in consolidated net income (loss). Under U.S. GAAP, the Company does not designate commodity swaps as hedges.

(e) Minimum pension liability

Under U.S. GAAP, if the accumulated benefit obligation exceeds the market value of plan assets, a minimum pension liability for the excess is recognized to the extent that the liability recorded in the balance sheet is less than the minimum liability. Any portion of this additional liability that relates to unrecognized prior service cost is recognized as an intangible asset while the remainder is charged to comprehensive income (loss). Canadian GAAP has no such requirement to record a minimum liability.

(f) Comprehensive income

Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income", requires that a company classify items of other comprehensive income in a financial statement and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of the balance sheet.

(g) Accounting standard issued but not yet implemented

There are no U.S. GAAP standards issued but not yet implemented that are expected to materially impact the Company's financial position, results of operations or cash flows.

MANAGEMENT'S RESPONSIBILITY

Management's report on financial statements and assessment of internal control over financial reporting

Catalyst Paper Corporation's management is responsible for the preparation, integrity and fair presentation of the accompanying consolidated financial statements and other information contained in this Annual Report. The consolidated financial statements and related notes were prepared in accordance with generally accepted accounting principles ("GAAP") in Canada, except note 28 which sets out the significant measurement differences had these statements been prepared in accordance with U.S. GAAP, and reflect management's best judgments and estimates. Financial information provided elsewhere in this Annual Report is consistent with that in the consolidated financial statements.

Management is responsible for designing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for reporting purposes. Internal control over financial reporting include those processes and procedures that:

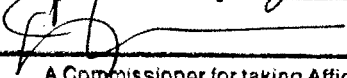
- pertain to the maintenance of records that, in reasonable detail, accurately reflect the transactions of the Company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements and footnote disclosures;
- provide reasonable assurance that receipts and expenditures of the Company are appropriately authorized by the Company's management and directors; and
- provide reasonable assurance regarding the prevention or timely detection of an unauthorized use, acquisition or disposition of assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in condition, or that the degree of compliance with policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. Management based this assessment on the criteria for internal control over financial reporting described in the "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management's assessment included an evaluation of the design of the Company's internal control over financial reporting and testing of the operational effectiveness of its internal control over financial reporting. Management reviewed the results of its assessment with the Audit Committee of our Board of Directors.

Based on this assessment, management determined that, as of December 31, 2007, the Company's internal control over financial reporting was effective.

This is Exhibit "B" referred to in the
affidavit of William A. Sharkey
sworn before me at Vancouver, BC
this 19th day of June 2012


A Commissioner for taking Affidavits
within British Columbia

The Company's independent auditor which audited and reported on the Company's consolidated financial statements has also issued an auditors' report on the Company's internal control over financial reporting.

The Board of Directors is responsible for satisfying itself that management fulfills its responsibilities for financial reporting and internal control. The Audit Committee, which is comprised of three non-management members of the Board of Directors, provides oversight to the financial reporting process. The Audit Committee meets periodically with management, the internal auditors and the external auditors to review the consolidated financial statements, the adequacy of financial reporting, accounting systems and controls and internal and external auditing functions.

The consolidated financial statements have been reviewed by the Audit Committee, which has recommended their approval by the Board of Directors. These consolidated financial statements have been audited by KPMG LLP, the independent auditors, whose report follows.



Richard Gameau
President and
Chief Executive Officer

Vancouver, Canada
February 5, 2008



David Smales
Vice-President, Finance
and Chief Financial Officer

AUDITORS' REPORT ON FINANCIAL STATEMENTS**To the shareholders of Catalyst Paper Corporation**

We have audited the consolidated balance sheets of Catalyst Paper Corporation ("the Company") as at December 31, 2007 and 2006 and the consolidated statements of earnings and comprehensive income, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2007. 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. With respect to the consolidated financial statements for the years ended December 31, 2007 and 2006, we also conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

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

KPMG LLP

Chartered Accountants
Vancouver, Canada

February 5, 2008, except as to note 29 which is as of February 11, 2008

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING UNDER STANDARDS OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (UNITED STATES)****To the shareholders and board of directors of Catalyst Paper Corporation**

We have audited Catalyst Paper Corporation ("the Company")'s internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Financial Statements and Assessment of Internal Control Over Financial Reporting. Our responsibility is to express an opinion of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING UNDER STANDARDS OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (UNITED STATES) (continued)**

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have conducted our audits on the consolidated financial statements in accordance with Canadian generally accepted auditing standards. With respect to the years ended December 31, 2007 and 2006, we also have conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our report dated February 5, 2008, except as to note 29 which is as of February 11, 2008, expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Chartered Accountants
Vancouver, Canada

February 5, 2008

CONSOLIDATED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME

Years ended December 31,

(In millions of dollars, except where otherwise stated)

	2007	2006	2005
Sales	\$ 1,714.6	\$ 1,882.5	\$ 1,823.9
Operating expenses			
Cost of sales	1,574.6	1,609.3	1,604.3
Selling, general and administrative	48.3	62.2	57.7
Restructuring and change-of-control (note 5)	64.7	-	6.7
Amortization (note 13)	178.4	207.1	180.3
	1,864.0	1,878.6	1,849.0
Operating earnings (loss)	(149.4)	3.9	(25.1)
Interest expense, net (note 6)	(70.7)	(73.8)	(75.7)
Foreign exchange gain (loss) on long-term debt	103.9	(0.3)	24.7
Other income (expense), net (note 7)	(15.3)	1.8	4.5
Earnings (loss) before income taxes and non-controlling interest	(131.5)	(68.4)	(71.6)
Income tax recovery (note 8)	(100.0)	(54.0)	(46.6)
Net earnings (loss) before non-controlling interest	(31.5)	(14.4)	(25.0)
Non-controlling interest (note 4)	(0.1)	(1.5)	(0.6)
Net earnings (loss)	\$ (31.6)	\$ (15.9)	\$ (25.6)
Other comprehensive income (note 2 (c))	14.3	-	-
Comprehensive income (loss)	\$ (17.3)	\$ (15.9)	\$ (25.6)
Basic and diluted earnings (loss) per share (note 9) (in dollars)	\$ (0.15)	\$ (0.07)	\$ (0.12)
Weighted average common shares outstanding (in millions)	214.7	214.6	214.6

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

As at December 31,
(In millions of dollars)

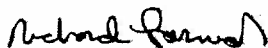
	2007	2006
Assets		
Current assets		
Cash and cash equivalents	\$ —	\$ 35.5
Accounts receivable (note 10)	213.1	277.9
Inventories (note 11)	238.7	245.0
Prepays and other (note 12)	40.7	15.4
	489.5	573.8
Property, plant and equipment (note 13)	1,912.8	2,023.1
Other assets (note 14)	51.1	40.8
	\$ 2,453.4	\$ 2,637.7
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 15)	\$ 268.2	\$ 291.5
Current portion of long-term debt	1.2	1.8
	269.4	293.3
Long-term debt (note 16)	784.6	858.7
Employee future benefits (note 17)	211.7	187.2
Other long-term obligations (note 18)	26.9	23.3
Future income taxes (note 8)	150.5	243.9
Deferred credits (note 19)	21.7	25.5
	1,464.8	1,631.9
Shareholders' equity		
Share capital (note 20)	913.9	913.6
Contributed surplus	12.1	9.3
Retained earnings	49.0	82.9
Accumulated other comprehensive income (note 2 (c))	13.6	—
	988.6	1,005.8
	\$ 2,453.4	\$ 2,637.7

Commitments, guarantees and indemnities and contingent liabilities (notes 24, 25 and 26)

Subsequent event (note 29)

The accompanying notes are an integral part of the consolidated financial statements.

On behalf of the board:



Richard Gameau
Director



Thomas S. Chambers
Director

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

Years Ended December 31, (In millions of dollars, except where otherwise stated)		2007	2006	2005
Share capital (note 20)				
Number of shares outstanding, beginning of year	214,604,120	214,604,120	214,604,120	
Number of shares issued under stock option plan	80,009	-	-	
Number of shares outstanding, end of year	214,684,129	214,604,120	214,604,120	
Balance, beginning of year	\$ 913.6	\$ 913.6	\$ 913.6	
Stock options exercised	0.3	-	-	
Balance, end of year	913.9	913.6	913.6	
Contributed surplus				
Balance, beginning of year	9.3	7.3	4.8	
Stock option compensation expense	3.2	2.0	2.5	
Stock options exercised	(0.4)	-	-	
Balance, end of year	12.1	9.3	7.3	
Retained earnings				
Balance, beginning of year	82.9	98.8	124.4	
Adoption of new accounting standards for financial instruments (note 2 (c))	(2.3)	-	-	
Net earnings (loss)	(31.6)	(15.9)	(25.6)	
Balance, end of year	49.0	82.9	98.8	
Accumulated other comprehensive Income (loss) (note 2 (c))				
Balance, beginning of year	-	-	-	
Adoption of new accounting standards for financial instruments	(0.7)	-	-	
Unrealized net gain on cash flow hedges on revenue, net of tax of \$13.8 million	28.4	-	-	
Reclassification of net gain on cash flow hedges on revenue included in net loss, net of tax of \$7.3 million	(14.1)	-	-	
Balance, end of year	13.6	-	-	
Total shareholders' equity	\$ 988.6	\$ 1,005.8	\$ 1,019.7	

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31,
(In millions of dollars)

	2007	2006	2005
Cash flows provided (used) by:			
Operations			
Net earnings (loss)	\$ (31.6)	\$ (15.9)	\$ (25.6)
Items not requiring (providing) cash			
Amortization	176.4	183.7	180.3
Impairment loss on property, plant and equipment (note 3)	-	23.4	-
Loss (gain) on disposal of property, plant and equipment (note 7)	13.6	(1.1)	1.6
Future income taxes (note 8)	(100.7)	(56.1)	(51.6)
Foreign exchange loss (gain) on long-term debt	(103.9)	0.3	(24.7)
Employee future benefits, excess of expense over funding	6.7	6.4	(0.2)
Increase (decrease) in other long-term obligations	7.5	0.9	(7.4)
Non-controlling interest	0.1	1.5	0.6
Other	(20.9)	(6.3)	(0.8)
	(52.8)	136.8	72.2
Changes in non-cash working capital			
Accounts receivable	64.2	(35.5)	(9.1)
Inventories	9.2	0.7	12.4
Prepays and other	(5.0)	(0.9)	(6.7)
Accounts payable and accrued liabilities	(18.3)	26.1	(8.1)
	50.1	(9.6)	(11.5)
Cash flows provided (used) by operations	(2.7)	127.2	60.7
Investing			
Additions to property, plant and equipment	(85.8)	(93.2)	(95.2)
Proceeds from sale of property, plant and equipment	6.5	3.5	3.5
Purchase price adjustment (note 23)	-	4.3	-
Increase in other assets	(4.4)	(0.4)	(1.3)
Cash flows used by investing activities	(83.7)	(85.8)	(93.0)
Financing			
Increase (decrease) in revolving loan and loan payable	47.0	(5.5)	6.4
Deferred financing costs	-	-	0.1
Increase (decrease) in other long-term debt	3.6	(0.4)	(0.2)
Issue of shares from exercise of stock options	0.3	-	-
Cash flows provided (used) by financing activities	50.9	(5.9)	6.3
Cash and cash equivalents, increase (decrease) in the year	(35.5)	35.5	(26.0)
Cash and cash equivalents, beginning of year	35.5	-	26.0
Cash and cash equivalents, end of year	\$ -	\$ 35.5	\$ -
Supplemental disclosures:			
Income taxes paid	\$ 0.5	\$ 2.7	\$ 3.9
Net interest paid	67.8	71.5	75.3

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BUSINESS SEGMENTS

Year ended December 31, 2007 (In millions of dollars)	Specialty paper	Newsprint	Pulp	Corporate adjustments	Consolidated
Sales to external customers	\$ 919.6	\$ 338.0	\$ 457.0	\$ -	\$ 1,714.6
Inter-segment sales	-	-	45.3	(45.3)	-
Restructuring and change-of-control (note 5)	42.2	12.9	9.6	-	64.7
Amortization	101.3	33.2	41.9	-	176.4
Operating earnings (loss)	(75.1)	(56.9)	(17.4)	-	(149.4)
Total assets	1,306.6	662.0	468.2	16.6	2,453.4
Additions to property, plant and equipment	42.8	32.4	10.6	-	85.8

Year ended December 31, 2006 (In millions of dollars)	Specialty paper	Newsprint	Pulp	Corporate adjustments	Consolidated
Sales to external customers	\$ 918.4	\$ 529.8	\$ 434.3	\$ -	\$ 1,882.5
Inter-segment sales	-	-	47.2	(47.2)	-
Restructuring and change-of-control	-	-	-	-	-
Amortization	94.6	45.8	43.3	-	183.7
Impairment loss	0.5	19.1	3.8	-	23.4
Operating earnings (loss)	9.7	6.9	(12.7)	-	3.9
Total assets	1,355.3	737.8	529.5	15.1	2,637.7
Additions to property, plant and equipment	48.4	34.4	10.4	-	93.2

Year ended December 31, 2005 (In millions of dollars)	Specialty paper	Newsprint	Pulp	Corporate adjustments	Consolidated
Sales to external customers	\$ 900.5	\$ 529.1	\$ 394.3	\$ -	\$ 1,823.9
Inter-segment sales	-	-	46.6	(46.6)	-
Restructuring and change-of-control	0.5	6.2	-	-	6.7
Amortization	91.0	45.8	43.5	-	180.3
Operating earnings (loss)	24.8	12.3	(62.2)	-	(25.1)
Total assets	1,379.1	738.1	560.2	18.5	2,695.9
Additions to property, plant and equipment	49.3	23.6	22.3	-	95.2

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED GEOGRAPHIC BUSINESS SEGMENTS

2007 (In millions of dollars)	Specialty paper	Newsprint	Pulp	Total
Sales by shipment destination:				
Canada	\$ 121.0	\$ 60.7	\$ 14.5	\$ 196.2
United States	712.2	145.7	47.0	904.9
Asia and Australasia	22.7	67.8	242.2	332.7
Latin America	59.9	61.6	36.7	158.2
Europe and Other	3.8	2.2	116.6	122.6
	\$ 919.6	\$ 338.0	\$ 457.0	\$1,714.6

2006 (In millions of dollars)	Specialty paper	Newsprint	Pulp	Total
Sales by shipment destination:				
Canada	\$ 104.0	\$ 88.7	\$ 13.9	\$ 206.6
United States	759.3	256.7	37.8	1,053.8
Asia and Australasia	15.6	106.0	201.0	322.6
Latin America	38.5	78.0	55.4	171.9
Europe and Other	1.0	0.4	126.2	127.6
	\$ 918.4	\$ 529.8	\$ 434.3	\$ 1,882.5

2005 (In millions of dollars)	Specialty paper	Newsprint	Pulp	Total
Sales by shipment destination:				
Canada	\$ 91.7	\$ 85.2	\$ 19.8	\$ 196.7
United States	743.6	269.3	37.5	1,050.4
Asia and Australasia	24.4	108.1	150.2	282.7
Latin America	39.9	66.1	41.9	147.9
Europe and Other	0.9	0.4	144.9	146.2
	\$ 900.5	\$ 529.1	\$ 394.3	\$ 1,823.9

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Amounts expressed in millions of dollars, except where otherwise stated

1. Nature of operations

Catalyst Paper Corporation, together with its subsidiaries and partnerships (collectively, the "Company") is a significant specialty groundwood paper and newsprint producer in North America. The Company operates four manufacturing divisions, and one paper recycling division in British Columbia, Canada. The Company operates in three business segments.

- | | |
|-----------------|---|
| Specialty Paper | • Manufacture and sale of groundwood specialty printing paper. |
| Newsprint | • Manufacture and sale of newsprint. |
| Pulp | • Manufacture and sale of long and short fibre pulp and containerboard. |

The Company manages its business based on the products that it manufactures and sells to customers. All manufacturing facilities are located in British Columbia. Inter segment sales consist of pulp transfers at cost.

The primary market for the Company's paper products is North America. The primary markets for the Company's pulp products are Asia, Australasia, and Europe.

2. Summary of significant accounting policies

The consolidated financial statements of the Company are expressed in millions of Canadian dollars and are prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). These financial statements differ in certain respects from those prepared in accordance with United States generally accepted accounting principles ("U.S. GAAP"). These measurement differences are described in note 28 "Reconciliation of Canadian and United States generally accepted accounting principles".

(a) Basis of consolidation

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 and partnerships. In addition, the consolidated financial statements include the accounts of the Company's joint venture, Powell River Energy Inc. ("PREI"), a variable interest entity. All inter-company transactions and amounts have been eliminated on consolidation.

(b) Variable interest entities

Variable interest entities ("VIE") are entities in which equity investors do not have a controlling financial interest or the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by other parties. The Company consolidates the accounts of VIEs where it has been determined that the Company is the primary beneficiary, defined as the party that receives the majority of the expected residual returns and/or absorbs the majority of the entity's expected losses.

(c) Changes in accounting policies

Effective January 1, 2007, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants ("CICA") Section 3855, "Financial Instruments – Recognition and Measurement", Section 1530, "Comprehensive Income", Section 3865, "Hedges", Section 3861, "Financial Instruments – Disclosure and Presentation", and Section 3251, "Equity". These new standards, which apply to fiscal

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

years beginning on or after October 1, 2006, introduce new requirements for recognition, measurement and disclosure of financial instruments, when and how hedge accounting may be applied, establishes the concept of comprehensive income and rules for reporting it, and establishes rules for the presentation of equity and changes in equity. Prior period financial statements are not revised for the adoption of these new standards.

The new pronouncements require an entity to account for its derivatives at fair value at each balance sheet date. The effective portion of changes in the derivative fair values that qualify and are designated as cash flow hedges is deferred and recorded as a component of "Accumulated Other Comprehensive Income (Loss)" ("AOCI"), a component of shareholders' equity, until the underlying transaction is recorded in earnings while the ineffective portion flows through net earnings. Changes in the derivative fair values that qualify and are designated as fair value hedges flow through net earnings at the same time as the hedged item. In addition, the new pronouncements also require entities to either expense deferred financing costs immediately or to net them against the carrying value of debt. The Company opted to net its deferred financing costs against debt.

The adoption of these standards resulted in the Company recording on its balance sheet, at fair value, certain revenue and interest rate derivative financial instruments that were previously off balance sheet and the reclassification of its deferred financing costs against long-term debt. This resulted in the following adjustments at January 1, 2007:

Assets	
Prepays and other	\$ (7.8)
Other assets	(12.0)
	\$ (19.8)
Liabilities and shareholders' equity	
Accounts payable and accrued liabilities	\$ (0.2)
Long-term debt	(14.7)
Other long-term obligations	(0.2)
Future income taxes	(1.7)
Retained earnings	(2.3)
Accumulated other comprehensive income	(0.7)
	\$ (19.8)

(d) Use of estimates

The consolidated financial statements have been prepared in conformity with Canadian GAAP, which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the year. On an ongoing basis, management reviews its estimates, including those related to inventory obsolescence, estimated useful lives of assets, environmental and legal liabilities, impairment of long-lived assets, pension and post-retirement benefits, bad debt and doubtful accounts and income taxes, based on currently available information. Actual amounts could differ from estimates.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

(e) Revenue recognition

The Company recognizes revenues upon shipment when the significant risks and rewards of ownership are transferred to the customer. Title to products is typically transferred to the customers at the time of shipment, and payment is based on agreed prices and credit terms contained in sales invoices. Customers have no contractual right of return.

(f) Translation of foreign currencies

The majority of the Company's sales are denominated in foreign currencies, principally U.S. dollars. Revenue and expense items denominated in foreign currencies are translated at exchange rates prevailing during the period. Monetary assets and liabilities denominated in foreign currencies are translated at the period-end exchange rates. Non-monetary assets and liabilities are translated at exchange rates in effect when the assets are acquired or the obligations are incurred. Foreign exchange gains and losses are reflected in net earnings (loss) for the period.

(g) Derivative financial instruments

The Company uses derivative financial instruments in the management of foreign currency, and price risk associated with its revenues, energy costs and long-term debt. The Company also uses interest rate swaps to manage its net exposure to interest rate changes. The Company's policy is to use derivatives for managing existing financial exposures and not for trading or speculative purposes. The Company accounts for its derivatives at fair value at each balance sheet date (note 2 (c)). Prior to January 1, 2007, the Company used hedge accounting to account for the derivative financial instruments designated as hedging instruments, and the fair value method to account for derivative financial instruments not designated as hedging instruments.

The Company designates the hedge relationship and formally documents at its inception, the particular risk management objective and strategy, the specific asset, liability or cash flow being hedged, as well as how effectiveness is assessed. Risk management strategies and relationships are assessed on an on-going basis to ensure each derivative instrument is effective in accomplishing the objective of offsetting either changes in the fair value or cash flow attributable to the exposure being hedged both at inception and over the term of the hedging relationship.

Realized and unrealized gains or losses associated with hedging instruments are recognized in earnings in the same period the hedge item is recognized. Realized and unrealized gains or losses when hedging instruments have ended or ceased to be effective prior to their maturity are deferred and recognized in earnings concurrently with the recognition of the item being hedged.

Foreign exchange exposure to foreign currency revenue and related receivables, primarily in U.S. currency, is managed through the use of foreign exchange forward contracts and options to sell foreign currencies. Realized foreign exchange translation gains and losses from transactions formally designated as hedges are recognized concurrently with the hedged revenue in "Sales". The effective portion of changes in the fair value of derivatives that qualify and are designated as cash flow hedges are deferred and recorded as a component of AOCI until the underlying transaction is recorded in earnings. When the hedged item affects earnings, the gain or loss is reclassified from AOCI to "Sales". Any ineffective portion of a hedging derivative's change in fair value and the portion that is excluded from the assessment of hedge effectiveness is recognized immediately in "Sales".

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

Price risk associated with the sale of products, primarily Northern Bleached Softwood Kraft ("NBSK") pulp and containerboard, is managed from time to time through the use of commodity swap agreements. These contracts are not designated as hedging instruments for accounting purposes, and are reported at fair value in "Prepays and other" or "Accounts payable and accrued liabilities" on the consolidated balance sheet. Changes in fair value are recognized in "Sales".

Price risk associated with the purchase of certain inputs, primarily oil and gas, is managed from time to time through the use of commodity swaps. These instruments are not designated as hedges for accounting purposes and are reported at their fair value in "Prepays and other" or "Accounts payable and accrued liabilities" on the consolidated balance sheet. Changes in fair value are recognized in "Cost of sales".

Foreign currency exposure on long-term debt denominated in U.S. currency is managed through the use of forward contracts and options to purchase U.S. dollars. These instruments are not designated as hedging instruments for accounting purposes and are reported under "Other assets" or "Other long-term obligations" on the consolidated balance sheet at their fair value with changes in fair value recognized in "Foreign exchange gain (loss) on long-term debt", offsetting the respective translation gains and losses on the underlying foreign currency long-term debt.

Exposure to interest rates on long-term debt is managed through the use of interest swaps. These swap agreements require the periodic exchange of payments without the exchange of the notional principal amount on which the payments are based. These instruments are designated as fair value hedging instruments. The effective portion of changes in the fair value of the derivatives are netted in "long-term debt" and the ineffective portion is recognized in "Interest expense, net".

Cash flows from derivative financial instruments that are designated as hedges and for which hedge accounting does not apply are classified in "Operations" on the consolidated statement of cash flows consistent with the hedged transaction.

(h) Cash and cash equivalents

Cash and cash equivalents include cash and short-term investments with original maturities of less than three months and are presented at cost.

(i) Inventories

Inventories other than supplies and work-in-progress which are valued at cost, are valued at the lower of average cost and net realizable value.

(j) Property, plant and equipment

Property, plant and equipment are stated at cost, less accumulated amortization, including asset impairment charges. Interest costs are capitalized for capital projects in excess of \$10 million and having a minimum duration of six months. Buildings, machinery and equipment are generally amortized on a straight-line basis at rates that reflect estimates of the economic lives of the assets. The rates for major classes of assets based on the estimated remaining economic lives are:

• Buildings	2.5% – 5.0%
• Paper machinery and equipment	5.0% – 10.0%
• Pulp machinery and equipment	10.0% – 20.0%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

During periods of major production interruption, an obsolescence amount of 10% of normal amortization is charged on manufacturing machinery and equipment.

No amortization is charged on capital projects during the period of construction. Start-up costs incurred in achieving normal operating capacity on major capital projects are deferred and amortized over a five-year period.

Leasehold improvements are normally amortized over the lesser of their expected average service life or the term of the lease.

When property, plant and equipment are sold by the Company, the historical cost less accumulated amortization is netted against the sale proceeds and the difference is included in "Other income (expense), net".

(k) Impairment of long-lived assets

Long-lived assets are tested for recoverability when events or changes in circumstances indicate their carrying value may not be recoverable. A long-lived asset is potentially not recoverable when its carrying value is greater than the sum of its undiscounted cash flows expected to result from its use and eventual disposition. The impairment loss, if any, is measured as the amount by which the long-lived asset's carrying amount exceeds its fair value.

(l) Environmental costs

Environmental expenditures are expensed or capitalized depending upon their future economic benefit. Expenditures that prevent future environmental contamination are capitalized as part of "Property, plant and equipment", and amortization is subsequently charged to earnings over the estimated future benefit period of the assets. Expenditures that relate to an existing condition caused by past operations are expensed. Liabilities are recorded on an undiscounted basis when rehabilitation efforts are likely to occur and the costs can be reasonably estimated.

(m) Asset retirement obligations

Asset retirement obligations are recognized at fair value in the period in which the Company incurs a legal obligation associated with the retirement of an asset. The associated costs are capitalized as part of the carrying value of the related asset and amortized over its remaining useful life. The liability is accreted using a credit-adjusted risk-free interest rate.

The Company's obligations for the proper removal and disposal of asbestos products in the Company's mills meet the definition of a conditional asset retirement obligation. That is, the Company is subject to regulations that are in place to ensure that asbestos fibres do not become friable, or loose. The regulations require that friable asbestos be repaired or removed in accordance with the regulations.

The Company's asbestos can generally be found on steam and condensate piping systems throughout its facilities, as well as in transite cladding on buildings and in building insulation. As a result of the longevity of the Company's mills, due in part to the Company's maintenance procedures, and the fact that the Company does not have plans for major changes that would require the removal of asbestos, the timing of the removal of asbestos in the Company's mills is indeterminate. As a result, the Company is currently unable to estimate the fair value of its asbestos removal and disposal obligation.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

(n) Research and development

Research and development costs are expensed except in cases where development costs meet certain identifiable criteria for deferral. Deferred development costs are amortized over the life of the commercial production.

(o) Deferred financing costs

Deferred financing costs represent the issuance costs of the Company's long-term debt. These are netted against the carrying value of long-term debt (note 2 (c)) on the consolidated balance sheet and amortized using the effective interest rate method over the expected life of the related liability. Prior to January 1, 2007, deferred financing costs were included in "Other assets" on the consolidated balance sheet and related amortization was included in "Interest expense, net" on a straight-line basis over the term of the debt.

(p) Share issue costs

Direct costs of issuing shares, net of income tax recoveries thereon, are applied to reduce the value of consideration assigned to such shares.

(q) Stock-based compensation and other stock-based payments

Stock options and restricted share units granted to the Company's key officers, directors and employees are accounted for using the fair value-based method. Under this method, compensation cost is measured at fair value at the date of grant, and is expensed over the award's vesting period. Any consideration paid by plan participants on the exercise of share options or the purchase of shares is credited to "Share capital" together with any related stock-based compensation expense. Performance and time based share-based payments are amortized over their vesting periods based on management's best estimate.

Deferred share units are accounted for using the quoted market value at each reporting period until settlement, and are amortized over their vesting periods.

(r) Income taxes

Income taxes are accounted for using the asset and liability method. Future income tax assets and liabilities are based on temporary differences (differences between the accounting basis and the tax basis of the assets and liabilities) and non-capital loss carry-forwards and are measured using the enacted or substantively enacted tax rates and laws expected to apply when these differences reverse. Future tax benefits, including non-capital loss carry-forwards, are recognized to the extent that realization of such benefits is considered more likely than not. The effect on future tax assets and liabilities of a change in tax rates is recognized in earnings in the period that substantive enactment occurs.

(s) Deferred credits

Deferred credits represent the excess of amounts assigned to future income tax assets for tax losses acquired in other than business combinations over the consideration paid. Deferred credits are amortized to "Income tax recovery" in the consolidated statement of earnings during the period that the acquired tax asset is utilized.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

(t) Employee future benefits

Pensions and other employee future benefits

The estimated cost for pensions and other employee future benefits provided to employees by the Company is accrued using actuarial techniques and assumptions during the employees' active years of service. These plans include funded and unfunded defined benefit plans and defined contribution plans. The net periodic benefit cost includes:

- the cost of benefits provided in exchange for employees' services rendered during the year;
- the interest cost of benefit obligations;
- the expected long-term return on plan assets based on the fair value for all asset classes;
- gains or losses on settlements or curtailments;
- the straight-line amortization of past service costs and plan amendments over the average remaining service period of the active employee group covered by the plans as of the date such costs are first recognized, unless there are no active employees or the period is less than five years, in which case such costs are amortized over five years, and
- the amortization of cumulative unrecognized net actuarial gains and losses in excess of 10% of the greater of the accrued benefit obligation and the fair value of plan assets at the beginning of the year over the average remaining service period of the active employee group covered by the plans, unless there are no active employees or the period is less than five years, in which case such costs are amortized over five years.

The defined benefit plan obligations are determined in accordance with the projected benefit method prorated on services.

(u) Earnings per share

Basic earnings (loss) per share is computed by dividing net earnings (loss) for the period by the weighted average shares outstanding during the reporting period. Diluted earnings (loss) per share is computed using the treasury stock method. When the effect of options and other securities convertible into common shares is anti-dilutive, including when the Company has incurred a loss for the period, basic and diluted loss per share are the same.

(v) Comparative figures

Certain comparative figures disclosed in the consolidated financial statements have been reclassified to conform with the presentation adopted for the current year.

3. Measurement uncertainty – impairment of long-lived assets

The Company reviews long-lived assets, primarily plant and equipment, for impairment when events or changes in circumstances indicate that the carrying value of these assets may not be recoverable.

The Company tests for impairment using a two-step methodology:

- (i) Testing for impairment is accomplished by determining whether the projected undiscounted future cash flows from operations exceed the net carrying amount of the assets as of the assessment date, and

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

- (ii) If assets are determined to be impaired in step (i), then such impaired assets are written down to their fair value, determined principally by using discounted future cash flows expected from their use and eventual disposition.

Estimates of future cash flows and fair value require judgments, assumptions and estimates and may change over time. Due to the variables associated with judgments and assumptions used in these tests, the precision and accuracy of estimates of impairment charges are subject to significant uncertainties and may change significantly as additional information becomes known. Long-lived assets represented approximately 78% of total assets as at December 31, 2007. If future developments were to differ adversely from management's best estimate of key assumptions and associated cash flows, the Company could potentially experience future material impairment charges.

In the fourth quarter of 2007, as a result of rapid strengthening of the Canadian dollar and the decline in North American consumption of newsprint, the Company conducted step (i) impairment tests on its paper and pulp assets. Estimates of future cash flows used to test the recoverability of long-lived assets included key assumptions related to foreign exchange rates, forecast prices, estimated useful life of the long-lived assets, production levels, production costs, market supply and demand, inflation, weighted average cost of capital, and capital spending. The assumptions are derived from information generated internally, independent industry research firms, and other external published reports and forecasts. The useful life of the Company's assets was estimated at 20 years for paper assets and 5 to 10 years for pulp assets. Product sales prices and foreign exchange assumptions for years 2008 to 2012 were based on forecasts prepared by Resource Information Systems Inc. ("RISI"), an independent external firm. The foreign exchange assumption was CDN\$1.00 = US\$1.015 in 2008 declining to CDN\$1.00=US\$0.8512 by 2012. Product sales prices and foreign exchange rate assumptions for 2013 and subsequent years were estimated by management based on long-term trend pricing for product sales prices and a long term expected foreign exchange rate of CDN\$1.00=US\$0.8800. The Company concluded that an impairment charge for the pulp and paper assets was not required in 2007 as the estimated undiscounted future cash flows exceeded the carrying values.

As at December 31, 2007, the net book value of the indefinitely curtailed No. 4 paper machine in Port Alberni was \$63 million. The Company has not recorded an impairment for the indefinite curtailment. The Company will monitor market and other conditions and assess whether they improve sufficiently to allow this machine to be placed back into production. To the extent that conditions do not improve in a reasonable period of time and to the levels necessary to restart the machine, a write-down may have to be recorded in the future.

In 2006, the Company recorded an impairment loss of \$23.4 million, of which \$19.1 million related to the permanent closure of its Port Alberni No. 3 paper machine and ancillary assets, and \$4.3 million related to assets that were previously idled and where the Company determined the assets would not be used again in the future. The estimated fair value of these assets was based on the present value of the estimated asset proceeds net of dismantling and selling costs. The impairment loss was recorded in the Company's amortization expense.

4. Variable interest entities

The Company has a 50.0% interest in Powell River Energy Inc. ("PREI"). The Company consolidates 100% of PREI in accordance with Accounting Guideline 15, "Consolidation of Variable Interest Entities". PREI consists of an integrated hydroelectric power generating, transmission and distribution system which includes two hydroelectric stations in British Columbia with installed capacity of 82 Megawatts. The Company purchases 100% of the power generated by PREI. Prior to January 1, 2005, PREI was accounted for using the proportionate consolidation method.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

The Company has limited access to PREI's assets, which generally takes the form of interest on loans, management fees and earnings distributions based on the Company's interest in PREI. In addition, creditors of PREI have recourse limited to the assets in PREI. Condensed financial information with respect to PREI is as follows:

Years ended December 31,	2007	2006	2005
Condensed statement of earnings			
Sales – affiliate ¹	\$ 19.2	\$ 19.8	\$ 19.9
Cost of sales	8.1	5.3	5.9
Amortization	3.3	2.9	2.8
	8.4	8.2	8.7
Operating earnings	10.8	11.4	11.2
Interest expense	(8.2)	(8.1)	(8.4)
Interest expense – affiliate ¹	(3.1)	(3.1)	(3.5)
Other expense, net	(4.2)	(0.3)	–
Income tax recovery	4.9	3.0	1.9
Net earnings ²	\$ 0.2	\$ 2.9	\$ 1.2
As at December 31,			
Condensed balance sheets			
Current assets	\$ 3.8	\$ 2.7	
Property, plant and equipment	118.2	118.7	
Other assets	–	0.6	
	\$ 122.0	\$ 122.0	
Current liabilities	17.9	11.9	
Long-term debt	94.1	94.5	
Long-term debt – affiliate ¹	21.5	21.5	
Future income taxes	20.7	25.3	
Shareholders' deficit ²	(32.2)	(31.2)	
	\$ 122.0	\$ 122.0	

¹ Balances with Catalyst Paper Corporation.

² 50% is included in the Company's non-controlling interest.

During 2007, the Company took over the management of the warehouse facility that houses a large portion of the Company's paper products from a previously designated potential VIE. As a result, this entity is no longer a potential VIE. The Company has identified one other potential VIE, but has not been able to obtain the financial information necessary to evaluate whether the entity is a VIE, or if the entity is a VIE, whether the Company is the primary beneficiary. The potential VIE is a private entity and, as such, is unwilling to share financial information with the Company. The Company has entered into a building lease agreement

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

with this potential VIE whereby it has agreed to continue making the prescribed lease payments directly to the financial institution holding the mortgage on the building in the event the lessor is no longer able to meet its contractual obligations. As at December 31, 2007, the principal amount of the mortgage was \$10.6 million (2006 – \$11.9 million). This agreement does not increase the Company's liability beyond the obligation under the building lease.

5. Restructuring and change-of-control costs

In 2007, the Company announced and implemented, in various phases during the year, a restructuring program which included reductions of approximately 565 positions across the Company, the relocation of the Corporate office, and the centralization of certain mill administrative functions. This plan was substantially completed during the year and the Company incurred \$58.3 million of restructuring costs, of which \$3.0 million was capital related. Restructuring expenses and provisions are primarily severance related and have been recorded in accordance with the Emerging Issues Committee Abstract No. 134, "Accounting for Severance and Termination Benefits".

For the year ended December 31, 2007, the Company also expensed \$8.3 million for change-of-control payments, pension benefits and stock compensation to the now former President and Chief Executive Officer, and the now former Vice-President, Finance and Chief Financial Officer, who exercised their rights under Amended and Restated Change of Control Agreements and resigned their positions. These rights were triggered upon the acquisition by Third Avenue Management LLC of control or direction over 37.8% of the Company's common shares in October, 2006. In addition, the Company expensed \$1.1 million in change-of-control costs related to employee retention agreements that required certain key employees to remain actively employed by the Company for one year following a change-of-control.

The Company's restructuring and change-of-control expenses and related provisions at December 31, 2007 are as provided in the following table.

Balance, beginning of year	\$	-
Expensed in year		64.7
Disbursements		(23.6)
Other non-cash items		(0.4)
Balance, end of year	\$	40.7
Classification:		
Accounts payable and accrued liabilities (note 15)		
Restructuring and change-of-control	\$	20.0
Accrued benefit obligation – pension plan (note 17)		1.2
Employee future benefits (note 17)		11.4
Other long-term obligations (note 18)		8.1
	\$	40.7

At December 31, 2007, no significant expenses remain to be accrued or recorded under the initiatives noted above. Any variances from current estimates will be recorded in subsequent periods.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

6. Interest expense, net

The components of interest expense, net, for the years ended December 31 were as follows:

	2007	2006	2005
Interest on long-term debt	\$ 71.7	\$ 72.5	\$ 76.8
Fixed-to-floating interest rate swaps	-	(1.2)	(3.9)
Amortization of deferred financing costs	-	2.9	3.0
Other	0.1	0.9	0.7
	<u>71.8</u>	<u>75.1</u>	<u>76.6</u>
Capitalized interest	(0.2)	-	-
Interest income	(0.9)	(1.3)	(0.9)
	<u>\$ 70.7</u>	<u>\$ 73.8</u>	<u>\$ 75.7</u>

7. Other income (expense), net

The components of other income (expense), net, for the years ended December 31 were as follows:

	2007	2006	2005
Gain (loss) on disposal of property, plant and equipment	\$ (13.6)	\$ 1.1	\$ (1.6)
Financing expenses	(1.2)	-	-
Other	(0.5)	0.7	6.1
	<u>\$ (15.3)</u>	<u>\$ 1.8</u>	<u>\$ 4.5</u>

During the year ended December 31, 2007, the Company recognized \$7.5 million loss on sale of the Company's previously permanently closed Port Alberni No. 3 paper machine and ancillary assets. This is included in "Gain (loss) on disposal of property, plant and equipment".

Financing expenses for the year ended December 31, 2007 were in respect of the proposed \$200 million private debt placement which the Company decided to withdraw due to adverse market conditions.

8. Income taxes

The components of income tax recovery for the years ended December 31 were as follows:

	2007	2006	2005
Current	\$ 0.7	\$ 2.1	\$ 5.0
Future	(78.3)	(33.2)	(37.4)
Release of future taxes related to reduction in corporate income tax rates	(22.4)	(22.9)	(14.2)
	<u>\$ (100.0)</u>	<u>\$ (54.0)</u>	<u>\$ (46.6)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

The reconciliation of income taxes calculated at the statutory rate to the actual income tax provision for the years ended December 31 was as follows:

	2007		2006		2005	
Income tax recovery at Canadian statutory income tax rates	\$	(44.7) 34.0%	\$	(23.3) 34.1%	\$	(24.9) 34.8%
Increase (decrease) in income taxes for:						
Non-taxable income and expenses		(14.9) 11.3		0.8 (1.2)		(2.5) 3.5
Difference in foreign tax rate		(1.7) 1.3		(1.8) 2.6		(2.0) 2.8
Release of future income taxes related to reduction in corporate income tax rates		(22.4) 17.0		(22.9) 33.5		(14.2) 19.8
Change in the future income tax estimate		(14.4) 11.0		(4.5) 6.6		- -
Adjustment to deferred credits		(2.3) 1.7		1.0 (1.4)		(5.0) 7.0
Large corporations tax		- -		(0.3) 0.4		3.5 (4.9)
Other		0.4 (0.3)		(3.0) 4.4		(1.5) 2.1
Income tax recovery	\$	(100.0) 76.0%	\$	(54.0) 79.0%	\$	(46.6) 65.1%

The tax effects of temporary differences that give rise to significant future tax liabilities (assets) were as follows at December 31:

	2007	2006
Future income tax liabilities		
Property, plant and equipment	\$ 229.2	\$ 396.1
Other	61.7	92.6
	290.9	488.7
Future income tax assets		
Non-capital loss carry-forwards	(77.9)	(179.4)
Employee future benefits	(54.8)	(60.7)
Other	(11.8)	(10.5)
	(144.5)	(250.6)
Valuation allowance	4.1	5.8
	(140.4)	(244.8)
Net future income tax liability	\$ 150.5	\$ 243.9

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

9. Earnings per share

The following table provides the reconciliation between basic and diluted earnings (loss) per share:

	2007	2006	2005
Net earnings (loss) reported	\$ (31.6)	\$ (15.9)	\$ (25.6)
Weighted average shares used in computation of basic earnings per share (in millions)	214.7	214.6	214.6
Weighted average shares from assumed conversion of dilutive options (in millions)	-	-	-
Weighted average shares used in computation of diluted earnings per share (in millions)	214.7	214.6	214.6
Basic and diluted earnings (loss) per share (in dollars)	\$ (0.15)	\$ (0.07)	\$ (0.12)

10. Accounts receivable

The components of accounts receivable at December 31 were as follows:

	2007	2006
Trade receivables	\$ 197.0	\$ 267.0
Less: Allowance for doubtful accounts	(2.8)	(3.1)
	194.2	263.9
Sales taxes receivable	8.3	4.4
Other	10.6	9.6
	\$ 213.1	\$ 277.9

11. Inventories

The components of inventories at December 31 were as follows:

	2007	2006
Finished goods		
Specialty paper	\$ 40.6	\$ 44.1
Newsprint	10.3	26.8
Pulp	24.3	25.3
Total finished goods	75.2	96.2
Work-in-progress	1.5	1.4
Raw materials – wood chips, pulp logs and other	41.0	33.0
Operating and maintenance supplies and parts	118.0	114.4
	\$ 235.7	\$ 245.0

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

12. Prepaids and other

The components of prepaids and other at December 31 were as follows:

	2007	2006
Derivative financial instruments	\$ 32.0	\$ 6.1
Property taxes, insurance and licences	3.7	4.7
Other	5.0	4.8
	\$ 40.7	\$ 15.4

13. Property, plant and equipment

The components of property, plant and equipment at December 31 were as follows:

2007	Cost	Accumulated amortization	Net book value
Buildings and land			
Specialty paper and newsprint	\$ 472.2	\$ 172.2	\$ 300.0
Pulp	117.1	59.7	57.4
Machinery and equipment			
Specialty paper and newsprint	2,582.9	1,281.2	1,281.7
Pulp	883.5	609.8	273.7
	\$4,035.7	\$2,122.9	\$1,912.8
2006	Cost	Accumulated amortization	Net book value
Buildings and land			
Specialty paper and newsprint	\$ 471.4	\$ 158.4	\$ 313.0
Pulp	116.4	54.0	62.4
Machinery and equipment			
Specialty paper and newsprint	2,518.9	1,181.4	1,337.5
Pulp	881.1	570.9	310.2
	\$ 3,987.8	\$ 1,964.7	\$ 2,023.1

During 2007, interest of \$0.2 million (2006 – \$nil) was capitalized in connection with capital projects.

At December 31, 2007, a net carrying amount of \$8.3 million (2006 – \$4.6 million) included in machinery and equipment is held under capital leases, \$10.4 million for cost (2006 – \$6.3 million) and \$2.1 million for accumulated amortization (2006 – \$1.7 million).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

14. Other assets

The components of other assets at December 31 were as follows:

	2007	2006
Accrued benefit asset – pension plan (note 17)	\$ 18.6	\$ 1.8
Deferred financing costs (note 2 (c))	–	14.9
Non-controlling interest (note 4)	16.1	15.6
Deferred charges and other	13.4	8.5
Derivative financial instruments	5.0	–
	\$ 51.1	\$ 40.8

15. Accounts payable and accrued liabilities

The components of accounts payable and accrued liabilities at December 31 were as follows:

	2007	2006
Trade payables	\$ 135.7	\$ 150.8
Accrued payroll and related liabilities	74.9	85.1
Restructuring and change-of-control (note 5)	20.0	–
Accrued benefit obligation – pension plan (note 17)	5.5	4.5
Accrued benefit obligation – other employee future benefit plans (note 17)	6.7	6.3
Accrued interest	9.2	10.6
Other	16.2	34.2
	\$ 268.2	\$ 291.5

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

16. Long-term debt

The Company's long-term debt at December 31 was as follows (note 2 (c)):

	2007	2006
Recourse		
Senior notes, 8.625% due June 2011 (US\$400.0 million)	\$ 388.9	\$ 468.7
Senior notes, 7.375% due March 2014 (US\$250.0 million)	246.6	291.3
	635.5	760.0
Revolving operating facility of up to \$350.0 million due July 2009	47.1	—
Capital lease obligations	8.6	5.0
	691.2	765.0
Non-recourse (PREI)		
First mortgage bonds, 6.387% due July 2009	74.6	75.0
Subordinated promissory notes	19.5	19.5
Short-term loan payable	0.5	1.0
	94.6	95.5
Total debt	785.8	860.5
Less: Current portion	(1.2)	(1.8)
	\$ 784.6	\$ 858.7

Borrowings under the revolving operating facility (the "Facility") bear interest at a rate based on Canadian dollar banker's acceptance/prime or U.S. dollar LIBOR/base rates, plus a margin that varies with the Company's credit rating. The interest rates on borrowings under the Facility averaged 7.3% in 2007 (2006 – 7.3%). A commitment fee at a percentage of the margin applies to the undrawn portion of the Facility. Substantially all of the assets of the Company are pledged as security under the \$350.0 million Facility. Its availability is determined by a borrowing base which is calculated based on accounts receivable and inventory balances, and includes covenants to maintain the funded debt/capitalization ratio below 60%, secured debt/capitalization ratio below 30% and shareholders' equity above \$779.3 million as at December 31, 2007. At December 31, 2007, as calculated under the Facility, the Company's funded debt/capitalization ratio was 42% (December 31, 2006 – 44%), secured debt/capitalization ratio was 4% (December 31, 2006 – 2%) and shareholders' equity was \$988.6 million (December 31, 2006 – \$1,005.8 million). The borrowing base at December 31, 2007 was \$309.0 million and after drawings of \$47.5 million and outstanding letters of credit of \$20.7 million, \$240.8 million was available to the Company. A springing interest coverage covenant is applicable in certain circumstances if the Company incurs secured debt other than under the Facility. At December 31, 2007, no such debt has been incurred.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

The indentures and agreements governing the Company's senior notes and the Facility contain customary restrictive covenants, including restrictions on incurring additional indebtedness, certain payments including dividends and investments in other persons, the creation of liens, sale and leaseback transactions, certain amalgamations, mergers, consolidations and the use of proceeds arising from certain sales of assets and certain transactions with affiliates. At December 31, 2007, the Company was in compliance with the covenants under both its Facility and senior notes. The Company's Fixed Charge Coverage Ratio ("FCC Ratio") under the senior note indentures, calculated on a 12-month trailing average, was 0.8:1 at December 31, 2007 (December 31, 2006 – 3.0:1). While the FCC Ratio is below 2.0:1, the Company is limited in the amount of additional debt it may incur to "permitted debt" under the senior notes. Under the indenture for the 8.625% senior notes, "permitted debt" includes a) the Company's existing 8.625% notes and 7.375% notes, b) a credit facility basket in an amount equal to the greater of (i) \$725 million and (ii) the sum of 75% of the book value of the Company's accounts receivable, 50% of the book value of the Company's inventory and \$290 million, against which in either case utilization under the Company's \$350 million Facility is applied, c) purchase money debt and capital lease obligations in an amount equal to 5.0% of the Company's consolidated tangible assets, d) a \$40 million general basket, and e) a \$5 million basket for accommodation guarantees, trade or standby letters of credit, performance bonds, bankers' acceptances and surety bonds. The indenture for the 7.375% notes contains larger debt baskets, but while the 8.625% notes remain outstanding, the Company is bound by their more restrictive provisions. Also, the Company's restricted payments baskets under the 8.625% and 7.375% senior notes were negative \$189.0 million and negative \$164.0 million, respectively as at December 31, 2007, as a result of accumulated losses in recent years (December 31, 2006 – negative \$72.5 million and negative \$47.5 million, respectively). Under the senior note covenants, the Company cannot pay dividends unless the balance in these baskets is positive.

Non-recourse debt is debt owed by PREI. The Company has a 50% interest in PREI, and consolidates 100% of it as PREI is a VIE in which the Company is the primary beneficiary.

Scheduled total debt repayments	Recourse debt	Non-recourse debt (PREI)
2008	\$ 0.7	\$ 0.5
2009	47.9	74.6
2010	0.7	–
2011	389.7	–
2012	0.8	–
Thereafter	251.4	19.5
	\$ 691.2	\$ 94.6

Fair value of total debt

The following estimated fair values of the Company's total debt at December 31 have been determined based on management's best estimate of the fair value to refinance debt with similar terms at the respective year-end dates:

	2007	2006
Recourse	\$ 573.9	\$ 750.1
Non-recourse (PREI)	96.5	96.5
	\$ 670.4	\$ 846.6

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

17. Employee future benefits**Description of benefit plans**

The Company maintains pension benefit plans for all salaried employees, which include defined benefit and defined contribution segments. Employees hired subsequent to January 1, 1994, enroll in the defined contribution segment.

The defined benefit segment provides a pension based on years of service and earnings. For the defined contribution segment, the Company's contributions are based on a percentage of an employee's earnings with the Company's funding obligations being satisfied upon crediting contributions to an employee's account.

The Company also maintains pension benefits for former hourly employees that are not covered by union pension plans.

The Company provides other benefit plans consisting of provincial medical plan premiums, extended health care and dental benefits to eligible retired employees and their dependents. Assumed health care trend rates have a significant effect on the amounts reported for the post-retirement medical plans.

Total cash payments

Total cash payments for employee future benefits for the year ending December 31, 2007, consisting of cash contributed by the Company to its funded pension plans, cash payments directly to beneficiaries for its unfunded benefit plans and cash contributed to its defined contribution plans, was \$36.2 million (2006 – \$33.9 million).

Unionized employees of the Company are members of multi-employer industry-wide pension plans to which the Company contributes a predetermined amount per hour worked by an employee. The pension expense for these plans is equal to the Company's contribution of \$17.2 million in 2007 (2006 – \$18.0 million; 2005 – \$18.3 million).

Defined benefit plan

The Company measures the fair value of plan assets and the accrued benefit obligations for accounting purposes as at December 31 of each year. The most recent actuarial valuation of the majority of pension plans for funding purposes was as of December 31, 2006, and the next required valuation will be as of December 31, 2009.

Change in accrued defined benefit plan obligation

The following table represents the change in the accrued benefit obligation as determined by independent actuaries:

	Pension benefit plans		Other benefit plans	
	2007	2006	2007	2006
Accrued benefit obligations at beginning of year	\$ 376.5	\$ 364.9	\$ 227.6	\$ 216.8
Service cost for the year	5.3	6.9	5.1	5.6
Interest cost	18.2	17.8	11.4	10.9
Employee contributions	0.4	0.4	–	–
Benefit payments	(29.8)	(27.7)	(6.4)	(6.1)
Recognition of restructuring program (note 5)	12.6	–	–	–
Actuarial loss (gain) and other adjustments	(7.4)	14.2	(18.3)	0.4
Accrued benefit obligations balance at end of year	\$ 375.8	\$ 376.5	\$ 219.4	\$ 227.6

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

Change in fair value of defined benefit plan assets

The following table represents the change in the fair value of assets of the defined benefit plans:

	Pension benefit plans		Other benefit plans	
	2007	2006	2007	2006
Fair value of defined benefit plan assets at beginning of year	\$ 283.5	\$ 250.8	\$ -	\$ 0.2
Actual return on plan assets	(1.1)	37.7	-	-
Employee contributions	0.4	0.4	-	-
Company contributions	24.4	22.3	6.4	6.1
Other	(1.0)	-	-	-
Benefit payments	(29.8)	(27.7)	(8.4)	(6.3)
Fair value of defined benefit plan assets at end of year	\$ 276.4	\$ 283.5	\$ -	\$ -

The asset allocation for the Company's defined benefit pension plans, by asset category, was as follows:

Plan assets at December 31,	2007	2006
Equity securities	60.5%	59.4%
Fixed income securities	39.5%	40.6%
Total	100.0%	100.0%

Reconciliation of the funded status of the benefit plans to the amounts in the consolidated balance sheets

The following table presents the difference between the fair value of the defined benefit pension assets and the actuarially determined accrued benefit obligations as at December 31, 2007 and 2006. This difference is also referred to as either the deficit or surplus, as the case may be, or the funded status of the plans.

The table also reconciles the amount of the surplus or deficit (funded status) to the accrued benefit obligation in the consolidated balance sheets. This difference between the funded status and the obligation recognized in the consolidated balance sheets, in accordance with Canadian GAAP, represents the portion of the surplus or deficit not yet recognized for accounting purposes. Deferred recognition is a key element of the Canadian GAAP pension accounting. This approach allows for a gradual recognition of changes in accrued benefit obligations and fund performance over the expected average remaining service life of the employee group covered by the plans.

As at December 31, 2007, there was a total funding deficit of \$99.4 million (2006 – \$93.0 million) in the Company's various defined benefit pension plans. Of this amount, \$38.3 million (2006 – \$39.9 million) related to funded defined benefit pension plans and \$61.1 million (2006 – \$53.1 million) to "pay-as-you-go" unfunded defined benefit pension plans. In addition, the Company has other "pay-as-you-go" post-retirement benefit plans, consisting of group health care and life insurance, which had a deficit of \$219.4 million at December 31, 2007 (2006 – \$227.6 million).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

	Pension benefit plans		Other benefit plans	
	2007	2006	2007	2006
Accrued benefit obligation at end of year	\$ 375.8	\$ 376.5	\$ 219.4	\$ 227.6
Fair value of plan assets at end of year	276.4	283.5	-	-
Funded status-deficit	(99.4)	(93.0)	(219.4)	(227.6)
Unrecognized past service costs	-	0.1	(1.7)	(1.9)
Unrecognized actuarial losses	69.2	59.8	45.0	66.4
Accrued benefit obligation recognized in the consolidated balance sheets	\$ (31.2)	\$ (33.1)	\$ (176.1)	\$ (163.1)

Classification of accrued obligations

The accrued benefit obligation is included in the Company's balance sheet as follows:

	Pension benefit plans		Other benefit plans	
	2007	2006	2007	2006
Other assets	\$ 16.0	\$ 1.8	\$ -	\$ -
Accounts payable and accrued liabilities	(5.5)	(4.5)	(6.7)	(6.3)
Employee future benefits	(42.3)	(30.4)	(169.4)	(156.8)
	\$ (31.2)	\$ (33.1)	\$ (176.1)	\$ (163.1)

Components of net periodic benefit cost recognized in the year

Pension benefit plans	2007	2006	2005
Defined benefit costs			
Service cost for the year	\$ 5.3	\$ 6.9	\$ 5.4
Interest cost	18.2	17.8	19.4
Actual return on assets	1.1	(37.7)	(21.4)
Actuarial (gain)/loss	(9.0)	14.2	31.2
Settlement loss	0.5	-	-
Recognition of restructuring program (note 5)	12.6	-	-
Difference between actual and expected return	(20.7)	20.3	4.6
Difference between actual and recognized actuarial (gain)/loss and other	11.6	(7.7)	(28.5)
Difference between actual and recognized prior service costs	-	-	0.1
Amortization of transitional balance	-	-	0.1
	19.6	13.8	10.9
Defined contribution cost			
Service cost for the year	5.3	5.5	5.1
Net periodic benefit cost for pension benefit plans	\$ 24.9	\$ 19.3	\$ 16.0

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

Other benefit plans	2007	2006	2005
Defined benefit costs			
Service cost for the year	\$ 6.1	\$ 5.6	\$ 4.2
Interest cost	11.4	10.9	10.7
Actuarial (gain)/loss	(18.3)	0.4	28.9
Difference between actual and recognized actuarial (gain)/loss and other	21.9	3.0	(27.1)
Difference between actual and recognized prior service costs	(0.2)	(0.2)	(0.2)
Net periodic benefit cost for other benefit plans	\$ 19.5	\$ 19.7	\$ 16.5

Significant assumptions

Actuarial assumptions used in accounting for the Company-maintained benefit plans were:

	2007	2006
Benefit obligations at December 31,		
Discount rate	5.25%	5.00%
Rate of compensation increase	2.50%	3.00%
Net benefit cost for year ended December 31,		
Discount rate	5.00%	5.00%
Rate of compensation increase	3.00%	3.00%
Expected rate of return on plan assets	7.00%	7.00%
Assumed health care cost trend rate at December 31,		
Extended health benefits		
Initial health care cost trend rate	8.00%	9.00%
Annual rate of decline in trend rate	0.50%	1.00%
Ultimate health care cost trend rate	4.50%	5.00%
Dental benefits		
Dental care cost trend rate	4.00%	4.50%
Medical services plan benefits		
Premium trend rate	2.00%	2.00%

Sensitivity analysis

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1% change in assumed health care cost rates would have the following effects for 2007:

	Other benefit plans	
	Increase	Decrease
Total of service and interest cost	\$ 3.5	\$ (2.8)
Accrued benefit obligation at December 31,	\$ 39.7	\$ (31.0)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

18. Other long-term obligations

The components of other long-term obligations were as follows at December 31:

	2007	2006
Restructuring and change-of-control liabilities (note 5)	\$ 8.1	\$ -
Forward foreign currency contracts hedging long-term debt	5.4	4.2
Environmental and remedial	9.2	10.0
Other	4.2	9.1
	\$ 26.9	\$ 23.3

19. Deferred credits

Continuity of deferred credits for the years ended December 31 was as follows:

	2007	2006
Beginning of year	\$ 25.5	\$ 24.3
Net price adjustment related to acquired tax losses	-	1.4
Adjustment related to utilization of acquired tax losses	(2.3)	1.0
Adjustment resulting from reduction in corporate income tax rates	(1.5)	(1.2)
End of year	\$ 21.7	\$ 25.5

In prior years, the Company acquired from wholly owned subsidiaries of Fletcher Challenge Limited, a major shareholder up to July 28, 2000, companies with available tax losses. The purchase price of these companies is subject to adjustment under certain conditions. In 2007, there were no adjustments to the purchase price (2006 – net \$1.4 million reduction).

20. Share capital**(a) Authorized**

The Company is authorized to issue 100,000,000 preferred shares and an unlimited number of common shares.

(b) Issued and outstanding

	2007		2006	
	Shares	\$	Shares	\$
Issued and outstanding:				
Common shares	214,684,129	913.9	214,604,120	913.6

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

21. Stock-based compensation plans**(a) Details of stock-based compensation expense:**

	2007	2006	2005
Stock option awards	\$ 2.4	\$ 2.0	\$ 2.5
Restricted share units	0.8	-	-
Deferred share units	0.2	0.9	0.6
	\$ 3.4	\$ 2.9	\$ 3.1

(b) Stock option plans

The Company has an employee share option plan (the "Plan") for its key officers, directors and employees. The Plan provides for the issuance of up to a maximum of 12.0 million common shares.

Options granted prior to July 31, 2007 have a term of ten years. These options are exercisable as to one-third on and after the first anniversary date, as to two-thirds on and after the second anniversary date and as to all on and after the third anniversary date, unless, for all options other than those granted on March 28, 2007, the market price of the common shares exceeds a specified acceleration price, in which case all of the options are exercisable at that date. Market price is determined by the weighted average price per share for all sales of the shares on the Toronto Stock Exchange ("TSX") during the five consecutive trading days preceding the date on which a determination of Market Price is required under the Plan.

During the third quarter of 2007, the Company granted 1,804,624 stock options to its key executives that are time and performance based. These options vest on December 31, 2009 subject to certain conditions being met. 50% of the total number of stock options will vest if the executive remains employed with the Company for a three year period, subject to a minimum return on capital employed benchmark. The remaining 50% of the options will vest subject to the achievement of a relative return on capital employed compared to that of an industry peer group. These options have a term of seven years.

The Company applies the fair value-based method for recording share options granted to directors, officers and employees. Under the fair value method, compensation cost is measured at fair value at the date of grant, and is expensed over the award's vesting period. Compensation expense related to these noted options has been based on management's best estimate of the outcome of the performance conditions in accordance with CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based payments."

The fair value of share options was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	2007	2006	2005
Risk-free interest rate	4.5%	4.0%	3.7%
Annual dividends per share	Nil	Nil	Nil
Expected stock price volatility	30.5%	30.6%	30.3%
Expected option life (in years)	7.0	4.0	4.0
Average fair value of options granted (in dollars)	\$1.25	\$1.02	\$1.11

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

The risk-free interest rate was based on a zero-coupon Government of Canada bonds with a remaining term approximately equivalent to the expected life of the stock option. The Company estimated the annual dividends per share, expected stock price volatility and expected option life based upon historical experience. Forfeitures were recognized as they occurred.

Changes in the number of options outstanding during the years ended December 31, were as follows:

	2007		2006		2005	
	Number of options	Weighted average exercise price (in dollars)	Number of options	Weighted average exercise price (in dollars)	Number of options	Weighted average exercise price (in dollars)
Beginning of year	8,171,000	\$ 4.35	8,409,500	\$ 5.00	5,951,333	\$ 5.62
Granted	1,984,624	3.20	1,836,000	3.37	2,886,000	3.58
Exercised	(80,009)	3.31	-	-	-	-
Expired or cancelled	(6,111,591)	4.58	(2,074,500)	6.08	(427,833)	4.14
End of year	3,964,024	\$ 3.43	8,171,000	\$ 4.35	8,409,500	\$ 5.00

The following table summarizes information about stock options outstanding and exercisable at December 31, 2007:

Options outstanding				Options exercisable		
Range of exercise prices	Number of options	Weighted average remaining option life (years)	Weighted average range of exercise price (in dollars)	Number of options	Weighted average range of exercise price (in dollars)	Accelerated price (in dollars)
\$3.06 - \$3.29	2,115,524	6.8	\$ 3.09	155,566	\$ 3.22	\$ 4.62
\$3.31 - \$3.62	1,212,250	7.6	3.49	600,833	3.52	5.06
\$4.39 - \$4.57	636,250	7.0	4.44	456,250	4.39	6.30
	3,964,024	7.1	\$ 3.43	1,212,649	\$ 3.81	\$ 5.47

(c) Restricted share units

During 2007, the Company established a Restricted Share Unit Plan for its directors and key executives. Under the terms of this plan, senior executives are eligible to incentive remuneration paid to them in the form of restricted share units ("RSUs"). Each RSU, once vested, entitles the holder to receive one common share of the Company. The fair value of RSUs is based on the market value of the Company's shares on the day of the grant.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

During 2007, the Company granted 485,000 RSUs to its directors and 1,201,307 RSUs to its key executives. RSUs granted to directors vest three years following the grant date. RSUs granted to key executives are time and performance based and vest on December 31, 2009 subject to certain conditions being met. 50% of the total number of RSUs will vest if the executive remains employed with the Company until December 31, 2009, subject to a minimum return on capital employed benchmark. The remaining 50% will vest subject to the achievement of a relative return of capital employed compared to that of an industry peer group. Compensation expense related to these RSUs is based on management's best estimate of the outcome of the performance conditions in accordance with CICA Handbook Section 3870, "Stock-based Compensation and Other Stock-based Payments."

Changes in the number of outstanding RSUs during the year ended December 31, 2007 were as follows:

	Number of shares	Weighted average fair value at grant date (in dollars)
Beginning of year	–	\$ –
Granted	1,686,307	3.20
Expired or cancelled	–	–
End of year	1,686,307	\$ 3.20

(d) Deferred share unit plan

The Company has established a deferred share unit ("DSU") plan for its directors. Under the terms of this plan, directors may elect to receive their annual cash remuneration in DSUs, cash or a combination thereof. Each DSU initially has a value equivalent to the Company's weighted average share price on the TSX, during the ten consecutive trading days prior to the issuance date of the DSU. A director's DSU account is credited with dividend equivalents in the form of additional DSUs when dividends are paid on common shares. A director may elect the date of redemption by filing an irrevocable written election with the Company no later than December 15 of the calendar year commencing immediately after the director's termination date. The value shall be paid by the Company as a lump sum in cash, equal to the fair value of the notional underlying common shares plus accrued dividend equivalents at that date, after deduction of applicable taxes and other source deductions required to be withheld. Liabilities related to this plan are recorded in "Accounts payable and accrued liabilities". As at December 31, 2007, 365,188 DSUs were outstanding under this plan (2006 – 448,533 DSUs) and approximately \$0.6 million was payable (2006 – \$1.5 million).

22. Financial instruments**Derivative financial instruments**

The Company uses derivative financial instruments to reduce its exposure to foreign currency and price risk associated with its revenues, energy costs and long-term debt. The Company also uses interest rate swaps to manage its net exposure to interest rate changes.

Derivative financial instruments are accounted for in accordance with CICA Handbook Section 3855, "Financial Instruments – Recognition and Measurement", and where applicable, Section 3865, "Hedges." Under these standards, all derivatives are recorded on the balance sheet at fair value (see note 2 (c)).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

(a) Revenue risk management instruments

Foreign exchange exposure to foreign currency revenue and related receivables, primarily in U.S. currency, is managed through the use of foreign exchange forward contracts and options to sell foreign currencies.

The effective portion of changes in the fair value of derivatives that qualify and are designated as cash flow hedges are deferred and recorded as a component of AOCI until the underlying transaction is recorded in earnings. When the hedged item affects earnings, the gain or loss is reclassified from AOCI to "Sales". Any ineffective portion of a hedging derivative's change in fair value and the portion that is excluded from the assessment of hedge effectiveness is recognized immediately in "Sales". At December 31, 2007, instruments having a notional principal of US\$404 million are designated as hedging instruments. At period-end exchange rates, the net amount the Company would receive to settle the above contracts and options is \$32.9 million (December 31, 2006 – negative \$3.8 million).

Foreign currency options and forward contracts outstanding to sell U.S. dollars were as follows:

Term	Options				Forward contracts	
	Purchased US\$ put		Sold US\$ call			
	US\$millions	Average rate US\$/C\$	US\$millions	Average rate US\$/C\$	US\$millions	Average rate US\$/C\$
As at December 31, 2007						
0 to 12 months	\$ 498	0.9688	\$ 106	0.9190	\$ 47	1.0001
13 to 24 months	38	1.0355	—	—	—	—
	\$ 534	0.9733	\$ 106	0.9190	\$ 47	1.0001
As at December 31, 2006						
0 to 12 months	\$ 485	0.9031	\$ 205	0.8606	\$ 109	0.8727
13 to 24 months	34	0.8982	32	0.8898	—	—
	\$ 519	0.9028	\$ 237	0.8644	\$ 109	0.8727

At December 31, 2007, commodity swap agreements to fix the sales price of NBSK pulp and containerboard within the next 12 months are outstanding for 23,500 metric tonnes and 1,750 short tons, respectively. These contracts are not designated as hedging instruments for accounting purposes and are reported at their fair value, which was negative \$1.0 million (December 31, 2006 – negative \$0.3 million) at the end of the current year.

(b) Cost risk management instruments

Natural gas contracts and options outstanding were as follows:

Term	AECO or Sumas		Sold options		Purchased options		Fixed swap contracts	
	Gigajoules ("GJ")	Average rate	GJ	Average rate	GJ	Average rate	GJ	Average rate
	(millions)	C\$/GJ	(millions)	C\$/GJ	(millions)	C\$/GJ	(millions)	C\$/GJ
As at December 31, 2007	0.6	\$ 6.07	1.0	\$ 7.98	—	\$ —		
As at December 31, 2006	—	\$ —	0.4	\$ 7.91	1.0	\$ 8.33		

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

Oil contracts and options outstanding were as follows:

WTI NYMEX	Sold options		Purchased options		Fixed swap contracts	
Term	Barrels ("bbbls" – 000s)	Average rate US\$/bbl	bbbls (000s)	Average rate US\$/bbl	bbbls (000s)	Average rate US\$/bbl
As at December 31, 2007						
As at December 31, 2006	–	\$ –	–	\$ –	30	\$31.55

The above instruments are not designated as hedging instruments for accounting purposes. At period-end contract rates, the net amount the Company would pay to settle these commodity contracts is \$0.2 million (December 31, 2006 – \$0.6 million).

(c) Long-term debt risk management instruments

The Company is party to forward foreign currency contracts or options to acquire U.S. dollars totalling US\$228 million (December 31, 2006 – US\$23 million) over a seven-year period at rates averaging US\$/C\$0.9359. These instruments are not designated as hedging instruments for accounting purposes, and are included in "Other long-term obligations" on the balance sheet at their fair value. Settlements and changes in fair value are recognized in "Foreign exchange gain (loss) on long-term debt". At period-end exchange rates, the net amount the Company would pay to settle these contracts is \$5.4 million (December 31, 2006 – \$4.0 million).

(d) Interest rate swaps

The Company has entered into fixed-to-floating interest rate swaps on US\$80 million, under which it will receive a fixed rate of 7.375%, and pay a floating rate of U.S. six-month LIBOR plus 2.0%. The swaps mature March 1, 2014, although US\$10 million are cancellable at the counterparties' option between March 1, 2009 and March 1, 2014 for premiums which mirror the call premiums on the 7.375% senior notes. These instruments are designated as fair value hedging instruments. The effective portion of changes in the fair value of the derivatives are netted in "Long-term debt" and the ineffective portion is recognized in "Interest expense, net". At period-end swap rates, the net amount the Company would receive to settle these contracts is \$4.1 million (December 31, 2006 – \$1.2 million).

(e) Credit risk

The Company is exposed to credit risk on accounts receivable from its customers who are mainly in the newspaper publishing, commercial printing and paper manufacturing businesses. The Company manages its credit risk principally through credit policies, which include the analysis of the financial position of its customers and the regular review of their credit limits. The Company also subscribes to credit insurance for a majority of its receivables, periodically purchases accounts receivable puts on certain customers, and obtains bank letters of credit for some export market customers.

The Company is exposed to credit risk with counterparties to the Company's derivative financial instruments. The credit risk arises from the potential for a counterparty to default on its contractual obligations, and is limited to those contracts where the Company would incur a loss in replacing the defaulted transaction. The Company manages this risk by diversifying through counterparties that are of strong credit quality, normally major financial institutions.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

(f) Fair value of financial instruments

The carrying values of the Company's other financial instruments, namely cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their fair values because of the short-term maturity of these instruments.

23. Related party transactions

Related parties include Third Avenue Management LLC, which has control or direction over a significant number of the Company's common shares. The Company has not undertaken any transactions with TAM during the year ended December 31, 2007.

Related parties also included Norske Skogindustrier ASA ("Norske Skog"), together with its subsidiaries and affiliates, up to February 16, 2006 when Norske Skog disposed of its 29.4% interest in the Company and Norske Skog North America LLC ("NSNALLC"), which was a joint venture between Norske Skog and the Company until the shareholders of NSNALLC announced the dissolution of its U.S. marketing joint venture effective October 1, 2005. After the dissolution, the Company returned to marketing its specialty papers directly to North American customers.

Transactions or balances with these related parties not otherwise disclosed in these financial statements were as follows:

	2007	2006	2005
Norske Skog			
Selling, general and administrative	\$ -	\$ 0.2	\$ 0.1
Accounts receivable	-	-	2.7
Norske Skog North America LLC			
Commission expenses	-	-	4.4
Net loss	-	-	0.1
Investment (US\$0.5 million)	-	-	0.8

The Company previously entered into agency and distribution agreements with affiliates of Norske Skog to effect all sales of the Company's newsprint and specialty papers in certain international markets. The agency agreement was terminated in April, 2006. Product sales to these affiliates were \$13.6 million for 2006 and \$118.1 million for 2005. Neither of these entities were affiliates in 2007. Transactions that took place under the distribution agreement were in accordance with normal third-party trade practices.

In prior years, the Company acquired from wholly-owned subsidiaries of Fletcher Challenge Limited, now subsidiaries of Norske Skog, companies with tax losses. The purchase price of these companies is subject to adjustment under certain conditions. At December 31, 2007, there was no outstanding balance with respect to such adjustments (2006 - \$nil; 2005 - \$2.7 million). During 2006, the Company collected \$4.3 million in respect of the adjustments. The \$4.3 million was comprised of the \$2.7 million accounts receivable at December 31, 2005 and a further adjustment and interest totalling \$1.6 million.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

The Company undertakes certain transactions with companies affiliated with its directors. These transactions are in the normal course of business and are on the same terms as those accorded to third parties. During 2007, the Company paid aggregate fees of approximately \$8.7 million (2006 – \$0.4 million; 2005 – \$nil) primarily for obligations under a building lease, for services related to trucking chips and sawdust, and for other consulting services to companies affiliated with directors of the Company. In addition, the Company paid \$0.7 million (2006 – \$3.9 million; 2005 – \$1.8 million) primarily for chemicals used in the manufacturing process to a company affiliated with a former officer and director of the Company.

The Company has advanced interest-free loans to its officers. As at December 31, 2007, the balance outstanding was \$0.1 million (2006 – \$0.1 million). These loans were issued prior to the enactment of the United States Sarbanes-Oxley Act of 2002, which prohibits such loans effective July 30, 2002. The Company has made no loans to any of its directors or officers since that date.

24. Commitments

- (a) The Company has entered into operating leases for property, plant and equipment. The minimum future payments under various operating leases in each of the years ended December 31 are as follows:

2008	\$	10.1
2009		9.0
2010		8.0
2011		7.5
2012		5.6
Subsequent years		32.0
	\$	72.2

The total lease expense amounted to \$12.3 million in 2007 (2006 – \$13.0 million; 2005 – \$13.8 million).

- (b) The Company has entered into a six-year take-or-pay contract for the purchase of recycled paper used in the production of its paper products. The agreement, effective May 1, 2006, provides for minimum purchase quantities of recycled paper and prices are based on market rates at the beginning of each month. Total purchases in 2007 amounted to \$2.1 million (2006 – \$0.9 million). At current market rates, the Company is expected to pay approximately \$2.2 million per year for the duration of the contract.

25. Guarantees and indemnities

The Company has, over time, provided various indemnities with respect to tax, environment, and employment liabilities, as well as general representations and warranties on sales of portions of its business, acquisitions, and commodity contracts. Significant existing indemnities are as follows:

- (a) The Company sold a portion of its operations in June 2001. In this regard, the Company provided a 10-year environmental indemnity with a maximum liability to the Company of \$12.5 million. This liability has subsequently been reduced by expenditures related to certain decommissioning projects. The Company provided a tax indemnity, which continues while the relevant tax years of the indemnified parties remain open to audit. The Company also provided a general indemnity, capped at \$5 million,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

which expired in 2004. The purchaser of the operations has advised the Company that, based on the terms of the purchase and sale agreement, it believes it may be entitled to indemnification under the general indemnity in connection with certain labour matters. The Company is unable to estimate any potential liability under these indemnities as the amounts are dependent upon the outcome of future contingent events, the nature and likelihood of which cannot be determined at this time. As such, no liability has been recorded for these potential obligations.

- (b) In connection with the acquisition of the paper recycling business in December 2003, the Company has provided indemnities with respect to representations and warranties related to general corporate matters and to the shares that have been issued to the vendors. Liability under these indemnities expires in November 2008, except that the indemnity related to title to the shares does not expire. The Company does not expect any significant claims with respect to these indemnities. The Company has also provided indemnities with respect to general environmental matters under its lease of the land and buildings. The Company has agreed to indemnify the landlord for all costs, claims and damages related to any release by the Company of any hazardous substances on the property or the breach by the Company of its environmental covenants under the lease or any environmental laws. This indemnity is indefinite and survives after the lease is terminated. The Company is not liable for pre-existing environmental conditions.
- (c) The Company has entered a building lease agreement whereby it has agreed to continue making the prescribed lease payments directly to the financial institution holding the mortgage on the building in the event the lessor is no longer able to meet its contractual obligations. As at December 31, 2007, the value of the mortgage was \$10.6 million (2006 – \$11.9 million). This agreement does not increase the Company's liability beyond the obligation under the building lease.

26. Contingent liabilities

In the normal course of its business activities, the Company is subject to a number of claims and legal actions that may be made by customers, suppliers and others. While the final outcome with respect to actions outstanding or pending as at December 31, 2007, cannot be predicted with certainty, the Company believes an adequate provision has been made, or the resolution will not have a material effect on the Company's consolidated financial position, earnings or cash flows.

27. Accounting policy developments

The new recommendations of the CICA Handbook Section 3031, "Inventories" provides significantly more guidance on the measurement of inventory and requires enhanced disclosures. This standard is effective for interim and annual financial statements for fiscal years beginning on or after January 1, 2008. The transitional rules for this standard require retrospective application at the beginning of the fiscal year. While the Company is currently assessing the impact of these new recommendations on its consolidated financial statements, it does not expect the recommendations to have material impact on its earnings or cash flows.

The new recommendations of the CICA Handbook Section 1535, "Capital Disclosures" establishes guidelines for the disclosure of information related to an entity's objectives, policies and processes for managing capital, quantitative data on what the entity regards as capital and whether the entity has complied with any capital requirements and, if it has not complied, the consequences of such non-compliance. This standard is effective for interim and annual financial statements for fiscal years beginning on or after October 1, 2007. The Company does not expect the adoption of this standard to have a material impact on its consolidated financial position, earnings or cash flows.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

The CICA has released two new Handbook sections related to financial instruments: Section 3862, "Financial Instruments – Disclosures" and Section 3863, "Financial Instruments – Presentation". These standards enhance existing disclosures in previously issued Section 3861, "Financial Instruments – Disclosures and Presentation". The new recommendations under Section 3862, "Financial Instruments – Disclosures" require additional disclosures, relative to those currently, with an emphasis on risks associated with both recognized and unrecognized financial instruments to which an entity is exposed during the period and at the balance sheet date, and how the entity manages those risks. This standard is effective for interim and annual financial statements for fiscal years beginning on or after October 1, 2007. The Company does not expect the adoption of this standard to have a material impact on its consolidated financial position, earnings or cash flows.

28. Reconciliation of Canadian and United States generally accepted accounting principles

The Company's consolidated financial statements have been prepared in accordance with Canadian GAAP, which differ in some respects from U.S. GAAP. The following are the significant differences in accounting principles as they pertain to the consolidated earnings and consolidated balance sheets:

Net earnings adjustments

The following table provides a reconciliation of the net earnings (loss) for the years ended December 31 from Canadian GAAP to U.S. GAAP:

	2007	2006	2005
Net earnings (loss) as reported under Canadian GAAP	\$ (31.6)	\$ (15.9)	\$ (25.6)
U.S. dollar revenue hedges (a)	—	(9.4)	(32.4)
U.S. dollar long-term debt hedges (b)	—	(0.7)	(1.5)
Fixed to floating interest swaps (c)	—	(0.8)	(3.4)
Commodity swaps (d)	—	—	(0.3)
Income tax impact of above items and effect of rate change	(4.9)	1.1	12.8
Net earnings (loss) in accordance with U.S. GAAP	(36.5)	(25.7)	(50.4)
Other comprehensive income:			
Other comprehensive income in accordance with Canadian GAAP (e)	14.3	—	—
Reclass of amortization of employee future benefits included in pension cost, net of future income taxes of \$5.1 million	13.9	—	—
Employee future benefits liability adjustment, net of future income taxes of \$2.2 million	(5.8)	—	—
Minimum pension liability adjustment, net of future income taxes of \$nil (2006 – \$3.6 million; 2005 – \$7.0 million) (e)	—	7.9	(14.0)
Reclassification of effective portion of U.S. dollar hedges on de-designation, net of future income taxes of \$nil (2006 – \$5.2 million) (a)	—	(11.3)	—
Effective portion of U.S. dollar revenue hedges, net of future income taxes of \$nil (2006 – \$2.8 million; 2005 – \$2.4 million) (a)	—	6.1	4.5
Comprehensive income (loss) in accordance with U.S. GAAP	\$ (14.1)	\$ (23.0)	\$ (59.9)
Basic and diluted net earnings (loss) per share in accordance with U.S. GAAP (in dollars)	(0.17)	(0.12)	(0.23)
Basic and diluted weighted average number of shares in accordance with U.S. GAAP (in millions)	214.7	214.6	214.6

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

The following table presents the consolidated statements of earnings under Canadian and U.S. GAAP:

Years ended December 31,	2007		2006		2005	
	Canadian GAAP	U.S. GAAP	Canadian GAAP	U.S. GAAP	Canadian GAAP	U.S. GAAP
Sales	\$ 1,714.6	\$ 1,714.6	\$ 1,882.5	\$ 1,873.2	\$ 1,823.9	\$ 1,791.5
Operating expenses						
Cost of sales	1,574.6	1,574.6	1,609.3	1,609.3	1,604.3	1,604.6
Selling, general and administrative	48.3	48.3	62.2	62.2	57.7	57.7
Restructuring and change-of-control	64.7	64.7	-	-	6.7	6.7
Amortization	176.4	176.4	207.1	207.1	180.3	180.3
	1,864.0	1,864.0	1,878.6	1,878.6	1,849.0	1,849.3
Operating earnings (loss)	(149.4)	(149.4)	3.9	(5.4)	(25.1)	(57.8)
Interest expense, net	(70.7)	(70.7)	(73.8)	(74.6)	(75.7)	(76.0)
Foreign exchange gain (loss) on long-term debt	103.9	103.9	(0.3)	(1.0)	24.7	20.1
Other income (expense), net	(15.3)	(15.3)	1.8	1.8	4.5	4.5
Earnings (loss) before income taxes and non-controlling interest	(131.5)	(131.5)	(68.4)	(79.2)	(71.6)	(109.2)
Income tax recovery	(106.0)	(95.1)	(54.0)	(55.0)	(46.6)	(59.4)
Net earnings (loss) before non-controlling interest	(31.5)	(36.4)	(14.4)	(24.2)	(25.0)	(49.8)
Non-controlling interest	(0.1)	(0.1)	(1.5)	(1.5)	(0.6)	(0.6)
Net earnings (loss)	\$ (31.6)	\$ (36.5)	\$ (15.9)	\$ (25.7)	\$ (25.6)	\$ (50.4)
Other comprehensive income	14.3	22.4	-	2.7	-	(9.5)
Comprehensive income (loss)	\$ (17.3)	\$ (14.1)	\$ (15.9)	\$ (23.0)	\$ (25.6)	\$ (59.9)
Basic and diluted earnings (loss) per share (in dollars)	\$ (0.15)	\$ (0.17)	\$ (0.07)	\$ (0.12)	\$ (0.12)	\$ (0.23)
Weighted average common shares outstanding (in millions)	214.7	214.7	214.6	214.6	214.6	214.6

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

Balance sheet adjustments

The following table provides a reconciliation of the consolidated balance sheet components at December 31 from Canadian GAAP to U.S. GAAP:

	2007	2006
Prepays and other – Canadian GAAP	\$ 40.7	\$ 15.4
U.S. dollar revenue hedges	—	(6.1)
Fixed-to-floating interest swaps	—	1.2
Prepays and other – U.S. GAAP	\$ 40.7	\$ 10.5
Other assets – Canadian GAAP	\$ 51.1	\$ 40.8
Employee future benefits	(17.1)	(1.5)
Deferred financing costs	14.4	—
Other assets – U.S. GAAP	\$ 48.4	\$ 39.3
Accounts payable and accrued liabilities – Canadian GAAP	\$ 268.2	\$ 291.5
U.S. dollar revenue hedges	—	0.7
Employee future benefits	—	(0.1)
Accounts payable and accrued liabilities – U.S. GAAP	\$ 268.2	\$ 292.1
Long-term debt – Canadian GAAP	\$ 784.8	\$ 858.7
Fixed-to-floating interest swaps	—	0.6
Interest on long-term debt	1.8	—
Deferred financing costs (g)	14.4	—
Long-term debt – U.S. GAAP	\$ 800.6	\$ 859.3
Employee future benefits – Canadian GAAP	\$ 211.7	\$ 187.2
Employee future benefits	95.1	121.9
Employee future benefits – U.S. GAAP	\$ 306.8	\$ 309.1
Other long-term obligations – Canadian GAAP	\$ 26.9	\$ 23.3
U.S. dollar long-term debt hedges	—	(0.2)
Other long-term obligations – U.S. GAAP	\$ 26.9	\$ 23.1
Future income taxes – Canadian GAAP	\$ 150.5	\$ 243.9
Interest on long-term debt	(0.5)	—
Tax effect of employee future benefits adjustment	(37.6)	(40.6)
Tax effect of effective portion of U.S. dollar revenue hedges	—	(2.1)
Tax effect of other adjustments	7.3	2.6
Future income taxes – U.S. GAAP	\$ 119.7	\$ 203.8

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

(continued)	2007	2006
Shareholders' equity – Canadian GAAP	\$ 988.6	\$ 1,005.8
U.S. dollar revenue hedges	—	(6.8)
U.S. dollar long-term debt hedges	—	0.2
Fixed-to-floating interest swaps	—	0.6
Interest on long-term debt	(1.6)	—
Employee future benefits	(112.2)	(123.3)
Tax effect of employee future benefits adjustment	37.6	40.6
Tax effect of effective portion of U.S. dollar revenue hedges	—	2.1
Tax effect on interest on long-term debt	0.6	—
Tax effect of other adjustments	(7.3)	(2.6)
Shareholders' equity – U.S. GAAP	\$ 905.6	\$ 916.6

The following table provides a reconciliation of accumulated other comprehensive income at December 31 from Canadian GAAP to U.S. GAAP:

	2007	2006
Accumulated other comprehensive income – Canadian GAAP	\$ 13.6	\$ —
U.S. dollar revenue hedges	—	(0.7)
Employee future benefits – adoption of FAS 158	(74.8)	(49.0)
Employee future benefits – minimum pension liability	—	(33.7)
Accumulated other comprehensive income (loss) – U.S. GAAP	\$ (61.0)	\$ (83.4)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

The following table presents the consolidated balance sheets under Canadian and U.S. GAAP:

As at December 31,	2007		2006	
	Canadian GAAP	U.S. GAAP	Canadian GAAP	U.S. GAAP
Assets				
Current assets				
Cash and cash equivalents	\$ -	\$ -	\$ 35.5	\$ 35.5
Accounts receivable	213.1	213.1	277.9	277.9
Inventories	235.7	235.7	245.0	245.0
Prepays and other	40.7	40.7	15.4	10.5
	489.5	489.5	573.8	568.9
Property, plant and equipment	1,912.8	1,912.8	2,023.1	2,023.1
Other assets	51.1	48.4	40.8	39.3
	\$ 2,453.4	\$ 2,450.7	\$ 2,637.7	\$ 2,631.3
Liabilities				
Current liabilities				
Accounts payable and accrued liabilities	\$ 268.2	\$ 268.2	\$ 291.5	\$ 292.1
Current portion of long-term debt	1.2	1.2	1.8	1.8
	269.4	269.4	293.3	293.9
Long-term debt	784.6	800.6	858.7	859.3
Employee future benefits	211.7	306.8	187.2	309.1
Other long-term obligations	26.9	26.9	23.3	23.1
Future income taxes	150.5	119.7	243.9	203.8
Deferred credits	21.7	21.7	25.5	25.5
	1,464.8	1,545.1	1,631.9	1,714.7
Shareholders' equity				
Share capital	913.9	913.9	913.6	913.6
Contributed surplus	12.1	12.1	9.3	9.3
Retained earnings	49.0	40.6	82.9	77.1
Accumulated other comprehensive income (loss)	13.6	(61.0)	-	(83.4)
	988.6	905.6	1,005.8	916.6
	\$ 2,453.4	\$ 2,450.7	\$ 2,637.7	\$ 2,631.3

(a) U.S. dollar revenue hedges

Effective January 1, 2007, the Company adopted the new Canadian accounting standards that require entities to record its derivatives at fair value. Changes in the fair value of designated contracts, during the period of designation, are recorded in other comprehensive income, net of tax, until the hedged item is recognized. Changes in the fair value of undesignated contracts are recognized in income. Prior to January 1, 2007, under Canadian GAAP, translation gains and losses on foreign currency options and forward contracts to sell foreign currencies that were designated as hedges were recognized concurrently with the hedged revenue in "Sales". The new Canadian standards have eliminated this difference.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

Prior to April 1, 2005, the Company did not designate its revenue contracts as hedges for U.S. GAAP purposes. Effective April 1, 2005, the Company designated certain of its existing revenue contracts as hedges in accordance with criteria under U.S. GAAP and has, prospectively, accounted for them as hedges under U.S. GAAP.

(b) U.S. dollar long-term debt hedges

Under Canadian GAAP, prior to January 1, 2004, the Company designated foreign currency contracts related to its U.S. dollar debt as hedges. The forward premium or discount on forward foreign currency contracts used to hedge the U.S. dollar long-term debt was amortized to interest expense over the term of the forward contract. Effective January 1, 2004, foreign currency contracts related to U.S. dollar debt are not designated as hedges. Under U.S. GAAP, the Company does not account for such contracts as hedges of long-term debt and recognizes the foreign currency contracts on a fair value basis at each reporting period. The adoption of new Canadian standards on January 1, 2007 eliminated this difference.

(c) Fixed to floating interest swaps

Effective January 1, 2007, the Company adopted the new Canadian accounting standards that recognize the unrealized gains and losses on interest rate swap contracts in the financial statements. The ineffectiveness of the hedge is quantified, and the ineffective portion of the changes in fair value is recorded in interest expense. Prior to January 1, 2007, unrealized gains and losses on interest rate swap contracts designated as hedges were not recognized in the financial statements under Canadian GAAP. The adoption of new Canadian standards eliminated this difference. During 2003, the Company terminated prior to their maturity, certain interest rate swap contracts for cash proceeds of \$15.9 million. Under Canadian GAAP, the net gain is deferred and is being amortized as a reduction of interest expense based on the U.S. swap curve at the time of termination. Under U.S. GAAP, there is no deferred amount as the fluctuations in the fair value and interest payments are recognized in earnings as they arise.

(d) Commodity swaps

Under Canadian GAAP, prior to January 1, 2004, the Company accounted for commodity swaps as hedges. Effective January 1, 2004, commodity swaps are not designated as hedges and are recognized at their fair value at each reporting date with changes in fair value in the year included in consolidated net income (loss). Under U.S. GAAP, the Company does not designate commodity swaps as hedges.

(e) Employee future benefits

Effective December 31, 2006, the Company adopted Financial Accounting Standards No. 158 ("FAS 158"), "Employers' Accounting for Defined Benefit Pension and Other Post-retirement Plans". This statement requires the recognition of the overfunded or underfunded status of a defined benefit post-retirement plan as an asset or liability in the balance sheet and changes in that funded status in the year in which the changes occur through comprehensive income. This new standard replaced the U.S. GAAP requirement to recognize an additional minimum pension liability in cases where the accumulated benefit obligation exceeded the market value of plan assets. The portion of this additional liability that related to unrecognized prior service cost was recognized as an intangible asset while the remainder was charged to comprehensive income (loss). There is no change in the calculation of the pension and other employee future benefits expense. Canadian GAAP has no such requirement.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

(f) Comprehensive Income

Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income", requires that a company classify items of other comprehensive income in a financial statement and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of the balance sheet. The concept of comprehensive income exists under Canadian GAAP, but applies to fiscal years beginning on or after October 1, 2006 and applies to the Company in its 2007 fiscal year.

(g) Debt issue costs

Effective January 1, 2007, on adoption of the new Canadian accounting standards, the Company netted its debt issue costs against the carrying value of debt. Under U.S. GAAP, debt issue costs are reported in the balance sheet as deferred charges.

(h) Future income taxes

Income taxes for the year ended December 31, 2007 include a release of future income taxes of \$22.4 million related to the reduction in future federal corporate income tax rates and a release of \$14.0 million related to tax uncertainties resolved with the conclusion of an examination by the Canada Revenue Agency.

On January 1, 2007, the Company adopted FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes". FIN 48 clarifies the accounting for uncertainty in income taxes and uses a more-likely-than-not threshold to determine recognition in the financial statements of an uncertain tax position. The more-likely-than-not threshold means that a benefit related to an uncertain tax position is recognized only when it is more-likely-than-not that the position will be sustained based on its technical merits and where there is a greater than 50 per cent likelihood that the position would be sustained if challenged by a tax authority. The tax position is measured as the largest amount of benefit that is greater than 50 per cent likely of being realized upon settlement. The unresolved uncertain tax positions must be reassessed at each balance sheet date based on these thresholds. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods and disclosure. FIN 48 is effective for fiscal years beginning after December 31, 2006.

The Company did not record any unrecognized tax benefits as a result of applying this interpretation.

A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of 2007 is as follows:

Unrecognized tax benefits, beginning of year	\$ 36.7
Increases – tax positions taken in prior periods	–
Decreases – tax positions taken in prior periods	(2.5)
Current period tax positions	–
Settlements	(14.0)
Lapse of statute of limitations	–
Decrease resulting from tax rate reduction	(3.3)
Unrecognized tax benefits, end of year	\$ 16.9

The above balance, if recognized, would affect the Company's effective tax rate. Total amount of interests and penalties related to the above amount is \$nil.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Amounts expressed in millions of dollars, except where otherwise stated

In the normal course of business, the Company and its subsidiaries are subject to audits by the Canadian federal and provincial taxing authorities, by the U.S. federal and various state taxing authorities and by the taxing authorities in various foreign jurisdictions. All tax years up to and including August 31, 2001 have been audited by the Canadian federal taxing authorities. The Canadian federal taxing authorities are presently auditing the December 31, 2001 and the December 31, 2002 taxation years of the Canadian entities. The Company is not currently under audit by the U.S. Internal Revenue Service, by any U.S. state taxing authority or by any foreign taxing authority. The U.S. federal statute of limitations for pre-2003 tax years expired on September 15, 2006.

(i) Shareholders' equity

Accumulated other comprehensive income is recorded as a separate component of shareholders' equity under U.S. GAAP. The concept of accumulated other comprehensive income exists under Canadian GAAP, but applies to fiscal years beginning on or after October 1, 2006 and applies to the Company in its 2007 fiscal year.

(j) Consolidated cash flows

Under U.S. GAAP, the consolidated cash flows would not be significantly different from the presentation under Canadian GAAP, except that U.S. GAAP does not allow sub-totals within cash flows provided by operations.

Cash flows associated with hedging instruments are classified in "Operations" on the consolidated statement of cash flows, consistent with the hedged transaction.

(k) Future changes in accounting policy*Fair value measurement*

FASB has issued a new standard which clarifies the definition of "fair value" applicable under all United States accounting standards, with some limited exceptions. The standard establishes a single definition of fair value, sets out a framework for measuring fair value and requires additional disclosures about fair value measurements. The objective of the standard is to increase consistency, reliability and comparability in fair value measurements, and to enhance disclosures to help users of financial statements assess the effects of the fair value measurements used in financial reporting. The framework provides a hierarchy for reliably determining fair value based on the definition in the standard. This standard is effective November 1, 2008.

Business combinations

FASB has issued new guidance on accounting for business combinations on how entities should approach financial planning and reporting around business combinations. This will require entities to be more transparent in demonstrating the values of assets and liabilities. This standard is effective for fiscal years beginning after December 15, 2008.

29. Subsequent event

On February 11, 2008, the Company announced that it has entered into a definitive agreement with a subsidiary of AbitibiBowater to acquire its Snowflake Arizona recycled newsprint mill for cash consideration of US\$161 million. The purchase price excludes trade receivables of approximately US\$19 million that are being retained by AbitibiBowater. The acquisition will be financed through a combination of the Company's revolving credit facilities and a proposed \$125 million rights offering.