

BOWATER INC
Form 10-K/A
June 05, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(Amendment No. 2)

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of
1934 for the Fiscal Year Ended December 31, 2006**

COMMISSION FILE NO. 1-8712

Bowater Incorporated

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

62-0721803
(I.R.S. Employer Identification No.)

55 East Camperdown Way

P. O. Box 1028

Greenville, South Carolina 29602-1028

(Address of principal executive offices)

Registrant's telephone number, including area code: (864) 271-7733

Securities registered pursuant to Section 12(b) of the Act:

| Title Of Each Class |
|--|
| Common Stock, par value \$1 per share |
| Securities registered pursuant to Section 12(g) of the Act: None |

| Name Of Each Exchange On Which Registered |
|---|
| New York Stock Exchange |

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No "

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes " No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No "

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. "

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x

Accelerated Filer "

Non-accelerated Filer "

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes " No x

The aggregate market value of the voting common equity held by nonaffiliates of the registrant as of June 30, 2006, was approximately \$1.3 billion. Without acknowledging that any individual director or executive officer of the registrant is an affiliate, the shares over which they are deemed to have voting control are considered to be owned by affiliates solely for purposes of this calculation.

As of February 23, 2007, there were 56,205,141 shares of Bowater Incorporated's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

* See Explanatory Note on following page

EXPLANATORY NOTE

Bowater Incorporated is filing this Amendment No. 2 on form 10-K/A (this Amendment) to its Annual Report on Form 10-K for the fiscal year ended December 31, 2006, originally filed on March 1, 2007 and amended on April 30, 2007, for the purpose of making minor technical revisions to (i) the paragraphs under the heading Critical Accounting Estimates Pension and Other Postretirement Benefit Obligations Judgments and Uncertainties Involved in the Estimate (on page 22 of this Amendment) and Goodwill Judgments and Uncertainties Involved in the Estimate (on pages 23 and 24 of this Amendment), both of which are contained in Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations, and (ii) Note 2 Accounting Policies Goodwill in the Notes to Consolidated Financial Statements (on page 35 of this Amendment) which is contained in Item 8 Financial Statements and Supplementary Data. In addition, the registrant is also including as exhibits to this Amendment the certifications required pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act of 2002. Except as set forth herein, the registrant is making no other changes to its Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis provides information that we believe is useful in understanding our operating results, cash flows and financial condition for the three years ended December 31, 2006. The discussion should be read in conjunction with, and is qualified in its entirety by reference to, the Consolidated Financial Statements and related notes appearing in Item 8 of this Form 10-K. Except for the historical information contained herein, the discussions in this document contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and involve risks and uncertainties. Our actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under Cautionary Statements Regarding Forward-Looking Information and Use of Third-Party Data in Item 1 and Risk Factors in Item 1A of this Form 10-K and from time to time, in Bowater's other filings with the Securities and Exchange Commission.

YEAR IN REVIEW

Business Fundamentals

We manufacture approximately four million metric tons annually of a broad range of mechanical-based printing papers coated mechanical, mechanical specialty papers and newsprint. These products are sold to leading publishers, commercial printers and advertisers. We also sell excess pulp to paper, tissue and toweling manufacturers who do not have a sufficient supply of pulp for their own needs. We operate sawmills that produce approximately one billion board feet of lumber annually and provide a source of residual chips that we use to manufacture pulp and paper. Our lumber is sold to a diversified group of customers, namely large retailers, buying groups, distributors, wholesalers and industrial accounts.

To produce our pulp and paper products, we operate 12 pulp and paper mills, ten of which are located in eastern North America. We also operate a facility in the United States that converts a mechanical fiber-containing base sheet to coated products which is also located in eastern North America. The remaining two mills include a newsprint mill in the state of Washington for which we are the managing partner and a newsprint mill in South Korea that provides access to the growing Asian markets.

Our North American manufacturing facilities are located near key domestic markets or have access to export markets. They are supported by approximately 29 million acres of timberland about 0.8 million acres are owned or leased and the balance is under long-term cutting rights on Crown-owned land in Canada.

Our products are, in large part, commodities sold in global markets. Our business is influenced by general economic conditions that impact our customers as well as changes within our industry that affect demand, supply, pricing, shipments or the cost of production. North American demand for newsprint has continued to decline in 2006, and there is no indication as to if or when the demand will stabilize.

The manufacturing facilities we operate are capital-intensive and require significant amounts of cash to maintain. Our ability to generate positive cash flow is dependent on achieving revenues that exceed manufacturing and debt costs and on the amount of cash that must be reinvested in the business.

A significant portion of our manufacturing facilities are located outside the U.S.; however, the majority of our sales are denominated in U.S. dollars. Therefore, fluctuations in currency rates can have a significant impact on our costs, cost competitiveness and cash flows. In particular, our results can be materially influenced by the movement of the Canadian dollar. A stronger Canadian dollar will typically weaken our results, and a weaker Canadian dollar will tend to strengthen our earnings. We can also be subject to government imposed trade restrictions that can limit shipments or increase costs.

Significant cost components of manufacturing our products can be highly volatile, particularly the cost of wood, recycled fiber (old newspapers and magazines), energy, commodity and specialty chemicals.

The strength of the economy influences the level and extent of publishing and advertising, which in turn affects the demand for our pulp and paper products. The strength of the construction and real estate markets influences the level of building and remodeling, which impacts the demand for our lumber products. A decline in demand for our products also would likely have a negative effect on prices. Changes in the level of supply caused by capacity additions or contractions could also influence the supply and demand balance for our products and have a direct impact on shipment levels and pricing.

Overview of Financial Performance

Our net loss for 2006 was \$138.3 million, or \$2.41 per diluted share, as compared to a net loss of \$120.6 million, or \$2.10 per diluted share, for 2005.

Our sales in 2006 were \$3.53 billion, a slight increase from 2005 sales of \$3.48 billion. In 2006, average transaction prices increased for our specialty papers, newsprint and market pulp products, while coated papers and lumber average transaction prices were lower in 2006. Shipments increased for coated papers and specialty papers in 2006. The increase in specialty paper shipments was due to the conversion of a newsprint machine at our Calhoun facility to now produce a lightly coated freesheet hybrid product beginning in July 2006. Shipments of newsprint were significantly lower in 2006 compared to 2005 due to the conversion discussed above and the curtailment, beginning in September 2006, of paper production at our Thunder Bay, Ontario facility. We restarted one of the Thunder Bay paper machines in October 2006, but have not restarted the second machine, which has an annual capacity of approximately 160,000 metric tons. Shipments of market pulp decreased from 2006 compared to 2005 due to the permanent closure of our Thunder Bay A kraft pulp mill in May 2006 and increased internal consumption. Shipments of lumber were also lower in 2006 compared to 2005 due to weak demand in the housing construction market and the sale of our Baker Brook and Dégelis sawmills in 2006.

Our costs during 2006 as compared to 2005 increased by \$142.8 million, primarily due to the stronger Canadian dollar (\$107.9 million), which increased from an average rate of US\$0.83 to US\$0.88, reduced benefits from our Canadian dollar hedging program (\$61.8 million), higher chemical costs (\$14.9 million) higher energy costs (\$14.9 million) and higher repairs (\$13.6 million). These higher costs were partially offset by lower wood costs (\$31.7 million) and lower labor costs (\$2.2 million) and the benefits from our previously announced \$80 million cost reduction program which was implemented in 2006. These cost savings helped offset the increased input costs. More information regarding changes in our manufacturing and other costs is contained below in the section entitled Consolidated Results of Operations. In addition, we recorded impairment and other related charges of \$252.5 million in 2006 associated with the impairment of goodwill at our Thunder Bay, Ontario facility, the impairment of paper machine No. 3 at our Thunder Bay, Ontario facility, the indefinite shut of our Ignace and Girardville sawmills and the closure of our Benton Harbor, Michigan facility. We also recorded a net gain on the disposition of assets of \$185.7 million primarily associated with our ongoing land sales program. Our cash flows from operating activities and asset sale proceeds for 2006 were greater than our capital spending and dividends by \$268.6 million, contributing to a debt reduction of \$210.7 million, or \$279.5 million, net of cash. In 2006, we spent approximately \$200 million on capital projects.

Business Strategy and Outlook

2006 was a year of change for Bowater. In the latter part of 2006, we underwent a management transition and realigned our organizational structure from a divisional structure to a functional structure focusing on operational excellence. This realignment and our new management team, has established a manufacturing-focused culture to identify manufacturing improvements, improve consistency in our operations and further reduce our costs. In 2006, we exceeded our target in an \$80 million cost reduction program and in 2007 we have targeted further cost improvements. For instance, in February 2007, the unions at our Thunder Bay facility ratified an agreement that is expected to result in annual labor savings of over \$16 million.

We also continue the focus on improving our balance sheet by reducing our debt. The reduction in debt in 2006 was primarily due to our asset sales program and the lumber duties refund received at the end of the year.

We received proceeds of \$331.8 million in 2006 from the sale of timberlands and \$103.9 million from the refund of lumber duties and related interest. Although we don't anticipate the same amount of proceeds in 2007, we believe our asset sales will generate significant proceeds of approximately \$170 million. These proceeds will be used to further reduce our debt.

Additionally, we are focused on improving our product mix. North American newsprint demand declined significantly in 2006 and there is no indication of whether, or at what level, demand may stabilize. We periodically evaluate our production options to focus on our more profitable product lines. We believe our operations are positioned to deliver quality products and that capital reinvestment in the business can be held to appropriate levels. We expect to spend approximately \$150 million on capital projects in 2007.

We have also rigorously evaluated our strategic options. This evaluation resulted in our announcement, on January 29, 2007, that we have entered into an agreement to combine with Abitibi in a merger of equals. The combination, if completed, would have a material impact on our results of operations, financial condition and liquidity going forward. Management believes, as a result of the merger, the combined company would be operationally and financially stronger and better able to meet changing customer needs while competing more effectively globally. We expect that the combination would generate approximately \$250 million of cost synergies from improved efficiencies in such areas as production, selling, administrative, distribution and procurement costs. We expect to complete the combination in the third quarter of 2007, subject to the conditions described elsewhere in this report. In connection with this announced merger, we have approved a retention and severance program for approximately 320 Bowater employees who may be impacted by the pending merger with Abitibi. This program provides a retention bonus for employees who remain with Bowater through the closing of the merger or its cancellation and an additional retention bonus for employees who remain with Bowater for a transition period following closing of the merger.

Business and Financial Review

Consolidated Results of Operations

| <i>(In millions, except per share amounts)</i> | Year Ended December 31, | | | Change | |
|--|-------------------------|------------|------------|---------------|---------------|
| | 2006 | 2005 | 2004 | 2006 vs. 2005 | 2005 vs. 2004 |
| Sales | \$ 3,529.8 | \$ 3,483.8 | \$ 3,190.3 | \$ 46.0 | \$ 293.5 |
| Operating income (loss) | 41.2 | 98.8 | 29.5 | (57.6) | 69.3 |
| Net loss | (138.3) | (120.6) | (87.1) | (17.7) | (33.5) |
| Loss per diluted share | (2.41) | (2.10) | (1.52) | (0.31) | (0.58) |
| Significant items that improved (lowered) operating income (loss): | | | | | |
| Gain on disposition of assets | | | | \$ 119.9 | \$ 58.9 |
| Impairment and other related charges | | | | (169.9) | (82.6) |
| Product pricing | | | | 143.8 | 311.7 |
| Distribution costs | | | | 4.2 | (10.1) |
| Lumber duties refund | | | | 92.5 | |
| Manufacturing costs | | | | (242.2) | (207.4) |
| Employee termination costs | | | | (3.0) | (4.6) |
| Selling and administrative expenses | | | | (2.9) | 3.4 |
| | | | | \$ (57.6) | \$ 69.3 |

Year ended 2006 compared to 2005

Sales increased in 2006 as compared to 2005 due to product price increases in specialty papers, newsprint and market pulp products and higher shipments of coated papers and specialty papers. These increases were

partially offset by lower product prices in our coated papers and lumber products and lower shipments of newsprint, market pulp and lumber. Please refer to the discussion of **Product Line Information** for a more detailed analysis of pricing and shipments.

Operating income decreased in 2006 as compared to 2005. The above table analyzes the major items that caused the decrease in operating income. A brief explanation of these major items follows.

Gain on disposition of assets, primarily for the sale of timberlands, is discussed in Note 6 to the Notes to Consolidated Financial Statements included in this Report on Form 10-K.

Impairment and other related charges for 2006, increased materially as compared to 2005 due to a goodwill impairment charge of \$200.0 million associated with our Thunder Bay, Ontario facility, and asset impairment charges associated with our Benton Harbor operations (\$27.5 million), paper machine No. 3 at our Thunder Bay facility (\$18.9 million), our Ignace sawmill (\$5.2 million) and our Girardville sawmill (\$0.9 million). Please refer to the discussion of **Critical Accounting Estimates Goodwill** and **Critical Accounting Estimates Long Lived Assets** in Item 7 of this Form 10-K for information regarding the judgments and uncertainties involved in determining these impairment charges.

Product pricing for all of our major product groups increased during the year except for our coated papers and lumber product group. Please refer to the discussion of **Product Line Information** for a more detailed analysis of pricing.

Distribution costs decreased slightly in 2006 as a result of a reduction in lumber shipments and duties.

Lumber duties refund in 2006 is related to a refund of lumber duties for lumber shipments from Canada to the U.S. paid to the U.S. government from May 22, 2002 through October 12, 2006 as a result of the finalization of a softwood lumber agreement between the two countries. Please refer to **Product Line Information** for a discussion of the lumber duties and the related refund.

Manufacturing costs were higher in 2006 primarily as a result of the items that are discussed below. These higher manufacturing costs were partially offset by lower wood, depreciation, and labor costs.

Canadian dollar During 2006 the Canadian dollar rose in relation to the U.S. dollar. Since 40% of our pulp and paper production capacity is in Canada, our manufacturing costs incurred in Canadian dollars increased approximately \$107.9 million when translated into U.S. dollars. We also had \$61.8 million in reduced benefits from our Canadian dollar hedging program as compared to 2005.

Chemicals During 2006 the cost of chemicals we use in our production process increased by \$14.9 million due to an increase in the price of chemicals and more usage of chemicals due to an increase in specialty paper production.

Energy costs We are a significant user of electricity, natural gas and other fossil fuels. Although our overall consumption of these energy inputs decreased in 2006, increases in electricity and fuel prices resulted in a \$14.9 million increase in our total energy costs in 2006 as compared to 2005.

Employee termination costs were higher primarily due to the closure of our Benton Harbor facility, the closure of our Ignace sawmill and the organizational realignment that occurred in 2006.

Net loss in 2006 was higher compared to 2005. Our net loss in 2006 was higher as a result of the items previously discussed, especially the higher impairment charge, partially offset by an increase in other income primarily due to interest income on the lumber duty refund and a gain on foreign exchange. Our income tax provision was lower in 2006 due to a \$50.6 million valuation allowance being recorded compared to a \$96.7 million valuation allowance being recorded in 2005. See discussion under **Critical Accounting Estimates Tax Valuation Allowances** for a discussion of the judgments and uncertainties involved in determining a tax valuation allowance.

Year ended 2005 compared to 2004

Sales increased in 2005 compared to 2004 from both product price increases in all of our major product groups and increased shipments in coated and specialty papers and lumber. Please refer to the discussion of Product Line Information for a more detailed analysis of pricing and shipments.

Operating income for 2005 significantly improved when compared to 2004. The above table analyzes the major items that caused the improvement in operating income. A brief explanation of these major items follows.

Gain on sale of assets, primarily for the sale of timberlands, is discussed on in Note 6 to the Notes to Consolidated Financial Statements included in this Report on Form 10-K.

Impairment of assets for 2005 primarily relates to asset impairment charges of \$67.2 million for the permanent closure of the Thunder Bay A kraft pulp mill, \$11.9 million for the permanent shut of the older, higher cost original coating line at Benton Harbor and \$3.5 million for a paper machine at our Mokpo, Korea paper mill.

Product pricing for all of our major product groups increased during the year. Please refer to the discussion of Product Line Information for a more detailed analysis of pricing.

Distribution costs increased in 2005 as a result of increased shipments, lumber duties on increased shipments and lumber transactions prices, increased fuel prices, and export-related costs. Please refer to Product Line Information for a more detailed discussion of the lumber duties.

Manufacturing costs were higher in 2005 primarily as a result of the items that are discussed below. These higher manufacturing costs were partially offset by higher production volumes.

Canadian dollar During 2005, the Canadian dollar strengthened in relation to the U.S. dollar. Since over 40% of our pulp and paper production capacity is in Canada, our costs stated in U.S. dollars increased approximately \$138.1 million.

Energy costs We are a significant user of electricity, natural gas and other fossil fuels. Although our overall consumption of these energy inputs decreased in 2005, increases in electricity and fuel prices caused an increase in energy costs, resulting in a \$28.4 million increase in our total energy costs in 2005 as compared to 2004.

Wood costs We use both harvested timber and residual sawmill chips to make our pulp and paper products. The cost for harvested timber and residual chips in Canada increased in 2005 due primarily to increased fuel prices. Additionally, the fees we pay to the Canadian government for harvesting trees increased as a result of higher average lumber transaction prices. As a result of these and other factors, our wood costs increased \$13.5 million in 2005 as compared to 2004.

Labor and repair materials Labor costs were \$10.3 million higher in 2005 as a result of increased labor and fringe rates, primarily from increased pension costs. Repair materials were \$7.4 million higher, primarily as a result of increased maintenance outages in 2005.

Employee termination costs were higher primarily due to severance charges related to the closure of the A kraft pulp mill at our Thunder Bay facility, which was completed in the second quarter of 2006.

Net loss in 2005 was higher compared to 2004. Net loss in 2005 was higher as a result of the items previously discussed and due to the fact that income tax benefits generated primarily on our 2005 Canadian net operating losses, including the Thunder Bay impairment, were offset by a tax valuation allowance charge of approximately \$96.7 million.

Fourth Quarter of 2006

Net income for the fourth quarter of 2006 was \$107.2 million, or \$1.86 per diluted share, on sales of \$861.3 million. This compares to a net loss for the fourth quarter of 2005 of \$101.9 million, or \$(1.78) per diluted share, on sales of \$876.4 million.

Operating income for the fourth quarter of 2006 was \$113.3 million compared to an operating loss of \$23.8 million for the fourth quarter of 2005. The increase to operating income was primarily the result of the refund of lumber duties (\$92.5 million) as discussed in Lumber section of Product Line Information below, higher product pricing for our newsprint, specialty papers and market pulp (\$23.1 million), lower asset impairment charges (\$64.6 million) and slightly lower manufacturing costs.

Interest income increased \$12.1 million, from \$1.6 million in the fourth quarter of 2005 to \$13.7 million in the fourth quarter of 2006, primarily due to the interest received with the refunded lumber duties.

Other, net increased \$8.5 million, from \$0.8 million in the fourth quarter of 2005 to \$9.3 million in the fourth quarter of 2006, primarily due to a gain on the early extinguishment of the debt, net of the fees, associated with the debt we repurchased in November 2006. For further discussion on the repurchase of debt, see the discussion in Note 14 of the Notes to our Consolidated Financial Statements included in this Form 10-K.

Product Line Information

During the third quarter of 2006, Bowater announced that it was realigning its organizational structure to move from a divisional organization to a functional organization that supports and focuses on our multi-line manufacturing and sales across our mill base. As a result of this organizational realignment, our reportable segments have been changed to reflect how we internally manage our business, which is now based on products that we manufacture and sell to external customers. Our primary product lines include coated papers, specialty papers, newsprint, market pulp, and lumber. This Management's Discussion and Analysis section reflects our new reportable segments, and prior year information has been recast to the current year presentation. For further information regarding our segments, see Note 25 of the Notes to our Consolidated Financial Statements included in this Form 10-K.

In general, our products are globally-traded commodities. Pricing and the level of shipments of these products will continue to be influenced by the balance between supply and demand as affected by global economic conditions, changes in consumption and capacity, the level of customer and producer inventories and fluctuations in currency exchange rates.

Coated Papers

| | 2006 | 2005 | 2004 |
|--|---------------|-------------|-------------|
| Average price (per short ton) | \$ 769 | \$ 792 | \$ 670 |
| Shipments (thousands of short tons) | 796.5 | 789.9 | 738.7 |
| Downtime (thousands of short tons) | 68.3 | 83.8 | 89.4 |
| Inventory at end of year (thousands of short tons) | 37.2 | 34.5 | 22.9 |

| (In millions) | Year Ended December 31, | | | Change | |
|--|-------------------------|----------|----------|---------------|---------------|
| | 2006 | 2005 | 2004 | 2006 vs. 2005 | 2005 vs. 2004 |
| Sales | \$ 612.2 | \$ 625.3 | \$ 494.9 | \$ (13.1) | \$ 130.4 |
| Segment income | 76.3 | 114.2 | 11.6 | (37.9) | 102.6 |
| Significant items that improved (lowered) segment income (loss): | | | | | |
| Product pricing | | | | \$ (17.1) | \$ 95.8 |
| Distribution costs | | | | (4.3) | (2.3) |
| Manufacturing costs | | | | (15.9) | 0.9 |
| Selling and administrative expenses | | | | (0.6) | 8.2 |
| | | | | \$ (37.9) | \$ 102.6 |

Year ended 2006 compared to 2005

Sales of coated paper decreased in 2006 as compared to 2005 as a result of lower transaction prices. Our average transaction price decreased 2.9% as a result of offshore imports, the high level of inventories in the industry and the restart of previously idled capacity in North America by a competitor. The effect of the lower transaction prices in 2006 was partially offset by an increase in coated mechanical papers shipments in 2006 due to increased production at our Catawba facility. During the third quarter of 2006, we made the decision to close our Benton Harbor facility. Previous to this closure, our Benton Harbor and Covington facilities were running at approximately 50% capacity. This closure will allow us to operate more efficiently and reduce costs while continuing to serve our customers effectively.

Segment income decreased in 2006 as compared to 2005 primarily due to lower transaction prices as discussed above, higher distribution costs and higher manufacturing costs. The higher manufacturing costs were primarily due to higher repair (\$4.3 million), wood (\$4.3 million), and chemical costs (\$4.1 million) and lower production volumes (\$0.8 million).

Coated Papers Third-Party Data: North American demand for coated mechanical papers increased 0.6% during 2006 compared to 2005. The industry operating rate in 2006 was 92% compared to 88% in 2005. According to Publishers Information Bureau, U.S. magazine monthly advertising pages decreased 0.1% in 2006 compared to 2005 and catalog/bulk mailings (measured by Standard mail pieces) increased 1.5% during 2006 as compared to 2005. North American coated mechanical mill inventories were at 18 days supply at December 31, 2006, compared to 17 days supply at December 31, 2005.

Year ended 2005 compared to 2004

Sales increased in 2005 as compared to 2004 as a result of higher transaction prices and higher shipments. Our transaction prices increased 18.2% which reflects the realization of price increases in 2005. Our coated mechanical papers shipments increased 6.9% compared to 2004, due primarily to increased production at our Catawba and Covington facilities.

Segment income increased in 2005 as compared to 2004 as a result of higher product pricing as discussed above and lower selling and administrative expenses and lower manufacturing costs partially offset by higher distribution costs. The lower manufacturing costs were primarily due to higher production volumes (\$20.2 million) and lower depreciation (\$5.9 million), partially offset by higher energy costs (\$7.7 million), higher wood costs (\$6.1 million), higher labor costs (\$6.3 million), and higher repair costs (\$1.8 million) and higher chemicals (\$1.0 million).

Specialty Papers

| | 2006 | 2005 | 2004 |
|--|--------|--------|--------|
| Average price (per short ton) | \$ 669 | \$ 628 | \$ 562 |
| Shipments (thousands of short tons) | 851.6 | 759.6 | 729.1 |
| Downtime (thousands of short tons) | 4.9 | 5.6 | 10.1 |
| Inventory at end of year (thousands of short tons) | 47.9 | 34.5 | 23.7 |

| (In millions) | Year Ended December 31, | | | Change | |
|--|-------------------------|----------|----------|---------------|---------------|
| | 2006 | 2005 | 2004 | 2006 vs. 2005 | 2005 vs. 2004 |
| Sales | \$ 569.7 | \$ 476.8 | \$ 409.5 | \$ 92.9 | \$ 67.3 |
| Segment (loss) income | (35.4) | 2.2 | (7.7) | (37.6) | 9.9 |
| Significant items that improved (lowered) segment income (loss): | | | | | |
| Product pricing | | | | \$ 36.6 | \$ 54.0 |
| Distribution costs | | | | (1.8) | (4.8) |
| Manufacturing costs | | | | (72.4) | (31.0) |
| Selling and administrative expenses | | | | | (8.3) |
| | | | | \$ (37.6) | \$ 9.9 |

Year ended 2006 compared to 2005

Sales of specialty papers increased in 2006 as compared to 2005 as a result of a 6.5% increase in our average transaction price in 2006 and a 12.1% increase in shipments. This increase in average price reflects the realization of price increases in 2006 and the introduction of a freesheet hybrid product at our Calhoun mill in June 2006 which has a higher transaction price than our other specialty paper offerings. Our increase in shipments is due to the conversion of a newsprint machine to specialty production at our Calhoun mill in July 2006 and increased shipments to customers moving from traditional freesheet grades to mechanical specialties and customers upgrading from newsprint to mechanical specialties.

Segment income decreased in 2006 as compared to 2005 primarily due to higher manufacturing costs, partially offset by higher sales discussed above. The higher manufacturing costs were primarily due to a stronger Canadian dollar (\$23.3 million) and reduced benefits from our Canadian dollar hedging program (\$13.6 million), combined with higher repair (\$19.5 million), labor (\$18.7 million), depreciation (\$5.7 million), energy (\$6.0 million) and chemical costs (\$5.2 million). These costs were partially offset by higher production volume (\$14.3 million) and lower wood costs (\$3.6 million).

Specialty Papers Third-Party Data: North American demand for supercalendered high gloss paper ended down 2.4% and other uncoated mechanical papers ended up 1.2% in 2006 as compared to 2005. The supercalendered high gloss operating rate in North America in 2006 was 83% and mill inventories at the end of December 2006 are 23.8% higher than at the end of December 2005. North American lightweight and standard grade uncoated mechanical inventories at December 2006 increased 13.5% over December 2005 with 15 days supply on December 31, 2006 and 13 days supply on December 31, 2005.

Year ended 2005 compared to 2004

Sales increased in 2005 as compared to 2004 as a result of higher average transaction prices and slightly higher shipments. Our average transaction price increased 11.7% as a result of a realization in price increases in 2005. Specialty paper shipments increased 4.2% compared to 2004, due to increased shipments to book market customers moving from traditional freesheet grades to mechanical specialties and retailer circular customers upgrading from newsprint to mechanical specialties.

Segment income increased in 2005 as compared to 2004 as a result of higher product pricing as discussed above, partially offset by higher manufacturing costs, selling and administrative expenses and distribution costs. The higher manufacturing costs were primarily due to a stronger Canadian dollar (\$19.1 million), reduced benefits from our Canadian dollar hedging program (\$7.8 million), combined with higher energy (\$6.2 million), depreciation (\$4.2 million), repair (\$3.6 million), labor (\$2.3 million), and chemical costs (\$1.9 million), partially offset by higher production volumes (\$16.4 million).

Newsprint

| | 2006 | 2005 | 2004 |
|---|---------|---------|---------|
| Average price (per metric ton) | \$ 636 | \$ 583 | \$ 528 |
| Shipments (thousands of metric tons) | 2,260.3 | 2,451.6 | 2,541.6 |
| Downtime (thousands of metric tons) | 245.0 | 199.1 | 192.1 |
| Inventory at end of year (thousands of metric tons) | 67.9 | 87.0 | 89.8 |

| (In millions) | Year Ended December 31, | | | Change | |
|--|-------------------------|------------|------------|---------------|---------------|
| | 2006 | 2005 | 2004 | 2006 vs. 2005 | 2005 vs. 2004 |
| Sales | \$ 1,437.6 | \$ 1,428.8 | \$ 1,340.8 | \$ 8.8 | \$ 88.0 |
| Segment income | 79.5 | 72.3 | 31.1 | 7.2 | 41.2 |
| Significant items that improved (lowered) segment income (loss): | | | | | |
| Product pricing | | | | \$ 123.3 | \$ 135.8 |
| Distribution costs | | | | 0.2 | (11.7) |
| Manufacturing costs | | | | (119.0) | (87.6) |
| Selling and administrative expenses | | | | 2.7 | 4.7 |
| | | | | \$ 7.2 | \$ 41.2 |

Year ended 2006 compared to 2005

Sales of newsprint increased marginally in 2006 as compared to 2005 as a result of higher product pricing being offset by lower shipments. Our average newsprint transaction price was 9.1% higher in 2006 compared to 2005. The increase reflects the realization of price increases in our North American and international markets. Shipments were 7.8% lower in 2006 as we converted a newsprint machine at our Calhoun site to specialty paper production and newsprint production was curtailed at our Thunder Bay facility in the third and fourth quarters of 2006 and at our Mokpo facility in the fourth quarter of 2006. Specifically, 68,000 metric tons at our Thunder Bay mill and 19,000 metric tons at our Mokpo mill were curtailed. At Thunder Bay, two of our paper machines were curtailed beginning in September with one restarted in the fourth quarter. The downtime at our Mokpo mill was a result of labor issues which have been resolved. In January 2007, we rebuilt a newsprint machine at our Calhoun facility which will reduce first quarter production by 10,000 tons. Additionally, in January 2007, the cost of our recycled fiber has increased 2% from December of 2006, and we are expecting additional price increases for the balance of the quarter.

Segment income increased in 2006 as compared to 2005 as a result of higher product pricing as noted above and lower distribution and selling and administrative expenses, offset by higher manufacturing costs. The higher manufacturing costs were primarily due to a stronger Canadian dollar (\$54.4 million), lower production volumes (\$45.2 million), a reduced benefit from our Canadian dollar hedging program (\$25.8 million), combined with higher energy (\$13.0 million) and chemical costs (\$3.9 million) partially offset by lower labor (\$11.8 million) and wood costs (\$6.6 million).

Newsprint Third-Party Data: Total North American newsprint demand declined 6.0% in 2006 compared to 2005, reflecting conservation measures taken by publishers, reduced North American newspaper circulation,

lower advertising linage, and substitution in some applications by other uncoated mechanical grades. Over the same time period, North American newsprint production declined 6.3%. The industry operating rate was 94% in 2006 compared to 95% in 2005. In 2006, North American net exports of newsprint decreased 8.6% from 2005 levels. North American mill inventories at year end 2006 declined 3,000 metric tons and customer inventories declined 102,000 metric tons from 2005 levels. Total inventories (North American mills and users) ended 2006 at 1.1 million metric tons, 105,000 metric tons below the 2005 level. Days of supply at the U.S. dailies declined to 39 days from 42 days at year end 2005. Newspaper advertising linage declined 0.1% in 2006 compared to 2005.

Year ended 2005 compared to 2004

Sales increased in 2005 as compared to 2004 primarily as a result of higher product pricing, partially offset by lower shipments. Our average newsprint transaction price was 10.4% higher in 2005 compared to 2004 due to the realization of price increases in our North American and international markets. Newsprint shipments decreased by 3.5% compared to 2004 primarily due to production shifting from newsprint to higher margin specialty papers.

Segment income increased in 2005 as compared to 2004 primarily as a result of higher product pricing as noted above and lower selling and administrative expenses, partially offset by higher distribution costs and manufacturing costs. The higher manufacturing costs were primarily due to a stronger Canadian dollar (\$50.2 million), lower production volumes (\$25.4 million), reduced benefit from our Canadian dollar hedging program (\$17.0 million), combined with higher energy (\$10.3 million), chemical (\$6.9 million), and repair costs (\$2.5 million), partially offset by lower depreciation (\$8.4 million), labor (\$7.0 million) and wood costs (\$2.8 million).

Market Pulp

| | 2006 | 2005 | 2004 |
|---|--------|---------|---------|
| Average price (per metric ton) | \$ 576 | \$ 531 | \$ 513 |
| Shipments (thousands of metric tons) | 971.9 | 1,005.6 | 1,058.8 |
| Downtime (thousands of metric tons) | 25.1 | 66.7 | 62.3 |
| Inventory at end of year (thousands of metric tons) | 48.9 | 63.4 | 49.9 |

| (In millions) | Year Ended December 31, | | | Change | |
|--|-------------------------|----------|----------|---------------|---------------|
| | 2006 | 2005 | 2004 | 2006 vs. 2005 | 2005 vs. 2004 |
| Sales | \$ 559.4 | \$ 534.3 | \$ 543.3 | \$ 25.1 | \$ (9.0) |
| Segment income | 36.6 | 7.7 | 37.1 | 28.9 | (29.4) |
| Significant items that improved (lowered) segment income (loss): | | | | | |
| Product pricing | | | | \$ 42.9 | \$ 19.1 |
| Distribution costs | | | | (6.7) | (1.8) |
| Manufacturing costs | | | | (7.2) | (49.1) |
| Selling and administrative expenses | | | | (0.1) | 2.4 |
| | | | | \$ 28.9 | \$ (29.4) |

Year ended 2006 compared to 2005

Sales of market pulp increased in 2006 as compared to 2005 as a result of higher product pricing which was partially offset by lower shipments. Our average price for market pulp was 8.5% higher in 2006 compared to 2005. This increase reflects improved world-wide demand. Our shipments decreased 3.4% compared to 2005, due to reduced production from our Thunder Bay facility as a result of the permanent shut of our

A kraft pulp mill at this site in May 2006. Our market pulp inventories at the end of 2006 were at 18 days supply which was 11 days below industry average. Generally, our inventories are below industry average because our mills are

geographically close to the markets they serve. Our downtime decreased significantly in 2006 primarily due to maintenance downtime taken at our Calhoun and Coosa Pines facilities in 2005. We have announced price increases of \$20 per metric ton for softwood grades and \$30 per metric ton for fluff pulp grades effective January 1, 2007.

Segment income increased in 2006 as compared to 2005 primarily as a result of higher product pricing as noted above, partially offset by higher manufacturing costs and higher distribution costs. The higher manufacturing costs were due to a reduced benefit from our Canadian dollar hedging program (\$16.2 million), a stronger Canadian dollar (\$13.0 million), lower production volumes (\$9.9 million) and higher chemical costs (\$1.7 million), partially offset by lower wood (\$10.9 million), repair (\$6.4 million), depreciation (\$5.6 million), energy (\$3.0 million) and labor costs (\$4.1 million).

Market Pulp Third-Party Data: World-wide demand for market pulp increased by 3.9% or 1.5 million metric tons in 2006 compared to 2005. Demand in North America grew by 2.6% as a result of increased consumption by printing and writing and tissue manufacturers. Demand for pulp was up 9.4% in China and 5.2% in Latin America. Demand in Western Europe, the world's largest pulp market, increased by 3.0%. World-wide producers shipped at 95% capacity. World-wide producer inventories decreased to 29 days supply, which is 3 days lower than 2005.

Year ended 2005 compared to 2004

Sales decreased in 2005 as compared to 2004 as a result of reduced shipments, partially offset by higher product pricing. Our average price for market pulp was 3.5% higher in 2005 compared to 2004. The increase reflects the price increases in 2005 brought about by improved world-wide demand and continued strength of currencies in market pulp producing regions. Our shipments decreased 5% in 2005 compared to 2004, due to increased integration of our pulp to produce paper and reduced production from our Coosa Pines facility which incurred an extended planned maintenance shut to rebuild its boiler. Our market pulp inventories ended 2005 at 23 days supply, 9 days below the industry average.

Segment income decreased in 2005 as compared to 2004 primarily as a result of higher manufacturing costs and higher distribution costs, partially offset by higher product pricing as noted above and lower selling and administrative costs. The higher manufacturing costs were primarily due to stronger Canadian dollar (\$13.7 million), a reduced benefit from our Canadian dollar hedging program (\$12.3 million), lower production volumes (\$6.3 million), combined with higher energy (\$4.2 million), chemical (\$4.0 million), wood (\$1.7 million), and labor costs (\$1.5 million).

Lumber

| | 2006 | 2005 | 2004 |
|---------------------------------|---------|---------|---------|
| Average price (per mbf) | \$ 317 | \$ 358 | \$ 355 |
| Shipments (mmbf) | 1,045.3 | 1,076.3 | 1,043.1 |
| Downtime (mmbf) | 232.2 | 201.1 | 297.7 |
| Inventory at end of year (mmbf) | 44.2 | 54.4 | 60.4 |

| (In millions) | Year Ended December 31, | | | Change | |
|--|-------------------------|----------|----------|---------------|---------------|
| | 2006 | 2005 | 2004 | 2006 vs. 2005 | 2005 vs. 2004 |
| Sales | \$ 331.6 | \$ 385.1 | \$ 370.2 | \$ (53.5) | \$ 14.9 |
| Segment income | 63.0 | 14.4 | 17.8 | 48.6 | (3.4) |
| Significant items that improved (lowered) segment income (loss): | | | | | |
| Product pricing | | | | \$ (43.5) | \$ 3.5 |
| Lumber duties refund | | | | 92.5 | |
| Distribution costs | | | | 16.8 | 10.5 |
| Manufacturing costs | | | | (17.2) | (21.3) |
| Selling and administrative expenses | | | | | 3.9 |
| | | | | \$ 48.6 | \$ (3.4) |

Year ended 2006 compared to 2005

Sales decreased in 2006 as compared to 2005 as a result of an 11.5% lumber price decrease due primarily to a weaker U.S. housing market. Our lumber shipments decreased 2.9% in 2006 compared to 2005 mainly as a result of the sale of two sawmills in 2006 offset by the continued ramp up of the Thunder Bay sawmill as a result of a recent plant modernization.

Segment income increased in 2006 as compared to 2005 primarily as a result of the \$ 92.5 million refund of lumber duties in December 2006 as discussed below and lower distribution costs, partially offset by lower product pricing discussed above and higher manufacturing costs. The decrease in distribution costs is primarily due to the decrease in lumber duties in 2006 and the sale of the two sawmills. The higher manufacturing costs were primarily due to a stronger Canadian dollar (\$16.8 million), lower production volumes (\$10.4 million), a reduced benefit from our Canadian dollar hedging program (\$6.1 million), and a higher lower of cost or market inventory adjustment (\$3.7 million), partially offset by lower wood (\$15.0 million), labor (\$3.6 million), and repair costs (\$2.9 million), and lower depreciation (\$2.3 million). Downtime taken at our sawmills is the result of weak lumber markets and limited availability of timber supply from our cutting rights on Crown-owned land.

Lumber duties imposed by the U.S. Department of Commerce (DOC) were effective for lumber shipments from Canada to the U.S. beginning May 22, 2002. Between May 22, 2002, and October 12, 2006, we paid duties totaling approximately \$113 million to cover the various duty rates then in effect. Lumber duties were included as a component of distribution costs on our Consolidated Statements of Operations.

On October 12, 2006, an agreement regarding Canada's softwood lumber exports to the U. S. became effective. The agreement provides for the return of approximately \$4.5 billion in accumulated cash deposits to Canadian industry with the remaining \$1 billion to U.S. interests. Through an arrangement with Export Development Corporation (EDC), which the government of Canada designated as its agent to expedite the refund of duties, we recovered approximately \$103.9 million on November 10, 2006. The refund consisted of a return of \$92.5 million of the duties paid and \$11.4 million in interest due the company. We do not expect to recover any additional amounts.

The SLA provides for softwood lumber to be subject to one of two ongoing border restrictions, depending upon the province of first manufacture with several provinces, including Nova Scotia, being exempt from these border restrictions. The provincial governments of Ontario and Québec selected a border restriction defined as Option B in the SLA, based upon input from the manufacturers within those provinces. Option B provides for a volume quota to be established for each company within a province. These volume quotas are based on historical production and are not transferable between provinces. For our sawmills in Québec, the volume quota is in line with historical production, and we anticipate our 2007 production to be similar to what we produced in 2006. The provincial government of Ontario also based its quota allocation on historical production, but did not provide for

a mechanism that addressed the needs of new entrants. As a result, the volume that we were allocated is insufficient to operate both our Ignace and Thunder Bay, Ontario sawmills; therefore, we decided to indefinitely shut our Ignace sawmill in December 2006. Based on Thunder Bay's allocated quota, production in 2007 will be limited to approximately 65% of its annual capacity. U.S. composite prices would have to rise above \$355 per thousand board feet before the quota volume restrictions would be lifted. Our average transaction price for lumber in the fourth quarter of 2006 was \$280 per thousand board feet.

In 2005, the province of Québec mandated that the annual harvests of softwood timber on Crown-owned land would be reduced 20% below 2004 levels. The 20% reduction was required to be achieved, on average, for the period 2005 to 2008. In December 2006, the province of Québec increased that reduction to 23.8% below 2004 levels for the period 2008 to 2013. These requirements did not have any material impact on our results of operations or financial condition during 2006 and are not expected to have a material impact for 2007.

Lumber Third-Party Data: Lumber markets have been very weak due to reduced lumber demand driven mostly by residential housing construction. U.S. housing starts decreased in 2006, 12.9% to 1.8 million units compared to 2.1 million units in 2005.

Year ended 2005 compared to 2004

Sales increased in 2005 as compared to 2004 as a result of a slight increase in product pricing and an increase of 3.2% in lumber shipments in 2005 compared to 2004 as we continued our ramp up of the Thunder Bay sawmill as a result of a plant modernization.

Segment income decreased in 2005 as compared to 2004 as a result of higher manufacturing costs, partially offset by higher product pricing and lower distribution and selling and administrative costs. Distribution costs were lower primarily as a result of lower duty rates on lumber shipments from Canada and the U.S. The higher manufacturing costs were primarily due to a stronger Canadian dollar (\$17.1 million), higher wood costs (\$8.4 million), higher labor costs (\$2.2 million) and higher depreciation (\$1.3 million), partially offset by higher volumes (\$8.7 million) and lower repair costs (\$1.1 million).

Corporate and other

We exclude gain (loss) on disposition of assets, impairment and other related charges and severance charges from our internal review of product line results. Also excluded from our product line results are corporate and other items which include timber sales and general and administrative expenses. These items are analyzed separately from our product line results. The following table is included in order to facilitate the reconciliation of our product line sales and segment income to our total sales and operating income on our Consolidated Statements of Operations.

| <i>(In millions)</i> | Year Ended December 31, | | | Change | |
|--------------------------------------|-------------------------|---------|---------|---------------|---------------|
| | 2006 | 2005 | 2004 | 2006 vs. 2005 | 2005 vs. 2004 |
| Corporate and other: | | | | | |
| Sales | \$ 19.3 | \$ 33.5 | \$ 31.6 | \$ (14.2) | \$ 1.9 |
| Segment loss: | | | | | |
| Net gain on disposition of assets | 185.7 | 65.8 | 6.9 | 119.9 | 58.9 |
| Impairment and other related charges | (252.5) | (82.6) | | (169.9) | (82.6) |
| Severance | (16.3) | (13.3) | (8.7) | (3.0) | (4.6) |
| Corporate and other | (95.7) | (81.9) | (58.6) | (13.8) | (23.3) |

Net gain on disposition of assets: During 2006, we sold timberlands, our Baker Brook and Dégelis sawmills and other fixed assets for proceeds of \$331.8 million, resulting in a pre-tax gain of \$185.7 million. This gain was primarily due to the sale of 381,900 acres of Canadian timberlands and 153,300 acres of timberlands in the southeastern U.S.

During 2005, we sold timberlands and other fixed assets for proceeds of \$75.7 million, resulting in a pre-tax gain of \$65.8 million. This gain was primarily due to the sale of approximately 29,900 acres of timberlands in Canada and the U.S.

During 2004, we sold timberlands and other fixed assets for proceeds of \$12.0 million, resulting in a pre-tax gain of \$6.9 million. This gain was primarily due to the sale of approximately 3,200 acres of owned timberlands and leaseholds in Canada and the U.S.

Impairment and other related charges: During 2006, we recorded impairment and other related charges related to impairment of goodwill at our Thunder Bay, Ontario facility (\$200.0 million), the closure of our Benton Harbor, Michigan facility (\$27.5 million), paper machine No. 3 (\$18.9 million) at our Thunder Bay facility, our Ignace sawmill (\$5.2 million), and our Girardville sawmill (\$0.9 million). Please refer to the discussion of Critical Accounting Estimates Goodwill and Critical Accounting Estimates Long Lived Assets in Item 7 of this Form 10-K for information regarding the judgments and uncertainties involved in determining these impairment charges. For further information, see Note 5 of the Notes to the Consolidated Financial Statements included in this annual report on Form 10-K.

During 2005, we recorded asset impairment charges related to our Thunder Bay A kraft pulp mill (\$67.2 million), a coating line at our Benton Harbor facility (\$11.9 million) and a paper machine at our Mokpo, Korea paper mill (\$3.5 million).

Severance: In 2006, Bowater recorded approximately \$16.3 million of employee termination costs including severance and other benefits related to the closure of our Benton Harbor facility (38 employees), the closure of our Ignace sawmill (28 employees), the sale of certain other sawmills and organizational realignments (16 employees). For further information, see Note 13 of the Notes to the Consolidated Financial Statements included in this annual report on Form 10-K.

In 2005, Bowater recorded approximately \$13.3 million of employee termination costs including severance and other benefits. Approximately \$11.5 million of the \$13.3 million relates to the permanent closure of the A kraft pulp mill at our Thunder Bay facility in May 2006 and the elimination of approximately 260 positions.

In 2004, Bowater recorded severance charges of approximately \$8.7 million for employee termination costs, primarily from the voluntary termination of 35 employees related to the indefinite closure of the groundwood pulp mill at our Thunder Bay facility, and 11 additional employees related to retirements, and our streamlining of the former Forest Products Division.

Corporate and other: Sales decreased in 2006 as compared to 2005 due to lower timber sales as a result of our timberland sales. The increase in operating loss in 2006 as compared to 2005 is primarily related to pension and other postretirement benefit plan amendments.

Sales increased in 2005 as compared to 2004 due to higher product pricing for timber. The increase in operating loss in 2005 as compared to 2004 is primarily related to lower gains on foreign currency hedges.

Interest Expense

Interest expense decreased \$3.2 million in 2006, from \$199.3 million in 2005 to \$196.1 million in 2006, due primarily to lower average debt balances carried in 2006 and slightly higher capitalized interest in 2006 as compared to 2005.

Interest expense increased \$4.0 million in 2005, from \$195.3 million in 2004 to \$199.3 million in 2005, due primarily to higher average interest rates in 2005 as compared to 2004, partially offset by slightly higher capitalized interest in 2005 as compared to 2004.

Income Taxes

Bowater's effective tax rate in 2006, which resulted in net tax expense, was (17.3)% compared to an expense of (43.5)% in 2005. During 2005, based on continuing operating losses for our Canadian operations and an evaluation of available tax planning strategies, it was determined in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109) that we would record a tax charge of \$96.7 million to establish a valuation allowance against our remaining net Canadian deferred tax assets, which were primarily for loss carryforwards and tax credits in Canada. Our Canadian operations continued to experience operating losses in 2006, and a valuation allowance of \$50.6 million was recorded in 2006 to reduce the income tax benefits generated by our Canadian operations. See *Critical Accounting Estimates Tax Valuation Allowance* for a discussion of the judgments and uncertainties involved in determining a tax valuation allowance. The 2006 effective tax rate was also impacted by the goodwill impairment charge, which does not provide any tax benefit, the reversal of certain tax reserves, and the tax treatment on foreign currency gains and losses. The 2005 effective tax rate was also impacted by the tax treatment on foreign currency gains and losses.

Bowater's effective tax rate in 2005, which was an expense, was (43.5)% compared to a benefit of 36.9% in 2004. As discussed above, in accordance with SFAS 109 we established a valuation allowance against our remaining net Canadian deferred tax assets. As a result, income tax benefits generated on our 2005 Canadian net operating losses were offset by tax charges to record a valuation allowance.

Our effective tax rate varies frequently and substantially from the weighted-average effect of both domestic and foreign statutory tax rates primarily as a result of special tax treatment on foreign currency gains and losses. We have a number of Canadian subsidiaries whose unconsolidated income and gains are taxed in Canada. On consolidation, such income and gains are eliminated but we are still liable for the Canadian taxes. Due to the variability and volatility of foreign exchange rates we are unable to estimate the impact of future changes in exchange rates on our effective tax rate. Additionally, we will probably not be recording income tax benefits on any 2007 operating losses generated in Canada, which would have the impact of increasing our overall effective income tax rate in future periods. To the extent that our Canadian operations become profitable, the impact of this valuation allowance would lessen or reverse and positively impact our effective tax rate in those periods.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity and capital resources are cash provided from operations and available borrowings under our credit facilities, which are discussed in more detail below. We periodically review timberland holdings and sell timberlands. In 2006, the sale of timberlands and other assets generating proceeds of \$331.8 million has been a significant source of liquidity and, in combination with the lumber duties refund, has allowed us to reduce our total debt outstanding, net of the increase in cash by \$279.5 million. Since late 2005, we have generated approximately \$375 million of proceeds and expect an additional \$170 million in proceeds from this program by the end of 2007. We believe that cash from operations and access to our credit facilities will be sufficient to provide for our anticipated requirements for working capital, contractual obligations, capital expenditures, and dividend payments for the next twelve months.

Cash Provided by Operations

During 2006 and 2005, Bowater had net losses of \$138.3 million and \$120.6 million, respectively. Cash provided by operating activities totaled \$182.3 million in 2006 compared to \$169.4 million in 2005. Cash from operations increased primarily as a result of the \$103.9 million refund of lumber duties and related interest and increases in product prices for most of our products. These increases were offset by a stronger Canadian dollar, lower production at our Thunder Bay mill as a result of the permanent shut of the A kraft pulp line, lower production and higher maintenance costs at the Calhoun mill as we converted a newsprint machine to the production of specialty papers in the second quarter of 2006 and higher costs associated with the closure of our Benton Harbor facility. (See *Product Line Information* section of our *Management's Discussion and Analysis*.)

Working capital in 2006 was negatively impacted by an increase in accounts receivable, primarily as a result of higher product pricing from most of our products, and lower income taxes payable. The negative impact to working capital was partially offset by lower inventory levels, primarily as a result of the shut of the Thunder Bay A line and curtailed newsprint production at our Thunder Bay mill.

In 2005, cash provided by operating activities totaled \$169.4 million compared to \$122.5 million in 2004. Cash generated from operations increased due primarily to higher operating income and lower working capital needs. The higher operating income in 2005 was driven by higher product pricing, partially offset by higher distribution and manufacturing costs. See discussion of manufacturing costs, distribution costs and product pricing in the Product Line Information section of our Management's Discussion and Analysis. Additionally, see Risks Factors for discussion of product pricing, costs, exchange rates and debt levels.

Working capital in 2005 was negatively impacted by an increase in accounts receivable, which resulted primarily from higher pricing, and higher inventory levels to support increased export shipments. These working capital changes were partially offset by an increase in accounts payable and accrued liabilities primarily due to the timing of payments. Please see the discussion entitled Short-Term Financing below.

Cash Provided by (Used for) Investing Activities

Cash provided by (used for) investing activities totaled \$130.1 million, (\$91.7) million, and (\$72.1) million in 2006, 2005, and 2004, respectively. The increase in cash from investing activities in 2006 as compared to 2005 is due primarily to the increased proceeds from the disposition of timberlands and other asset sales, partially offset by increased capital expenditures. The capital expenditures in 2006 of \$199.1 million include \$35.9 million associated with the conversion of a machine at our Calhoun mill to specialty paper production and other return-based projects of approximately \$60 million for our Catawba, Calhoun, Coosa Pines and Thunder Bay facilities. The increase in cash used for investing activities in 2005 as compared to 2004 is due to increased capital expenditures partially offset by an increase in asset sales as we began our timberland asset sales program in late 2005. Capital expenditures in 2005 compared to 2004 were significantly higher as we began the conversion at our Calhoun mill in 2005 (\$42 million) and other return-based projects at our Catawba, Coosa Pines, and Gatineau facilities (\$33 million). Capital expenditures for all periods include compliance, maintenance, and projects to increase returns on production assets. We expect to spend approximately \$150 million on similar capital projects in 2007.

Cash Used for Financing Activities

Cash used for financing activities totaled \$243.6 million, \$77.3 million and \$40.1 million for 2006, 2005, and 2004, respectively. Bowater had net payments of \$62.1 million on its short-term borrowings, net payments of \$22.3 million on its long-term debt and debt repurchases of \$112.8 million during 2006. We used our lumber duty refund and the majority of our increased proceeds from land and asset sales discussed above to repurchase our debt in 2006. We had net payments of \$19.0 million and \$132.7 million on our short-term credit facilities during 2005 and 2004, respectively. The net payments on short-term credit facilities in 2004 were primarily due to an increase in our long-term financing of \$132.0 million.

During August 2006, we repurchased approximately \$15.6 million of our \$250 million floating rate notes due March 15, 2010 for total cash consideration of approximately \$15.8 million, or a 1.4% premium over face value. During September 2006, we repurchased approximately \$1.9 million of our \$250 million 9% notes due August 1, 2009 for total cash consideration of approximately \$2.0 million, or a 3.7% premium over face value. In conjunction with these transactions, we recorded charges of approximately \$0.5 million for premiums, fees and unamortized deferred financing fees. These charges for the early extinguishment of debt are included in Other income, net on the accompanying Consolidated Statements of Operations.

During November 2006, we repurchased \$95.3 million face value of our Series A, 10.625% notes due June 15, 2010 for total cash consideration of approximately \$102.7 million, or a 7.8% premium over face value.

This repurchased debt had a book carrying value of \$107.9 million, which was comprised of \$95.3 million face value, plus \$12.6 million related to the revaluation of Series A debt from the acquisition of Avenor in 1998. In conjunction with this transaction, we recorded charges of \$7.5 million for premiums and fees. We also recorded a gain on the extinguishment of debt of approximately \$12.6 million associated with the revaluation of the debt as discussed above. Therefore, the net impact for the extinguishment of the Series A notes is a net gain of approximately \$5.1 million, which is included in Other income, net on the accompanying Consolidated Statements of Operations.

SHORT-TERM FINANCING

At December 31, 2006, we had available borrowings under our credit facilities as follows:

| Short-Term Bank Debt | Commitment | Amount Outstanding | Commitment Available ⁽¹⁾ | Termination Date | Weighted Average Interest Rate ⁽²⁾ |
|---------------------------|------------|--|--|---------------------|--|
| | | (in millions, except for dates and interest rates) | | | |
| U.S. Credit Agreement | \$ 415.0 | \$ | \$ 347.3 | 05/11 | n/a |
| Canadian Credit Agreement | \$ 165.0 | \$ | \$ 132.4 | 05/07 | n/a |
| | \$ 580.0 | \$ | \$ 479.7 | | |

- (1) The commitment available under each of the revolving credit facilities is subject to collateral requirements and covenant restrictions as described below and is reduced by outstanding letters of credit of \$67.7 million for the U.S. and \$32.6 million for Canada. Commitment fees for unused portions of the U.S. and Canadian facilities are 50 basis points and 25 basis points, respectively.
- (2) Borrowings under the revolving credit facilities incur interest based, at our option, on specified market interest rates plus a margin. No borrowings were outstanding under these credit facilities during the year.

On May 31, 2006, we entered into (i) a five-year Credit Agreement among Bowater Incorporated (Bowater) as Borrower, several lenders, and Wachovia Bank, National Association, as Administrative Agent (the U.S. Credit Agreement) and (ii) a 364-day Credit Agreement, along with its subsidiary Bowater Canadian Forest Products Inc. (BCFPI), among BCFPI as Borrower, Bowater as parent Guarantor, several lenders, and The Bank of Nova Scotia as Administrative Agent (the Canadian Credit Agreement).

The U.S. Credit Agreement provides for a \$415 million revolving credit facility with a scheduled maturity date of May 25, 2011. The U.S. Credit Agreement is guaranteed by certain of our wholly-owned subsidiaries in the United States, and is secured by (i) liens on the inventory, accounts receivable and deposit accounts of Bowater and the guarantors (ii) pledges of 65% of the stock of certain of our foreign subsidiaries, and (iii) pledges of the stock of our U.S. subsidiaries that do not own mills or converting facilities. Availability under the U.S. Credit Agreement is limited to 90% of the net consolidated book value of our accounts receivable and inventory, excluding BCFPI and its subsidiaries.

The Canadian Credit Agreement provides for a \$165 million revolving credit facility with a maturity date of May 29, 2007, subject to annual extensions. The Canadian Credit Agreement is secured by liens on the inventory, accounts receivable and deposit accounts of BCFPI. Availability under the Canadian Credit Agreement is limited to 65% of the net book value of the accounts receivable and inventory of BCFPI and its subsidiaries.

Financial covenants under both the U.S. Credit Agreement and Canadian Credit Agreement are based upon our consolidated financial results and consist of the following two ratios:

a maximum ratio of senior secured indebtedness (including all advances and letters of credit under the US and Canadian facilities, and any other indebtedness secured by assets of Bowater and its subsidiaries) to EBITDA (generally defined as net income, excluding extraordinary, non-recurring or non-cash items and gains (or losses) on asset dispositions, plus income taxes plus depreciation plus interest expense) of 1.25 to 1; and

a minimum ratio of EBITDA (defined as EBITDA, plus gains (or minus losses) from asset dispositions) to interest expense of 2.00 to 1.

We believe we are in compliance with all of our covenants and other requirements set forth in our credit facilities.

CONTRACTUAL OBLIGATIONS

We have an obligation to repay our outstanding debt. In addition, we enter into various supply and cutting rights agreements, guarantees and purchase commitments in the normal course of business. The following summarizes our contractual obligations at December 31, 2006 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

| <i>(In millions)</i> | Total | 2007 | 2008-2010 | 2011-2012 | Thereafter |
|---|-------------------|----------------|------------------|-------------------|-------------------|
| Long-term debt, including current installments ⁽¹⁾ | \$ 2,223.8 | \$ 14.9 | \$ 538.9 | \$ 997.2 | \$ 672.8 |
| Non-cancelable operating lease obligations ⁽²⁾ | 89.4 | 10.6 | 24.7 | 12.4 | 41.7 |
| Purchase obligations ⁽³⁾ | 413.2 | 43.8 | 109.7 | 55.4 | 204.3 |
| Total contractual obligations | \$ 2,726.4 | \$ 69.3 | \$ 673.3 | \$ 1,065.0 | \$ 918.8 |

(1) Long-term debt commitments exclude related discounts and revaluation of debt of \$42.7 million at December 31, 2006, as these items require no cash outlay.

(2) We control 0.1 million acres of timberlands under long-term leases expiring 2023 to 2058. In addition, we lease certain office premises, office equipment, and transportation equipment under operating leases.

(3) Purchase obligations include, among other things, a fiber supply contract for our Coosa Pines operation with commitments totaling \$84.7 million through 2014 and a steam supply contract for our Dolbeau operations with commitments totaling \$191.0 million through 2023.

In addition to the items shown in the table above, Bowater is party to employment and change-in-control agreements with its executive officers. Those agreements are described under the heading **Executive Compensation Employment and Change in Control Agreements** in our Proxy Statement with respect to the 2007 Annual Meeting of Shareholders to be filed under Regulation 14A under the Securities Exchange Act of 1934, as amended.

OFF BALANCE SHEET ARRANGEMENTS

In connection with certain timberland sales transactions in 2002 and prior years, Bowater received a portion of the sale proceeds in notes receivable from institutional investors. In order to increase our liquidity, we monetized these notes receivable using qualified special-purpose entities (QSPEs) set up in accordance with SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. The more significant aspects of the QSPEs are as follows:

The QSPEs are not consolidated within our financial statements. The business purpose of the QSPEs is to hold the notes receivable and issue debt securities to third parties. The value of these debt securities is equal to approximately 90% of the value of the notes receivable. The full principal amounts of the notes receivable are backed by letters of credit issued by third-party financial institutions.

Our retained interest consists principally of the net excess cash flows (the difference between the interest received on the notes receivable and the interest paid on the debt issued by the QSPE to third parties) and a cash reserve account. Fair value of our retained interests was estimated based on the present value of future excess cash flows to be received over the life of the notes, using management's best estimate of key assumptions, including credit risk and discount rates.

The cash reserve accounts were established at inception and are required to meet specified minimum levels throughout the life of the debt issued by the QSPEs to third party investors. Any excess cash flows revert to Bowater on a quarterly or semi-annual basis. The cash reserve accounts revert to Bowater at the maturity date of the third-party debt.

We may be required to make capital contributions to the QSPEs from time to time in sufficient amounts so that the QSPEs will be able to comply with their covenants regarding the payment of taxes, maintenance as entities in good standing, transaction fees, contractual indemnification of the collateral agent and certain other parties, and the maintenance of specified minimum amounts in the cash reserve account. Notwithstanding these covenants, because of the expected net available cash flow to the QSPEs (interest and principal on notes receivable backed by letters of credit will be in excess of interest and principal on debt securities), Bowater does not expect to be required to make additional capital contributions, nor have any capital contributions been required to date.

Bowater currently guarantees approximately \$6.8 million, representing 25% of the outstanding investor notes principal balance of Timber Note Holdings LLC, one of our QSPEs. This guarantee is proportionately reduced by annual principal repayments on the investor notes (annual minimum repayment of \$2.0 million) through 2008. The remaining investor notes principal amount is to be repaid in 2009. Bowater would be required to perform on the guarantee if the QSPE were to default on the investor notes or if there were a default on the notes receivable, neither of which has ever occurred.

The following summarizes our transactions with QSPEs as of December 31, 2006 (in millions):

| Qualified Special Purpose Entity | Bowater's Retained Interest | Total Assets | Total Obligations | Excess of Assets over Obligations |
|--------------------------------------|-----------------------------------|-----------------|----------------------|--|
| Calhoun Note Holdings AT LLC | \$ 6.6 | \$ 73.9 | \$ 64.2 | \$ 9.7 |
| Calhoun Note Holdings TI LLC | 9.7 | 74.7 | 61.8 | 12.9 |
| Bowater Catawba Note Holdings I LLC | 2.0 | 19.8 | 17.4 | 2.4 |
| Bowater Catawba Note Holdings II LLC | 9.4 | 98.1 | 86.9 | 11.2 |
| Timber Note Holdings LLC | 4.0 | 31.1 | 27.3 | 3.8 |
| Bowater Saluda LLC | 7.9 | 103.0 | 91.5 | 11.5 |
| | \$ 39.6 | \$ 400.6 | \$ 349.1 | \$ 51.5 |

No QSPEs are permitted to hold Bowater stock and there are no commitments or guarantees that provide for the potential issuance of Bowater stock. These entities do not engage in speculative activities of any description and are not used to hedge Bowater positions, and no Bowater employee is permitted to invest in any QSPE.

CANADIAN-U.S.DOLLAR EXCHANGE RATE FLUCTUATION EFFECT ON EARNINGS

Nearly half of our manufacturing costs and a small portion of our financial assets and liabilities are denominated in Canadian dollars. Sales are denominated in the currency of the country in which they occur and only a small portion of our sales are denominated in Canadian dollars. Accordingly, changes in the Canadian-U.S. dollar exchange rate may significantly impact our revenues and costs. The magnitude and direction of this impact primarily depends on our production and sales volume, the proportion of our production and sales that occur in Canada, the proportion of our financial assets and liabilities denominated in Canadian dollars, our hedging levels, and the magnitude, direction and duration of changes in the Canadian-U.S. dollar exchange rate. Increases in the value of the Canadian dollar versus the U.S. dollar reduce our earnings, which are reported in U.S. dollar terms.

We attempt to partially limit our exposure to Canadian-U.S. dollar exchange rate fluctuations through hedging transactions. Under the exchange rates, hedging levels and operating conditions that existed at December 31, 2006, for every one-cent increase in the Canadian-U.S. dollar exchange rate, our operating income, before currency hedging, for 2006 would have been reduced by approximately \$15.0 million, net of hedging by approximately \$12.2 million.

We expect exchange rate fluctuations to continue to impact costs and revenues; however, we cannot predict the magnitude or direction of this effect for any quarter, and there can be no assurance that the future effect will

be similar to that set forth above. All of the existing contracts will mature on or before April 2007. Based on exchange rates, hedging levels and operating conditions projected for the first quarter of 2007, we project that a one-cent increase in the Canadian dollar exchange rate would reduce our operating income for the first quarter, before currency hedging, by approximately \$3.8 million.

HEDGING PROGRAMS

Canadian Dollar Hedging Program

At December 31, 2006, we had approximately \$0.4 million of unrealized losses recorded on our Canadian dollar hedging program compared to an approximately \$30.0 million unrealized gain at December 31, 2005. Hedging contracts outstanding at December 31, 2006 have been established to hedge forecasted transactions through the first quarter of 2007. Recently, we have been entering into short-term hedging contracts that extend out only a few months at a time. For a description of our hedging activities, see Note 15 to our Consolidated Financial Statements included in this Report on Form 10-K.

Natural Gas Hedging Program

Beginning in the third quarter of 2006, we entered into natural gas swap agreements under our natural gas hedging program for the purpose of reducing the risk inherent in fluctuating natural gas prices. Our hedged natural gas costs are billed to us based on a publicly traded index plus a fixed amount. The natural gas swap agreements allow us to minimize the effect of fluctuations in those indices by contractually exchanging the publicly traded index upon which we are billed for a fixed index of natural gas cost. The swap agreements, which did not qualify for hedge accounting treatment during the year, have been marked-to-market in the Consolidated Statement of Operations. As a result, approximately \$1.1 million of pre-tax losses were recognized in our Consolidated Statement of Operations in 2006 for outstanding contracts that we purchased in 2006 to financially hedge forecasted transactions expected to occur in 2007. For a description of our natural gas hedging activities, see Note 15 to our Consolidated Financial Statements included in this Report on Form 10-K. As of December 31, 2006, the fair value of our outstanding natural gas swap agreements, which have a notional amount of \$9.0 million, is a liability of \$1.1 million.

British Pound Sterling Programs

In the first quarter of 2007, we entered into British pound sterling forward contracts that expire at various dates in 2007. We entered into these contracts to limit our exposure to the fluctuations between the British pound sterling and the U.S. dollar based on our contracted sales that are denominated in British pound sterling. These contracts do not currently qualify for hedge accounting treatment.

ENVIRONMENTAL ITEMS

We are subject to a variety of federal, state, provincial and local environmental laws and regulations in the jurisdictions in which we operate. We believe our operations are in substantial compliance with current applicable environmental laws and regulations.

We currently anticipate capital spending for environmental requirements of approximately \$10 million per year in the near term. Environmental regulations promulgated in the future could require substantial additional expenditures for compliance and could have a material impact on Bowater, in particular, and the industry in general.

We currently have recorded \$19.7 million for environmental liabilities. Approximately \$18.2 million of this \$19.7 million relates to environmental reserves established in connection with prior acquisitions. The majority of these liabilities are recorded at undiscounted amounts and are included in other long-term liabilities on the Consolidated Balance Sheets. The \$19.7 million represents management's estimate based on an assessment of

relevant factors and assumptions of the ultimate settlement amounts for these liabilities. The amount of these liabilities could be affected by changes in facts or assumptions not currently known to management. Approximately \$17.6 million of the \$18.2 million relates to two previously owned Canadian mills for costs primarily associated with soil remediation, air compliance and landfill closure and one United States mill for costs primarily for soil testing and monitoring acquired in connection with the Alliance acquisition.

We have been notified that we may be a potentially responsible party (PRP) with respect to three hazardous waste sites which are being addressed pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, as amended (CERCLA or Superfund) or the Resource Conservation and Recovery Act (RCRA) corrective action authority. The first two sites are on CNC timberland tracts in South Carolina. One was contaminated when acquired, and subsequently, the prior owner remediated the site and continues to monitor the groundwater. On the second site, several hundred steel drums containing textile chemical residue were discarded by unknown persons. The U.S. EPA has listed it as No Further Action Status in September 2002. The third site, at our mill in Coosa Pines, Alabama, contained buried drums and has been remediated pursuant to RCRA. We continue to monitor the groundwater. We believe we will not be liable for any significant amounts at any of these sites.

RECENT ACCOUNTING PRONOUNCEMENTS

Income Taxes

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, (FIN48). FIN 48 clarifies the accounting uncertainty in income taxes recognized in an enterprise s financial statement in accordance with SFAS 109. FIN 48 clarifies the accounting for income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition and is effective for fiscal years beginning after December 15, 2006. We have not yet completed our evaluation of the impact the adoption of FIN 48 will have on our consolidated results of operations and financial position.

Fair Value Measurements

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements (SFAS 157). SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. SFAS 157 also responds to investors requests for expanded information about the extent to which company s measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements and is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the impact of this statement on our results of operations and financial position.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates, assumptions and judgments and rely on future projections of results of operations and cash flows. We base our estimates, assumptions and judgments on historical data and other information that we believe are reasonable under the circumstances. These estimates, assumptions and judgments affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of our financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting periods. It is important that the reader of our financial statements understand that actual results could differ materially from these estimates, assumptions and judgments.

A summary of our significant accounting policies is disclosed in Note 2 to our Consolidated Financial Statements. Based upon a review of our significant accounting policies, we believe the following accounting policies require us to make estimates, assumptions and judgments that can significantly affect the results reported in our Consolidated Financial Statements.

Pension and Other Postretirement Benefit Obligations

Description

We record assets and liabilities associated with our pension and other postretirement benefit obligations that may be considered material to our financial position. The amounts recognized changed significantly upon adoption of SFAS 158 (see Note 16 to our Consolidated Financial Statements). We also record net periodic benefit costs associated with these obligations as our employees render service.

Judgments and Uncertainties Involved in the Estimate

The following inputs are needed to calculate the fair value of our plan assets and our pension and other postretirement benefit obligations. These inputs are also used to determine our net periodic benefit costs each year. The determination of these inputs requires judgment.

discount rate used to arrive at the net present value of the pension and other postretirement benefit obligations;

return on assets used to estimate the growth in invested asset value available to satisfy pension benefit obligations;

rate of compensation increase used to calculate the impact future pay increases will have on pension and other postretirement benefit obligations; and

health care cost inflation rate used to calculate the impact of future health care costs on postretirement benefit obligations.

The discount rate is determined by considering the timing and amount of projected future benefit payments and is based on, for our U.S. plans, a portfolio of long-term high quality corporate bonds of a similar duration or, for our Canadian plans, a model that matches the plan's duration to published yield curves. To develop the expected long-term rate of return on assets assumption, we considered the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. In determining the rate of compensation increase, we reviewed historical salary increases and promotions while considering the impact of current industry conditions and future industry outlook. For the health care cost inflation rate, we considered historical trends in these types of costs in the U.S. and Canada.

Effect if Actual Results Differ from Assumptions

Variations in assumptions could have a significant effect on the net periodic benefit cost and net pension and other postretirement benefit obligations reported in our Consolidated Financial Statements. For example, a 25 basis point change in any one of these assumptions would increase (decrease) our 2006 pension and postretirement benefit expense and our net pension and other postretirement benefit obligations as follows (in millions):

| Assumption | Net Periodic Benefit Cost | | Net Pension and Other Postretirement Benefit Obligations | |
|---------------------------------|---------------------------|-------------------------|--|-------------------------|
| | 25 Basis Point Increase | 25 Basis Point Decrease | 25 Basis Point Increase | 25 Basis Point Decrease |
| Discount rate | \$ (7.0) | \$ 7.6 | \$ (73.1) | \$ 77.1 |
| Return on assets | (4.1) | (4.1) | | |
| Rate of compensation increase | 2.0 | (2.0) | 8.6 | (8.6) |
| Health care cost inflation rate | 1.6 | (1.0) | 7.6 | (6.3) |

Goodwill

Description

We have a significant amount of goodwill recorded in our Consolidated Balance Sheets. We review the carrying value of our goodwill for impairment in the fourth quarter of each year or more frequently, if an event occurs that triggers such an interim review. Goodwill is allocated to reporting units before performing a test for impairment. In 2006, we performed two tests of impairment one in the third quarter and one in the fourth quarter. The third quarter interim test for impairment was performed prior to the realignment of our organization (see Note 25 to our Consolidated Financial Statements). Goodwill was allocated to our new reporting units prior to performing the fourth quarter annual test for impairment. As discussed more fully in Note 2 to our Consolidated Financial Statements, if a reporting unit's carrying value exceeds its fair value, an impairment charge equal to the difference in the carrying value of the goodwill and the implied fair value of the goodwill is recorded. We recorded goodwill impairment charges of \$200 million in 2006 as a result of our third quarter interim test for impairment (see Note 4 to our Consolidated Financial Statements).

Judgments and Uncertainties Involved in the Estimate

We determined the fair values of our reporting units for both our third quarter interim test for impairment and our fourth quarter annual test for impairment, relying primarily on the discounted cash flow method. This method uses projections of cash flows from each of the reporting units. Several of the key assumptions include periods of operation, projections of product pricing, production levels, product costs, market supply and demand, foreign exchange rates, inflation, weighted average cost of capital and capital spending. We derive these assumptions used in our valuation models from several sources. Many of these assumptions are derived from our internal budgets, which would include existing sales data based on current product lines and assumed production levels, manufacturing costs and product pricing. We believe that our internal forecasts are consistent with those that would be used by a potential buyer in valuing our reporting units. Our products are commodity products; therefore, pricing is inherently volatile and often follows a cyclical pattern. The average price over a commodity cycle forms the basis of our product pricing assumption. We derive our pricing estimates from information generated internally, from industry research firms and from other published reports and forecasts.

Since performing our 2005 annual impairment test, exchange rates continued to climb to high levels. Given the exchange rate environment at the time of the interim test, we believe a potential buyer would consider a shorter-term view of exchange rates. Therefore, in our third quarter of 2006 interim test for impairment, foreign exchange rates were based on market forward rates for 2007 followed by a gradual reversion to a 5-year historical average as opposed to a 10-year historical average, which had been used in previous tests for impairment.

In addition to the assumptions discussed above, we determined the fair value of our Thunder Bay mill in both the third and fourth quarter tests for impairment utilizing a probability-weighted approach that assumes a potential buyer of the facility would consider alternative courses of action in estimating the discounted cash flows. Courses of action that were probability-weighted in our fair value estimation of the Thunder Bay facility include operating the mill as it is currently operated; restarting paper machine No. 3, which we permanently shut in the third quarter of 2006 but could be fully operational to a potential buyer of the facility; and conversion of one of Thunder Bay's other newsprint machines to production of coated paper grades.

For our fourth quarter impairment test, determining the reporting units to which we should allocate the goodwill takes considerable judgment and is based upon the determination of the reportable segments, which in and of itself, requires management's judgment. We are required to evaluate whether each component (i.e., one level below the reportable segment) is a business by assessing the business elements (inputs, processes, outputs) that are present within the component, the business elements that are missing from the component, and the degree of difficulty in replacing the missing elements. Further, if any of the components are considered a business, we are required to determine whether they are similar for purposes of aggregation into a single

reporting unit. Our similarity assessment included a review of the customers, products, distribution methods and other pertinent information associated with each component that qualified as a business. Once the reporting units were defined, existing goodwill was allocated to the newly identified reporting units based on their relative fair values.

In our third quarter impairment test, the fair values of each of our reporting units, except our Thunder Bay reporting unit, exceeded their carrying value amounts by at least 10%. In our fourth quarter impairment test, there were no indications of impairment for any of our reporting units, and the fair values of each exceeded their carrying value amounts by at least 10%.

Since the carrying value of our Thunder Bay reporting unit exceeded its fair value in our third quarter interim test for impairment, we were required to determine the implied fair value of the goodwill associated with that reporting unit. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. That is, the fair value of the reporting unit is allocated to the assets and liabilities of the reporting unit as if it had been acquired in a business combination. The implied fair value of goodwill related to our Thunder Bay reporting unit was approximately \$296.0 million; therefore, we recorded a goodwill impairment charge of \$200 million in 2006.

Effect if Actual Results Differ from Assumptions

A number of judgments were made in the determination of our reporting units. If a different conclusion had been reached for any one of those assumptions, it could have resulted in the identification of reporting units different from those we actually identified. This may have resulted in a different conclusion when comparing the fair value to the carrying value of the reporting unit.

The assumptions used in our valuation models are interrelated. The continuing degree of interrelationship of these assumptions is, in and of itself a significant assumption. Because of the interrelationships among the assumptions, we do not believe it would be meaningful to provide a sensitivity analysis on any of the individual assumptions. However, one key assumption in our valuation model is the weighted average cost of capital. If the weighted average cost of capital, which is used to discount the projected cash flows, was lower, the measure of the fair value of our assets would increase. Conversely, if the weighted average cost of capital was higher, the measure of the fair value of our assets would decrease. If our estimate of the weighted average cost of capital used in our fourth quarter annual test for impairment were to increase by 25 basis points, the excess of the fair values of each of the reporting units would continue to exceed their carrying value amounts. For our third quarter interim test for impairment, the impact of a 25 basis points increase to our estimate of the weighted average cost of capital would have been an additional goodwill impairment charge of approximately \$34.1 million. Another key assumption in our valuation model is foreign exchange. Continuation of a strong Canadian dollar could have a significant impact on the 5-year historical average and negatively impact future valuations.

Future changes in our assumptions or the interrelationship of those assumptions may negatively impact future valuations. In future measurements of fair value, adverse changes in discounted cash flow assumptions could result in an impairment of goodwill that would require a non-cash charge to the Consolidated Statements of Operations and may have a material effect on our financial condition and operating results.

Long-lived Assets

Description

Losses related to impairment of long-lived assets are recognized when circumstances indicate the carrying values of the assets may not be recoverable. When there are indicators that the carrying value of a long-lived asset may not be recoverable, we evaluate the carrying value of the asset in relation to its expected undiscounted future cash flows. If the carrying value of the asset is greater than the expected undiscounted future cash flows, an impairment charge is recorded based on the excess of the long-lived asset's carrying value over its fair value. We recorded long-lived asset impairment charges of \$48.5 million in 2006 and \$82.6 million in 2005. (See Note 5 to our Consolidated Financial Statements).

Judgments and Uncertainties Involved in the Estimate

Our impairment loss calculations require us to apply judgment in estimating asset fair values and future cash flows, including periods of operation, projections of product pricing, first quality production levels, product costs, market supply and demand, foreign exchange rates, inflation and projected capital spending. One key assumption, especially for our long-lived assets in Canada, is the foreign exchange rate. We determined the foreign exchange rates based on market forward rates for 2007 followed by a gradual reversion to a 5-year historical average.

Effect if Actual Results Differ from Assumptions

If actual results are not consistent with the assumptions and judgments used in estimating future cash flows and asset fair values, actual impairment losses could vary positively or negatively from estimated impairment losses.

Tax Exposure Matters

Description

In the normal course of business, we are subject to audits from the Federal, state, provincial and other tax authorities regarding various tax liabilities. Tax audits may alter the timing or amount of taxable income or deductions, or the allocation of income among tax jurisdictions. The amount ultimately paid upon resolution of issues raised may differ from the amount accrued. We believe that taxes accrued on the Consolidated Balance Sheets fairly represent the amount of future tax liability due. See further discussion of our ongoing and completed tax audits in Note 17 to our Consolidated Financial Statements.

We utilize certain income tax planning strategies to reduce our overall cost of income taxes. We have provided for our estimated exposure attributable to income tax planning strategies in accordance with SFAS No. 5 Accounting for Contingencies. We believe that the provision for liabilities resulting from the implementation of income tax planning strategies is appropriate. To date, we have not experienced an examination by governmental revenue authorities that would lead management to believe that our past provisions for exposures related to income tax planning strategies are not adequate.

Judgments and Uncertainties Involved in the Estimate

The amount of our income tax contingency reserve is based on our best estimate of the ultimate settlement amount upon audit related to specific issues. The process to derive our reserve for all income tax liabilities, including those related to tax planning strategies requires significant judgment, historical comparisons and reference to authoritative tax resources. On a quarterly basis, we review tax reserves based on changes in tax law, changes in facts or circumstances and all other relevant information. Our tax reserves are adjusted based on current year requirements, an agreed determination or settlement of a particular matter, the expiration of the statute of limitations for a particular tax period or a change in facts or circumstances regarding the matter.

Effect if Actual Results Differ from Assumptions

Upon audit, it is possible that certain tax strategies might be challenged resulting in a change in our liability for income taxes. If actual results are not consistent with the assumptions and judgments used in determining and estimating our income tax reserves, actual tax expense could vary positively or negatively from our estimates.

Tax Valuation Allowances

Description

We have significant deferred tax assets in the U.S. and Canada related to tax credit carryforwards and ordinary loss carryforwards. We evaluate the deferred tax assets and assess the need for a valuation allowance

based on changes in tax law, changes in facts or circumstances and all other relevant information. We have recorded a valuation allowance for almost all of our Canadian deferred tax assets. See discussion of our valuation allowances in Note 17 to our Consolidated Financial Statements.

Judgments and Uncertainties Involved in the Estimate

We are required to assess whether it is more likely than not that the deferred tax assets will be realized, based on forecasted income, or where necessary, the implementation of prudent and feasible tax planning strategies. The carrying value of our deferred tax assets (tax benefits expected to be realized in the future) assumes that we will be able to generate, based on certain estimates and assumptions, sufficient future taxable income in certain tax jurisdictions to utilize these deferred tax benefits, or in the absence of sufficient future taxable income, that we would implement tax planning strategies to generate sufficient taxable income.

Effect if Actual Results Differ from Assumptions

If actual results are not consistent with the assumptions and judgments used in determining and estimating the realization of our deferred tax assets, actual tax expense could vary positively or negatively from our estimates.

Item 8. Financial Statements and Supplementary Data

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CONSOLIDATED STATEMENTS OF OPERATIONS

| <i>(In millions, except per-share amounts) Years ended December 31,</i> | 2006 | 2005 | 2004 |
|---|-------------------|-------------|-------------|
| Sales | \$ 3,529.8 | \$ 3,483.8 | \$ 3,190.3 |
| Costs and expenses: | | | |
| Cost of sales, excluding depreciation, amortization and cost of timber harvested | 2,683.3 | 2,540.5 | 2,346.4 |
| Depreciation, amortization and cost of timber harvested | 323.2 | 329.4 | 335.2 |
| Distribution costs | 333.6 | 340.3 | 324.9 |
| Lumber duties refund | (92.5) | | |
| Selling and administrative expenses | 174.2 | 158.0 | 161.2 |
| Impairment and other related charges | 252.5 | 82.6 | |
| Net gain on disposition of assets | (185.7) | (65.8) | (6.9) |
| Operating income | 41.2 | 98.8 | 29.5 |
| Interest expense | (196.1) | (199.3) | (195.3) |
| Other income, net | 43.6 | 9.9 | 17.4 |
| Loss before income taxes, minority interests and cumulative effect of accounting changes | (111.3) | (90.6) | (148.4) |
| Income tax (provision) benefit | (19.3) | (39.3) | 54.8 |
| Minority interests, net of tax | (5.1) | 9.8 | 6.5 |
| Loss before cumulative effect of accounting changes | (135.7) | (120.1) | (87.1) |
| Cumulative effect of accounting changes, net of tax | (2.6) | (0.5) | |
| Net loss | \$ (138.3) | \$ (120.6) | \$ (87.1) |
| Loss per share: | | | |
| Basic loss per common share: | | | |
| Loss before cumulative effect of accounting changes | \$ (2.36) | \$ (2.09) | \$ (1.52) |
| Cumulative effect of accounting changes, net of tax | (0.05) | (0.01) | |
| Net loss | \$ (2.41) | \$ (2.10) | \$ (1.52) |
| Diluted loss per common share: | | | |
| Loss before cumulative effect of accounting changes | \$ (2.36) | \$ (2.09) | \$ (1.52) |
| Cumulative effect of accounting changes, net of tax | (0.05) | (0.01) | |
| Net loss | \$ (2.41) | \$ (2.10) | \$ (1.52) |
| Average number of shares outstanding: | | | |
| Basic and diluted | 57.4 | 57.4 | 57.2 |

See accompanying Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

| <i>(In millions, except share amounts) At December 31,</i> | 2006 | 2005 |
|--|-------------------|-------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 98.9 | \$ 30.1 |
| Accounts receivable, net | 444.5 | 410.1 |
| Inventories | 349.8 | 365.8 |
| Timberlands held for sale | 18.7 | 123.1 |
| Other current assets | 47.1 | 61.2 |
| Total current assets | 959.0 | 990.3 |
| Timber and timberlands | 60.8 | 85.4 |
| Fixed assets, net | 2,877.9 | 3,049.1 |
| Goodwill | 590.2 | 794.1 |
| Other assets | 158.0 | 233.5 |
| Total assets | \$ 4,645.9 | \$ 5,152.4 |
| Liabilities and shareholders' equity | | |
| Current liabilities: | | |
| Current installments of long-term debt | \$ 14.9 | \$ 22.2 |
| Short-term bank debt | | 55.0 |
| Accounts payable and accrued liabilities | 431.2 | 498.5 |
| Total current liabilities | 446.1 | 575.7 |
| Long-term debt, net of current installments | 2,251.6 | 2,400.0 |
| Pension and other postretirement benefit obligations | 651.1 | 465.3 |
| Other long-term liabilities | 92.5 | 107.6 |
| Deferred income taxes | 313.0 | 329.4 |
| Minority interests in subsidiaries | 59.0 | 58.9 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Common stock, \$1 par value. Authorized 100,000,000 shares; issued 67,585,104 and 67,527,993 shares at December 31, 2006 and 2005, respectively | 67.6 | 67.5 |
| Exchangeable shares, no par value. Unlimited shares authorized; 1,423,830 and 1,434,445 shares outstanding at December 31, 2006 and 2005, respectively | 67.6 | 68.1 |
| Additional paid-in capital | 1,630.1 | 1,621.6 |
| Retained (deficit) earnings | (76.0) | 100.1 |
| Accumulated other comprehensive loss | (371.0) | (156.0) |
| Treasury stock at cost, 11,600,717 and 11,605,074 shares at December 31, 2006 and 2005, respectively | (485.7) | (485.8) |
| Total shareholders' equity | 832.6 | 1,215.5 |
| Total liabilities and shareholders' equity | \$ 4,645.9 | \$ 5,152.4 |

See accompanying Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CAPITAL ACCOUNTS

| | Accumulated | | | | | | |
|--|-------------|--------------|--------------|---------------|---------------|------------|----------------|
| | | | Additional | Retained | Other | | |
| | Common | Exchangeable | Paid In | Earnings | Comprehensive | Treasury | Shareholders |
| <i>(In millions, except share amounts)</i> | Stock | Shares | Capital | (Deficit) | Loss | Stock | Equity |
| Balance at December 31, 2003 | \$ 67.0 | \$ 78.2 | \$ 1,601.6 | \$ 399.1 | \$ (47.1) | \$ (486.1) | \$ 1,612.7 |
| Retraction of exchangeable shares (174,954 shares issued and exchangeable shares retracted) | 0.2 | (8.5) | 8.3 | | | | |
| Dividends on common stock (\$0.80 per share) | | | | (45.5) | | | (45.5) |
| Stock options exercised including tax benefit of \$1.2 (223,600 shares) | 0.2 | | 7.6 | | | | 7.8 |
| Share-based compensation costs for equity awards | | | 1.0 | | | | 1.0 |
| Restricted stock units grant (7,774 shares) | | | (0.3) | | | | (0.3) |
| Treasury stock used for dividend reinvestment plans and to pay employee and director benefits (2,818 shares) | | | | | | 0.2 | 0.2 |
| Comprehensive (loss) income: | | | | | | | |
| Net loss | | | | (87.1) | | | (87.1) |
| Foreign currency translation | | | | | 5.3 | | 5.3 |
| Minimum pension liability, net of tax of \$22.7 | | | | | 43.8 | | 43.8 |
| Change in unrealized gain on hedged transactions, net of tax of \$18.8 | | | | | (30.6) | | (30.6) |
| Total comprehensive loss | | | | | | | (68.6) |
| Balance at December 31, 2004 | \$ 67.4 | \$ 69.7 | \$ 1,618.2 | \$ 266.5 | \$ (28.6) | \$ (485.9) | \$ 1,507.3 |
| Retraction of exchangeable shares (31,913 shares issued and exchangeable shares retracted) | | (1.6) | 1.6 | | | | |
| Dividends on common stock (\$0.80 per share) | | | | (45.8) | | | (45.8) |
| Stock options exercised including tax benefit of \$0.3 (69,000 shares) | 0.1 | | 2.1 | | | | 2.2 |
| Restricted stock units cancellation (10,203 shares) | | | (0.4) | | | | (0.4) |
| Share-based compensation costs for equity awards | | | 0.1 | | | | 0.1 |
| Treasury stock used for dividend reinvestment plans and to pay employee and director benefits (3,311 shares) | | | | | | 0.1 | 0.1 |
| Comprehensive (loss) income: | | | | | | | |
| Net loss | | | | (120.6) | | | (120.6) |
| Foreign currency translation | | | | | 3.3 | | 3.3 |
| Minimum pension liability, net of tax of \$1.3 | | | | | (73.0) | | (73.0) |
| Change in unrealized gain on hedged transactions, net of tax of \$35.3 | | | | | (57.7) | | (57.7) |
| Total comprehensive loss | | | | | | | (248.0) |
| Balance at December 31, 2005 | \$ 67.5 | \$ 68.1 | \$ 1,621.6 | \$ 100.1 | \$ (156.0) | \$ (485.8) | \$ 1,215.5 |
| Cumulative adjustment to retained earnings for adoption of SAB 108 | | | | 8.6 | | | 8.6 |
| Retraction of exchangeable shares (10,615 shares issued and exchangeable shares retracted) | | (0.5) | 0.5 | | | | |
| Dividends on common stock (\$0.80 per share) | | | | (46.4) | | | (46.4) |
| Restricted stock units vested (46,496 shares, net of shares forfeited for employee withholding taxes) | 0.1 | | (0.4) | | | | (0.3) |
| Share-based compensation costs for equity awards | | | 8.7 | | | | 8.7 |
| Treasury stock used for dividend reinvestment plans and employee and director benefits (4,357 shares) | | | | | | 0.1 | 0.1 |
| Other equity transaction | | | (0.3) | | | | (0.3) |

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| | | | | | | | | | | | | | | |
|--|-----------|-------------|-----------|-------------|-----------|----------------|-----------|---------------|---------------|----------------|-----------|----------------|-----------|--------------|
| Comprehensive (loss) income: | | | | | | | | | | | | | | |
| Net loss | | | | | | (138.3) | | | (138.3) | | | | | |
| Foreign currency translation | | | | | | | 0.5 | | 0.5 | | | | | |
| Minimum pension liability, net of tax of \$15.4 | | | | | | | 60.2 | | 60.2 | | | | | |
| Change in unrealized gain on hedged transactions, net of tax of \$11.9 | | | | | | | (19.4) | | (19.4) | | | | | |
| Total comprehensive loss | | | | | | | | | (97.0) | | | | | |
| Adjustment to initially apply SFAS 158, net of tax of \$59.8 | | | | | | | | | | | | | | |
| | | | | | | | (256.3) | | (256.3) | | | | | |
| Balance at December 31, 2006 | \$ | 67.6 | \$ | 67.6 | \$ | 1,630.1 | \$ | (76.0) | \$ | (371.0) | \$ | (485.7) | \$ | 832.6 |

See accompanying Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

| <i>(In millions) Years ended December 31,</i> | 2006 | 2005 | 2004 |
|---|----------------|---------------|---------------|
| Cash flows from operating activities: | | | |
| Net loss | \$ (138.3) | \$ (120.6) | \$ (87.1) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | | |
| Cumulative effect of accounting changes, net of tax | 2.6 | 0.5 | |
| Share-based compensation | 5.6 | 0.1 | 1.0 |
| Depreciation, amortization and cost of timber harvested | 323.2 | 329.4 | 335.2 |
| Impairment and other related charges | 252.5 | 82.6 | |
| Deferred income taxes | 25.2 | 28.8 | (50.5) |
| Minority interests, net of tax | 5.1 | (9.8) | (6.5) |
| Pension contributions, net of pension benefit costs | (40.8) | (33.0) | (8.8) |
| Net gain on disposition of assets | (185.7) | (65.8) | (6.9) |
| Gain on extinguishment of debt | (12.6) | | |
| Changes in working capital: | | | |
| Accounts receivable | (34.4) | (33.1) | (16.1) |
| Inventories | 20.5 | (40.1) | (34.8) |
| Income taxes receivable and payable | (20.7) | 22.1 | (50.8) |
| Accounts payable and accrued liabilities | (1.6) | 12.6 | 43.2 |
| Other, net | (18.3) | (4.3) | 4.6 |
| Net cash provided by operating activities | 182.3 | 169.4 | 122.5 |
| Cash flows from investing activities: | | | |
| Cash invested in fixed assets, timber and timberlands | (199.1) | (167.4) | (84.1) |
| Dispositions of assets, including timber and timberlands | 331.8 | 75.7 | 12.0 |
| Purchase of minority interest in subsidiary | (2.6) | | |
| Net cash provided by (used for) investing activities | 130.1 | (91.7) | (72.1) |
| Cash flows from financing activities: | | | |
| Cash dividends, including minority interests | (46.4) | (45.9) | (46.0) |
| Short-term financing | 370.4 | 572.0 | 733.4 |
| Short-term financing repayments | (432.5) | (591.0) | (866.1) |
| Long-term financing | | | 245.9 |
| Repurchases and payments of long-term debt | (135.1) | (14.3) | (113.9) |
| Stock options exercised | | 1.9 | 6.6 |
| Net cash used for financing activities | (243.6) | (77.3) | (40.1) |
| Net increase in cash and cash equivalents | 68.8 | 0.4 | 10.3 |
| Cash and cash equivalents: | | | |
| Beginning of year | 30.1 | 29.7 | 19.4 |
| End of year | \$ 98.9 | \$ 30.1 | \$ 29.7 |
| Supplemental disclosures of cash flow information: | | | |
| Cash paid during the year for: | | | |
| Interest, including capitalized interest of \$4.2, \$1.3, and \$0.1 | \$ 210.1 | \$ 206.6 | \$ 197.4 |
| Income taxes | \$ 14.7 | \$ | \$ 35.2 |

See accompanying Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Note 1. Basis of Presentation

Bowater Incorporated is a leading producer of coated and specialty papers and newsprint. In addition, we produce and sell bleached market pulp and lumber products. We operate 12 pulp and paper manufacturing facilities in the United States, Canada and South Korea. We also operate a facility in the United States that converts a mechanical fiber-containing base sheet to coated products. In addition, we own 10 sawmills in Canada and the United States. Our operations are supported by approximately 0.8 million acres of timberlands owned or leased in the United States and Canada and approximately 27.9 million acres of timber cutting rights on Crown-owned lands in Canada.

The accompanying Consolidated Financial Statements include the accounts of Bowater Incorporated and Subsidiaries (collectively *Bowater*). All significant inter-company transactions and balances with consolidated subsidiaries have been eliminated.

All consolidated subsidiaries are wholly-owned with the exception of the following:

| Consolidated Subsidiary | Bowater | Partners | Partner |
|-----------------------------------|-------------------|-------------------------|-------------------|
| | Percent Ownership | | Percent Ownership |
| Calhoun Newsprint Company (CNC) | 51% | Herald Company, Inc. | 49% |
| Bowater Mersey Paper Company Ltd. | 51% | Washington Post Company | 49% |

Bowater consolidated a 67% interest in Bowater Maritimes, Inc. (BMI) until December 22, 2006, at which time we acquired the minority interests from our partners Oji Paper Co. Ltd and Mitsui & Co., Ltd. BMI is now a wholly-owned subsidiary of Bowater. See Note 18, Acquisition of Minority Interest for details regarding this purchase.

Bowater also has a 40% interest in and is the managing partner of an unconsolidated entity, Ponderay Newsprint Company. The balance of this partnership is held by subsidiaries of five newspaper publishers. Additionally, Bowater has a 30% interest in a Canadian sawmill. Both partnerships are accounted for using the equity method of accounting.

In December 2006, we adopted the provisions of Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 clarifies the way that a company should evaluate an identified unadjusted error for materiality. SAB 108 requires that the effect of misstatements that were not corrected at the end of the prior year be considered in quantifying misstatements in the current year financial statements. Two techniques were identified as being used by companies in practice to accumulate and quantify misstatements the rollover approach and the iron curtain approach. The rollover approach, which is the approach we previously used, quantifies a misstatement based on the amount of the error originating in the current year income statement. Thus, this approach ignores the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years. The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement's year(s) of origination. The primary weakness of the iron curtain approach is that it does not consider the correction of prior year misstatements in the current year to be errors.

Using the rollover approach resulted in an accumulation of misstatements to our balance sheets that were deemed immaterial to our financial statements because the amounts that originated in each year were quantitatively and qualitatively immaterial. We have elected, as allowed under SAB 108, to reflect the effect of initially applying this guidance by adjusting the carrying amount of the impacted liabilities as of the beginning of 2006 and recording an offsetting adjustment to the opening balance of our retained earnings in 2006. We

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

recorded a cumulative adjustment to increase our retained earnings by \$8.6 million for the adoption of SAB 108. We evaluated the impact of these adjustments on previous periods presented in our Consolidated Financial Statements, individually and in the aggregate, under the rollover method and concluded that they were immaterial to those periods' Consolidated Financial Statements.

The following table presents a description of the individual adjustments included in the cumulative adjustment to retained earnings. These adjustments were identified by management in the normal course of performing our internal control activities:

| (In millions) | Adjustment | Description of the Adjustment | Years Impacted |
|--|---------------|---|----------------|
| Vacation liability (net of tax of \$4.6) | \$ (9.2) | Adjusted to reflect under accrual of vacation liability | 1980 s 2003 |
| Deferred tax liability | 7.9 | Adjusted to reflect impact of tax rate changes | 1998 2002 |
| Deferred tax liability | 6.7 | Adjusted to reflect tax basis of retirement assets | 1980 s 2005 |
| Purchased materials liability | 3.2 | Adjusted to reflect accrual of amounts owed | 2004 2005 |
| Total | \$ 8.6 | | |

In the 1980 s, Bowater s vacation expenses were recorded on a cash basis. Upon review of the vacation policies, it was determined that certain of our mill locations were not accruing their liabilities based on the vacation earned by the employees under these policies. In 2003, we began adjusting the vacation liability for the change in vacation earned as compared to the prior year, thus reflecting the correct adjustment to each year s income statement. A tax benefit of \$4.6 million was recorded for the vacation liability adjustment.

In 1998, in connection with an acquisition, we established deferred tax liabilities through purchase accounting associated with certain Canadian mills acquired. These purchase accounting related deferred taxes were maintained at the existing effective tax rate and were not adjusted for changes in our effective tax rates during the years noted. In 2003, we began adjusting these deferred tax liabilities for the current year s income statement impact.

In the 1980 s, we established deferred tax liabilities for certain retirement plan assets based on our conclusions regarding the tax basis of these assets. Upon recent and further evaluation, it was determined that the actual tax basis should have been lower than originally calculated and adjusted for contributions and distributions.

During a balance sheet review at one of our locations, it was determined that a liability account for accruals of purchased materials and services was not being appropriately released upon completion of a project and therefore resulted in an overstatement of the liability of \$3.2 million. Automatic accruals were established for the purchase order amount upon receipt of materials or services rendered, however, the appropriate amount was not released from the system upon receipt of final invoice. The purchased materials liability was adjusted to reflect the proper accrual of amounts owed.

Note 2. Accounting Policies

USE OF ESTIMATES: The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

date of the financial statements. In addition, they affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates and assumptions.

CASH EQUIVALENTS: Cash equivalents generally consist of direct obligations of the United States and Canadian governments and their agencies, investment-grade commercial paper and other short-term investment-grade securities with original maturities of three months or less. These investments are stated at cost, which approximates market value.

FINANCIAL INSTRUMENTS: Derivative financial instruments are accounted for in accordance with Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted (SFAS 133). SFAS 133 establishes accounting and reporting standards for derivative instruments and hedging activities and requires that we record all derivatives as either assets or liabilities in the balance sheet at fair value. Changes in the fair value of a derivative that has been designated and qualifies as a cash flow hedge are deferred and recorded as a component of Accumulated other comprehensive loss until the underlying transaction is recorded in earnings. At that time, gains or losses are reclassified from Accumulated other comprehensive loss to the Consolidated Statements of Operations on the same line as the underlying transaction (cost of sales). Any ineffective portion of a hedging derivative's change in fair value is recognized immediately in earnings. Changes in the fair value of a derivative that has not been designated or does not qualify as a cash flow hedge are recognized in earnings immediately. See also Note 15, Financial Instruments.

INVENTORIES: We adopted SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4 (SFAS 151), as of January 1, 2006. SFAS 151 clarifies the types of costs that should be expensed rather than capitalized into inventory. This statement also clarifies the circumstances under which fixed overhead costs associated with operating facilities involved in inventory processing should be capitalized. The effect of adopting SFAS No. 151 was immaterial to our financial position and results of operations. Inventories are stated at the lower of cost or market. Cost includes labor, materials and production overhead and is determined by using the average cost and last-in, first-out (LIFO) methods. See also Note 9, Inventories.

TIMBER AND TIMBERLANDS: The acquisition cost of land and timber, property taxes, lease payments, site preparation and other costs related to the planting and growing of timber are capitalized. Capitalization policies are consistent prior to and during harvesting. These costs, excluding land, are charged against income at the time the timber is harvested, based on annually determined depletion rates, and are included in the line titled Depreciation, amortization and cost of timber harvested in the Consolidated Statements of Operations. Growth and yield models are used to estimate timber volume on our land from year to year. These volumes affect the depletion rates, which are calculated annually based on the capitalized costs and the total timber volume based on the current stage of the growth cycle.

FIXED ASSETS AND DEPRECIATION: Fixed assets are stated at cost less accumulated depreciation. Depreciation is generally provided on a straight-line basis over the estimated useful lives of the assets. Repairs and maintenance, including costs associated with planned major maintenance, are charged to operations as incurred. Bowater capitalizes interest on borrowings during the construction period of major capital projects. Capitalized interest is added to the cost of the underlying assets and is amortized on a straight-line basis over the useful lives of the assets. See also Note 11, Fixed Assets.

ASSET RETIREMENT OBLIGATIONS: In accordance with SFAS No. 143 Accounting for Asset Retirement Obligations and related interpretations (SFAS 143), the fair value of a liability for an asset retirement obligation, including one conditional on a future event that may or may not be within our control, is recorded in the period in which it is incurred; the life is determinable; and a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the related long-lived asset. Subsequently, the asset retirement costs are allocated to expense and the liability is accreted to its face amount. See also Note 3, Asset Retirement Obligations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF: Bowater accounts for the impairment or disposal of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). In accordance with SFAS 144, long-lived assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset or group of assets (herein defined as long-lived asset) may not be recoverable. See Note 5, *Impairment and Other Related Charges*, for information regarding impairment of certain of our long-lived assets.

Tests for recoverability of a long-lived asset to be held and used are measured by comparing the carrying amount of the long-lived asset to the sum of the estimated future undiscounted cash flows expected to be generated by the asset. In estimating the future undiscounted cash flows we use projections of cash flows directly associated with, and which are expected to arise as a direct result of, the use and eventual disposition of the assets. Several of the key assumptions include periods of operation, projections of product pricing, first quality production levels, product costs, market supply and demand, foreign exchange rates, inflation and projected capital spending. Changes in any of these estimates could have a material effect on the estimated future undiscounted cash flows expected to be generated by the asset. If it is determined that a long-lived asset is not recoverable, an impairment loss would be calculated equal to the excess of the carrying amount of the long-lived asset over its fair value.

A long-lived asset classified as held for sale is initially measured and reported at the lower of its carrying amount or fair value less cost to sell. Long-lived assets to be disposed of other than by sale are classified as held and used until the long-lived asset is disposed. See Note 10, *Timberlands Held for Sale* regarding timberlands that are being held for sale.

GOODWILL: In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), goodwill, which represents the excess of purchase price over fair value of net assets acquired, is to be tested for impairment at least on an annual basis. The initial step of the goodwill impairment test involves a comparison of the fair value of each of our reporting units, as defined under SFAS 142 with its carrying amount. If a reporting unit's fair value exceeds its carrying value, no impairment loss is recognized and the second step, which is a calculation of the impairment, is not performed. However, if a reporting unit's carrying value exceeds its fair value, an impairment charge equal to the difference in the carrying value of the goodwill and the implied fair value of the goodwill is recorded. Implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. That is, the fair value of the reporting unit is allocated to the assets and liabilities of the reporting unit as if it had been acquired in a business combination. The excess of the fair value of the reporting unit over the amounts allocated to assets and liabilities is the implied fair value of goodwill. In making our determination of the fair value of a reporting unit, we rely primarily on the discounted cash flow method. This method uses projections of cash flows from each of the reporting units and makes use of several key assumptions as described more fully in Note 4, *Goodwill*. We perform an impairment test annually in the fourth quarter of each year, unless an event occurs earlier in the year that requires us to perform an interim test. See information regarding impairment of our goodwill in Note 4, *Goodwill*.

The goodwill associated with Ponderay is not subject to the impairment guidance in SFAS 142. Instead, Ponderay's goodwill is combined with our equity method investment in Ponderay Newsprint Company and reviewed for impairment in accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB 18). APB 18 requires us to evaluate an equity method investment (including goodwill) for impairment when factors lead us to believe that there has been a decline in the investment's value that is not considered temporary.

TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES: Bowater monetized notes receivable using qualified special purpose entities (QSPEs) set up in accordance with SFAS

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. The QSPEs that were established for note monetization purposes have not been consolidated within our financial statements. We recorded gains or losses on the monetization of the notes receivable, with the amount of the gain or loss determined based on the original carrying amount of the notes, allocated between the assets monetized and the retained interests in the QSPE based on their relative fair values at the date of the monetization. Bowater's retained interest consists principally of the excess cash flows (the difference between the interest received on the notes receivable and the interest paid on the securities issued by the QSPE to third parties) and a cash reserve account established at inception. Fair value of the retained interests was estimated based on the present value of future excess cash flows to be received over the life of the notes, using management's best estimate of key assumptions, including credit risk and discount rates. Our retained interests are included in Other assets in the Consolidated Balance Sheet. Excess cash flows revert to Bowater on a quarterly or semi-annual basis. The cash reserve account reverts to Bowater at the maturity of the investor notes. See Note 14, Long-Term and Short-Term Debt and Off-Balance Sheet Arrangements for further discussion of the QSPEs.

FAIR VALUE OF FINANCIAL INSTRUMENTS: SFAS No. 107, Disclosure About Fair Value of Financial Instruments requires that we disclose the fair value of our financial instruments when it is practical to estimate.

Short-Term Assets and Liabilities The fair value of our cash and cash equivalents, trade receivables and accounts payable approximate their carrying values because of their short-term nature. The fair value of our derivative financial instruments (refer to Note 15, Financial Instruments.) approximates carrying value and is based on current termination values or quoted market prices of comparable contracts.

Short-Term Debt Our Revolving Credit Facilities incur interest at market rates plus a margin (refer to Note 14, Long-Term and Short-Term Debt and Off-Balance Sheet Arrangements), thus the fair value of our short-term debt approximates its carrying value.

Long-Term Debt The fair value of our notes and debentures (refer to Note 14, Long-Term and Short-Term Debt and Off-Balance Sheet Arrangements) were determined by reference to quoted market prices or were determined by discounting the cash flows using current interest rates for financial instruments with similar characteristics and maturities. There were no significant differences as of December 31, 2006 and 2005 between the carrying value and fair value of our notes and debentures.

INCOME TAXES: Income taxes are accounted for under the asset and liability method, as prescribed by SFAS No. 109, Accounting for Income Taxes (SFAS 109). Deferred tax assets and liabilities are recognized for the expected future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to be recovered or settled. Valuation allowances are recognized to reduce deferred tax assets to the amount that is more likely than not to be realized. In assessing the likelihood of realization, we consider estimates of future taxable income and tax planning strategies.

Bowater has not provided for U.S. income taxes on the undistributed earnings of certain of its foreign subsidiaries, as it has specific plans for the reinvestment of such earnings. See Note 17, Income Taxes for a discussion of the Company's undistributed earnings of its foreign subsidiaries.

FOREIGN OPERATIONS: Financial statements of the majority of Bowater's Canadian and Korean operations are prepared using the United States dollar as their functional currency. Non-monetary assets and liabilities and related depreciation and amortization for these foreign operations are remeasured into U.S. dollars using historical exchange rates. Remaining assets and liabilities are remeasured into U.S. dollars using the exchange rates as of the balance sheet date. Income and expense items are remeasured into U.S. dollars using an average exchange rate for the period. Gains and losses from foreign currency transactions and from remeasurement of the balance sheet are reported as Other income, net in the Consolidated Statements of Operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Financial statements of one foreign subsidiary are prepared using the local currency as the functional currency. Assets and liabilities of this subsidiary are translated into U.S. dollars at the exchange rates in effect at the balance sheet dates. Income and expense items are translated at average daily exchange rates for the period. The resulting translation gains or losses are recognized as a component of equity in Accumulated other comprehensive loss. Gains and losses from foreign currency transactions are included in the Consolidated Statements of Operations.

SHARE-BASED COMPENSATION: Share-based compensation is accounted for under the fair value recognition provisions of SFAS No. 123R,

Share-based Payments and related interpretations (SFAS 123R). Prior to January 1, 2006 our share-based compensation was accounted for under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations (APB 25) as permitted by SFAS No. 123, Accounting for Stock-based Compensation (SFAS 123).

Results for periods prior to adoption of SFAS 123R have not been restated. The table below illustrates the pro forma effect on net loss and loss per share if we had applied the fair value recognition provisions of SFAS 123 to Bowater's share-based compensation plans in the years ended December 31:

| <i>(In millions, except per-share amounts)</i> | 2005 | 2004 |
|--|-------------|-------------|
| Net loss as reported: | \$ (120.6) | \$ (87.1) |
| Add: Share-based compensation expense included in net loss | | 0.6 |
| Deduct: Share-based compensation expense determined under fair value based methods, net of related tax effects | (8.6) | (7.4) |
| Pro forma net loss | \$ (129.2) | \$ (93.9) |
| Loss per share: | | |
| Basic and diluted, as reported | \$ (2.10) | \$ (1.52) |
| Basic and diluted, pro forma | (2.25) | (1.64) |

For purpose of the above disclosure, the fair value of each option granted during the year ended 2005 and 2004 was estimated as of the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

| | 2005 | 2004 |
|--|-------------|-------------|
| Assumptions: | | |
| Expected dividend yield | 2.2% | 1.8% |
| Expected stock price volatility | 29.0% | 30.6% |
| Risk-free interest rate | 4.0% | 3.4% |
| Expected option lives | 7.2 years | 6.8 years |
| Weighted average fair value of options granted | \$ 11.19 | \$ 13.88 |

We estimated the expected dividend yield, expected volatility and expected life of each stock option based upon historical experience. The risk-free rate of interest was based on a zero-coupon U.S. Treasury instrument with a remaining term approximating the expected life of the stock option. Forfeitures were recognized as they occurred.

PENSION AND OTHER POSTRETIREMENT BENEFIT OBLIGATIONS: Prior to December 31, 2006, we recognized the assets and liabilities associated with our pension and other postretirement benefit plans (the Plans) in accordance with SFAS No. 87, Employers Accounting for Pensions, (SFAS 87) and SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions (SFAS 106), which allowed us to

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

defer the recognition of the impact of certain events such as plan changes applicable to prior service costs and actuarial gains and losses. As of December 31, 2006, we have adopted the provisions of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - An Amendment of FASB Statements No. 87, 88, 106 and 132R* (SFAS 158), that require us to recognize in our Consolidated Balance Sheet an asset for a plan's overfunded status or a liability for a plan's underfunded status. See Note 16, *Pension and Other Postretirement Benefit Plans* for information regarding the impact of adoption to our Consolidated Balance Sheet.

COMPREHENSIVE LOSS: Comprehensive loss, net of taxes, consists of net loss, foreign currency translation adjustments, minimum pension liability adjustments and unrealized gains and losses on hedged transactions and is presented in the Consolidated Statements of Capital Accounts. The components of Accumulated other comprehensive loss in the Consolidated Balance Sheets are as follows:

| <i>(In millions)</i> | 2006 | 2005 |
|--|-------------------|-------------------|
| Pension plan additional minimum liability ⁽¹⁾ | \$ | \$ (186.1) |
| Unrealized prior service costs ⁽²⁾ | (23.2) | |
| Unrealized actuarial gains and losses ⁽³⁾ | (358.9) | |
| Unrealized transition obligation ⁽⁴⁾ | (0.1) | |
| Foreign currency translation ⁽⁵⁾ | 12.0 | 11.5 |
| Unrealized gain on hedging transactions ⁽⁶⁾ | (0.8) | 18.6 |
| | \$ (371.0) | \$ (156.0) |

(1) Net of deferred tax benefit of \$66.8 million and minority interest of \$1.2 million in 2005. This component has been eliminated with the adoption of SFAS 158.

(2) This component was established with the adoption of SFAS 158. Net of deferred tax benefit of \$1.5 million and minority interest of \$2.4 million in 2006.

(3) This component was established with the adoption of SFAS 158. Net of deferred tax benefit of \$109.6 million and minority interest of \$5.2 million in 2006.

(4) This component was established with the adoption of SFAS 158. Net of deferred tax benefit of \$0.1 million in 2006.

(5) No tax effect is recorded for foreign currency translation since the foreign net assets translated are deemed permanently invested.

(6) Net of deferred tax benefit of \$0.5 million in 2006 and a deferred tax provision of \$11.4 million in 2005.

REVENUE RECOGNITION: Approximately 90% of Bowater sales are for pulp and paper products. These products are primarily delivered by either truck or rail and revenue recognition is based on shipping terms. These products are primarily delivered to our customers directly from our mills and typically have the terms free on board (FOB) shipping point. For these sales, revenue is typically recorded when the product leaves the mill. With regard to these sales or any other sale of any Bowater product, the following criteria must be met before revenue is recorded: persuasive evidence of an arrangement exists; delivery has occurred and we have no remaining obligations; prices are fixed or determinable; and collectibility is reasonably assured.

DISTRIBUTION COSTS: Bowater's shipping and handling costs are classified as distribution costs and presented separately on the Consolidated Statements of Operations, in accordance with the Emerging Issues Task Force Issue No. 00-10, *Accounting for Shipping and Handling Fees and Costs*.

BASIC AND DILUTED EARNINGS PER SHARE: Basic earnings per common share, including exchangeable shares issued by our subsidiary, Bowater Canada Inc. (Exchangeable Shares), is calculated assuming no dilution. Diluted earnings per common share is computed using the weighted average number of outstanding common shares, including Exchangeable Shares, adjusted for the incremental shares attributed to the dilutive effect of potentially dilutive securities (stock options and restricted stock units), which is calculated using the treasury stock method.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

ENVIRONMENTAL COSTS: Bowater expenses environmental costs related to existing conditions resulting from past or current operations and from which no current or future benefit is discernible. Expenditures that extend the life of the related property are capitalized. We determine our liability on a site-by-site basis and record a liability at the time it is probable and can be reasonably estimated. Such accruals are adjusted as further information develops or circumstances change. Costs of future expenditures for environmental remediation obligations are discounted to their present value when the amount and timing of expected cash payments are reliably determinable.

RECLASSIFICATIONS: Certain prior-year amounts in our Consolidated Financial Statements and the notes have been reclassified to conform to the 2006 presentation. In the first quarter of 2006, we adjusted the amount of goodwill allocated to the timberlands held for sale. As a result, goodwill allocated to timberlands held for sale as of December 31, 2005 decreased by \$12.7 million and goodwill increased by the same amount compared to the amounts previously reported in our 2005 Consolidated Financial Statements and related notes. The reclassifications had no effect on our previously reported net loss or shareholders' equity.

NEW ACCOUNTING PRONOUNCEMENTS: In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109. FIN 48 clarifies the accounting for income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition and is effective for fiscal years beginning after December 15, 2006. We have not yet completed our evaluation of the impact the adoption of FIN 48 will have on our consolidated results of operations and financial position.

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements (SFAS 157). SFAS 157 provides enhanced guidance for using fair value to measure assets and liabilities. SFAS 157 also responds to investors' requests for expanded information about the extent to which company's measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements and is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the impact of this statement on our results of operations and financial position.

Note 3. Asset Retirement Obligations

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations an interpretation of SFAS No. 143 (FIN 47). FIN 47 confirms that a legal obligation to perform an asset retirement activity should be recorded as a liability even if the timing and/or settlement is conditional on a future event that may or may not be within the control of an entity. Accordingly, we must determine if sufficient information is available to estimate the fair value of the liability and, if so, record a liability for the conditional asset retirement obligation. Bowater adopted FIN 47 during the fourth quarter of 2005, which resulted in a net charge of \$0.5 million that is included in Cumulative effect of accounting changes, net of tax in the 2005 Consolidated Statements of Operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The activity in our liability for asset retirement obligations is as follows:

| <i>(In millions)</i> | 2006 | 2005 |
|----------------------|---------------|-------------|
| Beginning of year | \$ 6.3 | \$ 4.6 |
| Adoption of FIN 47 | | 0.9 |
| Changes in estimate | | 0.4 |
| Accretion expense | 0.6 | 0.4 |
| Payments | (0.1) | |
| End of year | \$ 6.8 | \$ 6.3 |

These asset retirement obligations consist primarily of liabilities for landfills and sludge basins. The related costs are capitalized as part of land and land improvements. Bowater has not had to legally restrict these assets for purposes of settling our asset retirement obligations.

Additionally, we have certain asset retirement obligations for which the timing of settlement is conditional upon the closure of the related operating facility. These obligations include, for example, wastewater and effluent ponds that will be required to be drained, and storage sites or owned facilities for which removal of chemicals and other related materials will be required. At this time we have no specific plans for the closure of these related facilities, and we currently intend to make improvements to the assets as necessary that would extend their lives indefinitely. Furthermore, the settlement dates have not been specified by law, regulation or contract. As a result, we are unable to estimate the fair value of the liability because there are indeterminate settlement dates for the conditional asset retirement obligations. If a closure plan for any of these facilities is initiated in the future, the settlement dates will become determinable, an estimate of fair value will be made, and an asset retirement obligation will be recorded.

Note 4. Goodwill

During the third quarter of 2006, Bowater realigned its organizational structure from a divisional structure to a functional structure. Our reportable segments are now based on our primary product lines. As a result of economic conditions and the operating environment at our Thunder Bay site, including an asset impairment charge we recorded in the third quarter of 2006 related to paper machine No. 3 (See Note 5, Impairment and Other Related Charges) and our organizational realignment in the same quarter, we performed an interim goodwill impairment test on our existing reporting units. As discussed below, the testing methodology requires us to make estimates and judgments that are subjective and difficult to apply, and thus they are inherently uncertain. Our management has reviewed these estimates with the Audit Committee of our Board of Directors.

In making our determination of fair value, we rely primarily on the discounted cash flow method. This method uses projections of cash flows from each of the reporting units. Several of the key assumptions include periods of operation, projections of product pricing, production levels, product costs, market supply and demand, foreign exchange rates, inflation, weighted average cost of capital and capital spending. We derive these assumptions used in our valuation models from several sources. Many of these assumptions are derived from our internal budgets, which would include existing sales data based on current product lines and assumed production levels, manufacturing costs and product pricing. We believe that our internal forecasts are consistent with those that would be used by a potential buyer in valuing our reporting units. Our products are commodity products; therefore, pricing is inherently volatile and often follows a cyclical pattern. The average price over a commodity cycle forms the basis of our product pricing assumption. We derive our pricing estimates from information generated internally, from industry research firms and from other published reports and forecasts.

Since performing our 2005 annual impairment test, exchange rates continued to climb to high levels. Given the exchange rate environment at the time of the interim test, we believe a potential buyer would consider a

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

shorter-term view of exchange rates. Therefore, in our third quarter of 2006 interim analysis, foreign exchange rates were based on market forward rates for 2007 followed by a gradual reversion to a 5-year historical average as opposed to a 10-year historical average, which had been used in previous tests for impairment.

In addition to the assumptions discussed above, we determined the fair value of our Thunder Bay mill in both the third and fourth quarter tests utilizing a probability-weighted approach that assumes a potential buyer of the facility would consider alternative courses of action in estimating the discounted cash flows. Courses of action that were probability-weighted in our fair value estimation of the Thunder Bay facility include operating the mill as it is currently operated; restarting paper machine No. 3, which we permanently shut in the third quarter of 2006 but could be fully operational to a potential buyer of the facility; and conversion of one of Thunder Bay's other newsprint machines to production of coated paper grades.

As a result of the continued strengthening of the Canadian dollar and a reduction in our estimated probability that a potential buyer would restart paper machine No. 3 or convert another newsprint machine, our third quarter of 2006 interim test of our Thunder Bay reporting unit, under both our current operating scenario and our probability-weighted scenario, indicated that the carrying value of Thunder Bay's net assets exceeded its fair value. Therefore, we proceeded with the second step of the impairment analysis in order to measure the amount of the impairment loss. The implied fair value of goodwill related to our Thunder Bay reporting unit, which was previously included in our Coated and Specialty Papers segment, was approximately \$296.0 million; therefore, we recorded a goodwill impairment charge of \$200.0 million in 2006. Our third quarter of 2006 interim test of our other reporting units indicated that the fair value of each of the reporting units exceeded the carrying amount of the respective reporting unit's net assets.

As a result of our organizational realignment, we performed a reallocation of our goodwill to the newly identified reporting units. The steps for identifying the new reporting units included defining the new operating segments (See Note 25, Segment Information), determining the components one level below the operating segments, determining whether an identified component is a business, and determining whether components within an operating segment meet the requirements for aggregation. Our analysis resulted in the identification of two reporting units to which goodwill was allocated based on a relative fair value allocation approach.

Bowater completed its annual goodwill impairment test on the new reporting units in the fourth quarter of 2006. Assumptions similar to those described above for the third quarter of 2006 interim goodwill impairment test were used. There were no indications of impairment for any of our reporting units as a result of performing our annual impairment test.

In future measurements of fair value, adverse changes in any of these assumptions and/or changes in the probability of alternative courses of action at our Thunder Bay mill could result in an impairment of goodwill that would require a non-cash charge to the Consolidated Statements of Operations and may have a material effect on the financial condition and operating results of the company.

Goodwill by reportable segment is as follows as of December 31:

| <i>(In millions)</i> | 2006 | 2005 |
|---|-----------------|-----------------|
| Before Organizational Realignment: | | |
| Newsprint Division | \$ | \$ 26.4 |
| Coated and Specialty Papers Division | | 473.7 |
| Canadian Forest Products Division | | 294.0 |
| After Organizational Realignment: | | |
| Specialty Papers | 55.6 | |
| Newsprint | 534.6 | |
| | \$ 590.2 | \$ 794.1 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Our goodwill is associated with nine paper and pulp mills. Information needed to reallocate the 2005 goodwill to our new reporting units, and thus our new reportable segments is not readily available. Goodwill decreased by \$203.9 million in 2006 as a result of an impairment charge of \$200.0 million discussed above and tax adjustments of \$3.9 million related to previous acquisitions.

Note 5. Impairment and Other Related Charges

The principal components of impairment and other related charges are as follows:

| <i>(In millions)</i> | 2006 | 2005 | 2004 |
|---|-----------------|----------------|-----------|
| Impairment of goodwill | \$ 200.0 | \$ | \$ |
| Impairment of long-lived assets | 48.5 | 82.6 | |
| Lease obligations and other commitments | 3.8 | | |
| Severance and related costs | 0.2 | | |
| Impairment and other related charges | \$ 252.5 | \$ 82.6 | \$ |

GOODWILL IMPAIRMENT

We recorded a goodwill impairment charge of \$200.0 million in 2006. See Note 4, Goodwill, for details.

LONG-LIVED ASSET IMPAIRMENT AND OTHER RELATED CHARGES

In 2006, the impairment of long-lived assets and other related charges are associated with our Benton Harbor operations (\$27.5 million), the paper machine No. 3 at our Thunder Bay facility (\$18.9 million), our Ignace sawmill (\$5.2 million) and our Girardville sawmill (\$0.9 million). In 2005, the asset impairment charges relate to our Thunder Bay A kraft pulp mill (\$67.2 million), a coating line at our Benton Harbor paper mill (\$11.9 million) and a paper machine at our Mokpo, Korea paper mill (\$3.5 million).

During the third quarter of 2006, we decided to close the Benton Harbor operation. This close resulted in a review of the facility's long-lived assets for impairment. As a result, we recorded a non-cash asset impairment charge of \$23.5 million. The fair value of the assets was approximately \$3.4 million and was determined using discounted cash flows. An additional \$4.0 million was also recorded for lease costs, contract termination costs and severance. Inventory write-downs totaling \$0.4 million were recorded in cost of sales.

We idled newsprint production on paper machine No. 3 at our Thunder Bay facility in 2003. Based on the continued decline of North American newsprint consumption in 2006, we determined we had no plans to restart the machine. Accordingly, we recorded a non-cash asset impairment charge of \$18.9 million to write down the value of this paper machine to its estimated fair value, which was determined using discounted cash flows. Inventory write-downs totaling \$1.7 million were recorded in cost of sales.

On October 12, 2006, an agreement regarding Canada's softwood lumber exports to the United States became effective. See Note 19, Commitments and Contingencies for further discussion of this agreement. Beginning January 1, 2007, our Ontario sawmills became subject to volume limitations based on their share of U.S. consumption. In December 2006, we were notified that the volume limitations for our Ontario sawmills would be significantly lower than our current production volumes as the allocation mechanism used by the provincial government did not address the needs of new entrants. As a result, we indefinitely closed our Ignace sawmill and reduced production at our Thunder Bay sawmill. Accordingly, we reviewed the sawmills' long-lived assets for impairment and recorded a non-cash asset impairment charge of \$5.2 million. The fair value of the assets was nominal and was determined using discounted cash flows.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In 2006, we decided to permanently shut our Girardville sawmill, which had indefinitely stopped production in 2005. As a result, we recorded a non-cash asset impairment charge of \$0.9 million. The fair value of the assets was nominal and was determined using discounted cash flows.

During January 2006, Bowater announced its plans to permanently close the Thunder Bay A kraft pulp mill in the second quarter of 2006 and, as a result, recorded an asset impairment charge of \$67.2 million during the fourth quarter of 2005. Fair value of the A kraft pulp mill was nominal and was determined based on the estimated sale and salvage value plus any projected cash generated from its operations through April 2006. In connection with this decision, Bowater incurred a 20% staffing reduction at this site. See Note 13, Severance Related Liabilities, for a discussion of the severance costs associated with this staffing reduction.

During the second quarter of 2005, Bowater management decided to permanently shut the original coating line at Benton Harbor. This was based on the significant capital spending that would be required for the original line to meet the quality standards of our two newer Nuway lines and because the facility's infrastructure would not support a restart given the recent record production of the new Benton Harbor line. This permanent shut resulted in an asset impairment charge of \$11.9 million. Fair value was based on the estimated sale and salvage value. The original line had been idled since the third quarter of 2002.

Due to product quality and production issues, we replaced certain components of the paper machine at our Mokpo, Korea location during the fourth quarter of 2005 and recorded an asset impairment charge of \$3.5 million.

We do not allocate impairment charges to our reportable segments; therefore, these charges are included in Corporate and Other in Note 25, Segment Information.

Note 6. Net Gain on Disposition of Assets

| <i>(In millions)</i> | 2006 | 2005 | 2004 |
|--|-----------------|----------------|---------------|
| Net gain on disposition of timber and timberlands | \$ 179.0 | \$ 61.5 | \$ 5.7 |
| Net gain on disposition of sawmills and other fixed assets | 6.7 | 4.3 | 1.2 |
| Net gain on disposition of assets | \$ 185.7 | \$ 65.8 | \$ 6.9 |

We sold approximately 535,200 acres, 29,900 acres and 3,200 acres of timberlands primarily located in Tennessee and Canada during 2006, 2005 and 2004, respectively. During 2006, we also sold our Baker Brook and Dégelis sawmills for proceeds of \$21.4 million. Proceeds from the dispositions of assets, including timber and timberlands, can be found in our Consolidated Statements of Cash Flows. Goodwill of \$25.2 million was included in the calculation of the net gain on the disposition of certain of our timberlands.

Note 7. Other Income, Net

Other income, net includes non-operating items. The breakdown of the components of Other income, net for the three years ended December 31 is as follows:

| <i>(In millions)</i> | 2006 | 2005 | 2004 |
|---|----------------|---------------|----------------|
| Foreign exchange gain (loss) | \$ 8.6 | \$ (3.1) | \$ 3.0 |
| Earnings from equity method investments | 7.1 | 3.9 | 4.4 |
| Interest income (Note 19) | 17.8 | 4.8 | 4.2 |
| Charges related to repurchase of debt (Note 14) | (8.0) | | |
| Gain on extinguishment of debt (Note 14) | 12.6 | | |
| Miscellaneous income | 5.5 | 4.3 | 5.8 |
| | \$ 43.6 | \$ 9.9 | \$ 17.4 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Note 8. Loss Per Share

The information required to compute net loss per basic and diluted share is as follows:

| <i>(In millions)</i> | 2006 | 2005 | 2004 |
|---|-------------|-------------|-------------|
| Basic weighted-average number of common shares Outstanding | 57.4 | 57.4 | 57.2 |
| Effect of potentially dilutive securities: | | | |
| Stock options | | | |
| Restricted stock units | | | |
| Diluted weighted-average number of common shares Outstanding | 57.4 | 57.4 | 57.2 |

No adjustments to net loss are necessary to compute net loss per basic and diluted share. Options to purchase 5.0 million shares, 5.1 million shares and 4.6 million shares for years ended December 31, 2006, 2005 and 2004, respectively, were excluded from the calculation of diluted loss per share as the impact would have been anti-dilutive. In addition, 0.7 million restricted stock units for the year ended December 31, 2006, were excluded from the calculation of diluted loss per share for the same reason.

Note 9. Inventories

| <i>(In millions)</i> | 2006 | 2005 |
|--|-----------------|-----------------|
| At lower of cost or market: | | |
| Raw materials | \$ 87.7 | \$ 100.4 |
| Work in process | 20.1 | 30.5 |
| Finished goods | 123.0 | 131.8 |
| Mill stores and other supplies | 132.0 | 114.9 |
| | 362.8 | 377.6 |
| Excess of current cost over LIFO inventory value | (13.0) | (11.8) |
| | \$ 349.8 | \$ 365.8 |

Inventories valued using the LIFO method comprised 10.9% and 9.2% of total inventories at December 31, 2006 and 2005, respectively.

Note 10. Timberlands Held for Sale

Bowater is currently marketing for sale approximately 86,000 acres of timberlands in the United States and Canada. We expect sales of these assets to be completed in 2007. Timberlands held for sale are carried on our Consolidated Balance Sheets at cost as we expect the proceeds of the timberland sales to exceed their individual carrying values. There are no liabilities associated with timberlands held for sale at December 31, 2006. The timberlands held for sale and \$23.6 million of related liabilities held for sale at December 31, 2005 were sold during 2006 for amounts exceeding their individual carrying values.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11. Fixed Assets

| <i>(In millions)</i> | Range of Estimated Useful Lives in Years | 2006 | 2005 |
|--|---|------------|------------|
| Land and land improvements | 10-20 | \$ 50.2 | \$ 50.7 |
| Buildings | 20-40 | 296.2 | 296.4 |
| Machinery and equipment | 5-20 | 6,071.9 | 5,723.2 |
| Leasehold improvements | 10-20 | 1.6 | 1.9 |
| Construction in progress | | 123.3 | 141.5 |
| | | 6,543.2 | 6,213.7 |
| Less accumulated depreciation and amortization | | (3,665.3) | (3,164.6) |
| | | \$ 2,877.9 | \$ 3,049.1 |

Note 12. Accounts Payable and Accrued Liabilities

| <i>(In millions)</i> | 2006 | 2005 |
|--------------------------------|----------|----------|
| Trade accounts payable | \$ 217.9 | \$ 212.0 |
| Payroll, bonuses and severance | 84.2 | 74.6 |
| Accrued interest | 28.7 | 30.5 |
| Employee benefits | 29.3 | 83.1 |
| Income and other taxes payable | 20.3 | 18.7 |
| Deferred taxes | | 18.4 |
| Dividends payable | 11.2 | 11.2 |
| Other | 39.6 | 50.0 |
| | \$ 431.2 | \$ 498.5 |

Note 13. Severance Related Liabilities

The activity in our severance related liabilities is as follows:

| <i>(In millions)</i> | |
|--|---------|
| Balance at December 31, 2004 | \$ 5.5 |
| 2005 Charges | 13.9 |
| 2005 Payments | (3.5) |
| Balance at December 31, 2005 | 15.9 |
| 2006 Charges | 16.3 |
| 2006 Payments | (13.8) |
| 2006 Reclass to pension and other post retirement benefit obligation | (7.7) |
| Balance at December 31, 2006 | \$ 10.7 |

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In 2006, Bowater recorded approximately \$19.0 million of employee termination costs including severance and other benefits related to the closure of our Benton Harbor facility, the closure of our Ignace sawmill, the sale of certain other sawmills and organizational realignments. Approximately \$7.7 million of these costs increased our pension and other postretirement benefit obligations. The accrual was reduced by payments of \$6.3 million during 2006. The remaining severance accrual of \$5.0 million at December 31, 2006 is expected to be paid out in 2007, and is included in Accounts payable and accrued liabilities in the Consolidated Balance Sheet.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In 2005, Bowater recorded approximately \$13.3 million of employee termination costs including severance and other benefits. Approximately \$11.5 million of the \$13.3 million relates to the permanent closure of the A kraft pulp mill at our Thunder Bay facility in May 2006 and the elimination of approximately 260 positions. During 2006, the accrual was reduced by an adjustment of \$2.6 million and reduced by payments of \$5.0 million. The remaining severance accrual of \$5.7 million at December 31, 2006 is expected to be paid out in 2007, and is included in Accounts payable and accrued liabilities in the Consolidated Balance Sheet.

In 2004, Bowater recorded severance charges of approximately \$8.7 million for employee termination costs including severance, medical, pension and other benefits, primarily from the voluntary termination of 35 employees related to the indefinite closure of the groundwood pulp mill at our Thunder Bay facility, and 11 additional employees related to retirements, and our streamlining of the former Forest Products Division. Approximately \$3.2 million of the \$8.7 million employee termination costs were pension related costs. During 2005 the accrual was increased by \$0.6 million and reduced by payments of \$3.5 million. During 2006, the \$2.6 million accrual that remained as of December 31, 2005 was reduced by a change in estimate of \$0.1 million and payments of \$2.5 million.

Also included in 2004 were severance and related charges of \$1.1 million associated with a 2002 cost reduction program.

We do not allocate severance charges to our reportable segments; thus, these costs are included in Corporate and Other in Note 25, Segment Information. Termination costs are classified as either cost of sales (manufacturing personnel) or selling and administrative expense (administrative personnel) in our Consolidated Statements of Operations.

Note 14. Long-Term and Short-Term Debt and Off-Balance Sheet Arrangements

SHORT-TERM DEBT:

At December 31, 2006, we had available borrowings under our credit facilities as follows:

| Short-Term Bank Debt | Commitment | Amount Outstanding | Commitment Available ⁽¹⁾ | Termination Date | Weighted Average Interest Rate ⁽²⁾ |
|--|------------|--------------------|-------------------------------------|------------------|---|
| (in millions, except for dates and interest rates) | | | | | |
| U.S. Credit Agreement | \$ 415.0 | \$ | \$ 347.3 | 05/11 | n/a |
| Canadian Credit Agreement | \$ 165.0 | \$ | \$ 132.4 | 05/07 | n/a |
| | \$ 580.0 | \$ | \$ 479.7 | | |

(1) The commitment available under each of the revolving credit facilities is subject to collateral requirements and covenant restrictions as described below and is reduced by outstanding letters of credit of \$67.7 million for the U.S. and \$32.6 million for Canada. Commitment fees for unused portions of the U.S. and Canadian facilities are 50 basis points and 25 basis points, respectively.

(2) Borrowings under the revolving credit facilities incur interest based, at our option, on specified market interest rates plus a margin. No borrowings were outstanding under these credit facilities during the year.

On May 31, 2006, we entered into (i) a five-year Credit Agreement among Bowater Incorporated (Bowater) as Borrower, several lenders, and Wachovia Bank, National Association, as Administrative Agent (the U.S. Credit Agreement) and (ii) a 364-day Credit Agreement, along with its subsidiary Bowater Canadian Forest Products Inc. (BCFPI), among BCFPI as Borrower, Bowater as parent Guarantor, several lenders, and The Bank of Nova Scotia as Administrative Agent (the Canadian Credit Agreement).

The U.S. Credit Agreement provides for a \$415 million revolving credit facility with a scheduled maturity date of May 25, 2011. The U.S. Credit Agreement is guaranteed by certain of our wholly-owned subsidiaries in

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

the United States, and is secured by (i) liens on the inventory, accounts receivable and deposit accounts of Bowater and the guarantors (ii) pledges of 65% of the stock of certain of our foreign subsidiaries, and (iii) pledges of the stock of our U.S. subsidiaries that do not own mills or converting facilities. Availability under the U.S. Credit Agreement is limited to 90% of the net consolidated book value of our accounts receivable and inventory, excluding BCFPI and its subsidiaries.

The Canadian Credit Agreement provides for a \$165 million revolving credit facility with a maturity date of May 29, 2007, subject to annual extensions. The Canadian Credit Agreement is secured by liens on the inventory, accounts receivable and deposit accounts of BCFPI. Availability under the Canadian Credit Agreement is limited to 65% of the net book value of the accounts receivable and inventory of BCFPI and its subsidiaries.

Financial covenants under both the U.S. Credit Agreement and Canadian Credit Agreement are based upon our consolidated financial results and consist of the following two ratios:

a maximum ratio of senior secured indebtedness (including all advances and letters of credit under the US and Canadian facilities, and any other indebtedness secured by assets of Bowater and its subsidiaries) to EBITDA (generally defined as net income, excluding extraordinary, non-recurring or non-cash items and gains (or losses) on asset dispositions, plus income taxes plus depreciation plus interest expense) of 1.25 to 1; and

a minimum ratio of EBITDA (defined as EBITDA, plus gains (or minus losses) from asset dispositions) to interest expense of 2.00 to 1.

We believe we are in compliance with all of our covenants and other requirements set forth in our credit facilities.

As of December 31, 2005, we had \$55.0 million outstanding under a 364-day Accounts Receivable Securitization Arrangement whereby we agreed to sell a significant portion of our trade accounts receivable to a special purpose entity and pledge those receivables as security for outstanding borrowings. This arrangement was terminated in May 2006 upon the execution of our new credit facility.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

LONG-TERM DEBT:

Long-term debt, net of current installments, consists of:

| <i>(In millions)</i> | 2006 | 2005 |
|--|-------------------|-------------------|
| Unsecured: | | |
| 7.95% Notes due 2011, net of unamortized original discount of \$0.9 in 2006 and \$1.1 in 2005 | \$ 599.1 | \$ 598.9 |
| 6.5% Notes due 2013, net of unamortized original discount of \$1.0 in 2006 and \$1.2 in 2005 | 399.0 | 398.8 |
| Notes due 2010 with interest at floating rates (8.36% at December 31, 2006 and 7.49% at December 31, 2005) | 234.4 | 250.0 |
| 9.00% Debentures due 2009 | 248.1 | 250.0 |
| 9.38% Debentures due 2021, net of unamortized original discount of \$0.8 in 2006 and \$0.8 in 2005 | 199.3 | 199.2 |
| 9.50% Debentures due in 2012, net of unamortized original discount of \$0.1 in 2006 and \$0.1 in 2005 | 124.9 | 124.9 |
| 10.63% Notes due 2010 | 3.1 | 113.6 |
| 10.85% Debentures due 2014 | 130.0 | 131.6 |
| 10.50% Notes due at various dates from 2007 to 2010 | 40.5 | 52.7 |
| 10.60% Notes due 2011 | 80.7 | 82.8 |
| 7.75% recycling facilities revenue bonds due 2022 | 62.0 | 62.0 |
| 7.40% recycling facilities revenue bonds due 2022 | 39.5 | 39.5 |
| Industrial revenue bonds due 2029 with interest at floating rates | 33.5 | 33.5 |
| 7.62% recycling facilities revenue bonds due 2016 | 30.0 | 30.0 |
| 10.26% Notes due at various dates from 2007 to 2011 | 11.3 | 14.0 |
| Pollution control revenue bond due at various dates from 2007 to 2010 with interest at 7.40% | 4.6 | 5.2 |
| Non-interest bearing loan with Government of Québec due 2007 and 2008 | 6.4 | 7.6 |
| 6.5% UDAG loan agreement due at various dates from 2007 to 2010 | 5.2 | 5.7 |
| | \$ 2,251.6 | \$ 2,400.0 |

TOTAL DEBT:

Debt maturities for the next five years are as follows:

| Year | Amount |
|-----------------------------------|----------------------|
| | <i>(In millions)</i> |
| 2007 | \$ 14.9 |
| 2008 | 20.0 |
| 2009 | 261.8 |
| 2010 | 257.1 |
| 2011 | 672.2 |
| Thereafter | 997.8 |
| | 2,223.8 |
| Discounts and revaluation of debt | 42.7 |
| | \$ 2,266.5 |

The amounts due in 2007 are recorded as Current installments of long-term debt in our Consolidated Balance Sheet. All other amounts are recorded as Long-term debt, net of current installments. Total debt

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

includes an additional \$45.5 million at December 31, 2006 and \$67.6 million at December 31, 2005 due to the revaluation of the debt balances acquired with the purchase of the Grenada Operations paper mill in August 2000 and the acquisition of Avenor Inc. in July 1998. Total debt also includes discounts of \$2.8 million and \$3.2 million at December 31, 2006 and 2005, respectively.

In March 2004, Bowater sold, in a registered offering, \$250 million of notes due March 15, 2010. Interest on the notes accrue at a rate based on LIBOR plus 3% and is payable quarterly. We received net proceeds from the sale of the notes of \$246.2 million, which were net of underwriting fees of \$3.8 million. The proceeds were used to pay amounts outstanding under the short-term bank debt credit facilities (\$146.2 million) and the associated term loan (\$100.0 million). On or after March 15, 2006, Bowater may redeem all or a portion of the notes at par at any time.

During August 2006, we repurchased approximately \$15.6 million of our \$250 million floating rate notes due March 15, 2010 for total cash consideration of approximately \$15.8 million, or a 1.4% premium over face value. In September 2006, we repurchased approximately \$1.9 million of our \$250 million 9% notes due August 1, 2009 for total cash consideration of approximately \$2.0 million, or a 3.7% premium over face value. In conjunction with these transactions, we recorded charges of approximately \$0.5 million for premiums, fees and unamortized deferred financing fees. The charges for the early extinguishment of debt are included in Other income, net on the accompanying Consolidated Statements of Operations.

During November 2006, we repurchased \$95.3 million face value of our Series A, 10.625% notes due June 15, 2010 for total cash consideration of approximately \$102.7 million, or a 7.8% premium over face value. This debt had a book carrying value of \$107.9 million and was comprised of the \$95.3 million face value, plus \$12.6 million related to the revaluation of Series A debt from the acquisition of Avenor in 1998. In conjunction with this transaction, we recorded charges of \$7.5 million for premiums and fees. We also recorded a gain on the extinguishment of debt of approximately \$12.6 million associated with the revaluation of the debt as discussed above. Therefore, the net impact for the extinguishment of the Series A notes is a net gain of approximately \$5.1 million, which is included in Other income, net on the accompanying Consolidated Statements of Operations.

OFF-BALANCE SHEET ARRANGEMENTS:

In connection with certain timberland sales transactions in 2002 and prior years, Bowater received a portion of the sale proceeds in notes receivable from institutional investors. In order to increase our liquidity, we monetized these notes receivable using QSPEs set up in accordance with SFAS No. 140. The more significant aspects of the QSPEs are as follows:

The notes receivable were monetized through bankruptcy-remote limited liability companies. The bankruptcy-remote entities are QSPEs under SFAS No. 140 and are not consolidated in our financial statements.

These QSPEs have issued fixed and floating rate senior secured notes which are secured by the notes receivable held by the QSPEs. The value of these senior secured notes is equal to approximately 90% of the value of the notes receivable. The full principal amounts of the notes receivable are backed by letters of credit issued by third party financial institutions.

We retain interests in the excess future cash flows of the QSPEs (cash received from notes receivable versus cash paid out on the senior secured notes).

In connection with Bowater's 1999 land sale and note monetization, we guarantee 25% of the outstanding investor notes principal balance of Timber Note Holdings LLC, one of our QSPEs. Bowater currently guarantees approximately \$6.8 million of the investor notes principal balance. This guarantee is proportionately reduced by annual principal repayments on the investor notes (annual minimum repayments of \$2.0 million) through 2008. The remaining investor notes principal amount is

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

to be repaid in 2009. Timber Note Holdings LLC has assets of approximately \$31.1 million and obligations of approximately \$27.3 million, which include the investor notes. Bowater would be required to perform on the guarantee if the QSPE were to default on the investor notes or if there were a default on the notes receivable, neither of which has ever occurred.

The following summarizes our retained interest with QSPEs as of December 31, 2006 and 2005 and are included in Other assets on our Consolidated Balance Sheet.

| <i>(In millions)</i> | 2006 | 2005 |
|--------------------------------------|----------------|----------------|
| Calhoun Note Holdings AT LLC | \$ 6.6 | \$ 6.3 |
| Calhoun Note Holdings TI LLC | 9.7 | 9.3 |
| Bowater Catawba Note Holdings I LLC | 2.0 | 1.9 |
| Bowater Catawba Note Holdings II LLC | 9.4 | 9.0 |
| Timber Note Holdings LLC | 4.0 | 3.9 |
| Bowater Saluda LLC | 7.9 | 7.5 |
| | \$ 39.6 | \$ 37.9 |

Note 15. Financial Instruments

Bowater utilizes certain derivative instruments to enhance its ability to manage risk relating to cash flow exposure. Derivative instruments are entered into for periods consistent with related underlying cash flow exposures and do not constitute positions independent of those exposures. We do not enter into contracts for speculative purposes; however, we do, from time to time enter into commodity and currency option contracts that are not accounted for as accounting hedges. Counterparty risk is limited to institutions with long-term debt ratings of A or better for North American financial institutions or ratings of AA or better for international institutions.

For derivatives that qualify for hedge accounting, we designate the derivative as a cash flow hedge at the inception of the hedge. We formally document all relationships between the hedging instruments and the hedged items, as well as our risk-management objectives and strategies for undertaking the various hedge transactions. We link all hedges that are designated as cash flow hedges to forecasted transactions. Under the terms of our risk management policy, we may enter into derivative contracts to hedge forecasted transactions for a period not to exceed two years. We also assess, both at the inception of the hedge and on an on-going basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of the hedged items. If it is determined that a derivative is no longer highly effective as a hedge, we discontinue hedge accounting prospectively.

CANADIAN DOLLAR FORWARD CONTRACTS

We pay a significant portion of the operating expenses of our Canadian mill sites in Canadian dollars. To reduce our exposure to U.S. and Canadian dollar exchange rate fluctuations, we enter into and designate Canadian dollar forward contracts to hedge certain of our forecasted Canadian dollar cash outflows at the Canadian mill operations, which we believe are likely to occur. Hedging contracts outstanding at December 31, 2006 have been established to hedge forecasted transactions through the first quarter of 2007. Hedge ineffectiveness associated with these Canadian dollar forward contracts was not material for the periods presented.

NATURAL GAS HEDGING INSTRUMENTS

Beginning in the third quarter of 2006, we entered into natural gas swap agreements under our hedging program for the purpose of reducing the risk inherent in fluctuating natural gas prices. Our hedged natural gas

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

costs are billed to us based on a publicly traded index plus a fixed amount. The natural gas swap agreements allow us to minimize the effect of fluctuations in those indices by contractually exchanging the publicly traded index upon which we are billed for a fixed index of natural gas costs. The swap agreements, which did not qualify for hedge accounting treatment during the year, have been marked-to-market in the Consolidated Statement of Operations. As a result, approximately \$1.1 million of pre-tax losses were recognized in our Consolidated Statement of Operations in 2006 for outstanding contracts that we purchased in 2006 to financially hedge forecasted transactions expected to occur in 2007.

Information regarding our outstanding Canadian dollar and natural gas swap contracts' notional amount, fair market value, and range of exchange rates or natural gas index prices is summarized in the table below. The notional amount of these contracts represents the amount of foreign currencies or natural gas to be purchased or sold at maturity and does not represent our exposure on these contracts.

| (In millions of U.S. dollars) | Notional Amount of Derivatives | Asset/(Liability) Fair Market Value | Range Of | |
|---|--------------------------------------|--|-------------------------------|-------|
| | | | U.S./CDN\$ | |
| | | | Exchange Rates and Natural | |
| | | | Gas Index Prices | |
| As of December 31, 2006: | | | | |
| Foreign Currency Exchange Agreements Buy Currency: | | | | |
| Canadian dollar Due in 2007 | \$ 76.0 | \$ (0.4) | \$.8592 | .8801 |
| Natural Gas Swap | | | | |
| Agreements: | | | | |
| Due in 2007 | \$ 9.0 | \$ (1.1) | \$ 5.87 | 8.98 |

As of December 31, 2005:

| | | | | |
|---|----------|---------|----------|-------|
| Foreign Currency Exchange Agreements Buy Currency: | | | | |
| Canadian dollar Due in 2006 | \$ 183.0 | \$ 30.0 | \$.7609 | .7124 |

The counterparties to our derivative financial instruments are substantial and creditworthy multi-national financial institutions. The risk of counterparty nonperformance is considered to be remote, and no one financial institution holds more than 27% of our derivative financial instruments.

The components of the cash flow hedges included in Accumulated other comprehensive loss are as follows:

| (In millions) | 2006 | 2005 | 2004 |
|---|------------------|------------------|------------------|
| Gains reclassified on matured cash flow hedges | \$ (30.9) | \$ (95.7) | \$ (131.0) |
| Unrealized (losses) gains for change in value on outstanding cash flow hedges | (0.4) | 2.7 | 81.6 |
| | (31.3) | (93.0) | (49.4) |
| Income tax benefit | 11.9 | 35.3 | 18.8 |
| Net increase in Accumulated other comprehensive loss | \$ (19.4) | \$ (57.7) | \$ (30.6) |

We expect to reclassify losses of \$0.4 million (\$0.3 million, net of tax) from Accumulated other comprehensive loss to the Consolidated Statement of Operations during the next twelve months as the forecasted transactions occur.

Note 16. Pension and Other Postretirement Benefit Plans

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Bowater has multiple contributory and noncontributory defined benefit pension plans covering substantially all of our employees. We also sponsor a number of other postretirement benefit plans (e.g., defined benefit health

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

care and life insurance plans) for retirees at certain locations. Benefits are based on years of service and, depending on the Plan, average compensation earned by employees either during their last years of employment or over their careers. Our cash contributions to the plans have been sufficient to provide pension benefits to participants and meet the funding requirements of Employee Retirement Income Security Act (ERISA) in the United States and applicable Pension Benefits Acts in Canada. Net periodic benefit costs are recognized as employees render the services necessary to earn the pension and other postretirement benefits.

In addition to the previously described Plans, we also sponsor defined contribution plans within the United States and for certain sites outside of the United States. Employees are allowed to contribute to these plans, and we make matching contributions up to 7.2% of an individual employee's annual compensation. Our expense for the defined contribution Plans totaled \$7.4 million in 2006, \$7.9 million in 2005, and \$7.9 million in 2004. Bowater's contributions to these defined contribution plans are expensed as incurred.

Certain of the above plans are covered under collective bargaining agreements.

A measurement date of September 30 is used for all of our Plans. SFAS 158 will require us to use a December 31 measurement date beginning in 2008. The following tables include both our foreign and domestic Plans. The benefit obligations of the Plans outside the United States are significant relative to the total benefit obligation; however, the assumptions used to measure the obligations of those Plans are not significantly different from those used for the United States Plans.

We have adopted SFAS 158 as of the end of 2006. Below is a summary of the incremental effect of applying SFAS 158 (See Note 2) on individual items of our Consolidated Balance Sheet:

| <i>(In millions)</i> | Before application of SFAS 158 | Adjustments | After application of SFAS 158 |
|---|---|--------------------|--|
| Assets: | | | |
| Other assets: | | | |
| Pension and postretirement benefit asset | \$ 78.4 | \$ (77.9) | \$ 0.5 |
| Intangible pension asset | 21.1 | (21.1) | |
| Total assets | 99.5 | (99.0) | 0.5 |
| Liabilities: | | | |
| Accounts payable and accrued liabilities | 61.2 | (34.4) | 26.8 |
| Total current liabilities | 61.2 | (34.4) | 26.8 |
| Pension and other postretirement benefit obligations | 393.4 | 257.7 | 651.1 |
| Deferred income taxes, net of valuation allowance | (72.6) | (59.3) | (131.9) |
| Net Equity: | | | |
| Accumulated other comprehensive loss, net of tax and minority interests | (125.9) | (256.3) | (382.2) |
| Total shareholders' equity | (125.9) | (256.3) | (382.2) |

Prior to adoption of SFAS 158, we updated our balance sheet to reflect the calculations for additional minimum liabilities under previous accounting guidance. As a result, our intangible pension asset decreased by \$31.0 million, pension and other postretirement benefit obligations decreased by \$106.4 million and accumulated other comprehensive loss decreased by \$75.4 million (\$60.2 million after tax and minority interests). The figures in the column of the table above labeled "Before application of SFAS 158" reflect these updated balances.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The change in our benefit obligation, change in Plan assets, funded status and reconciliation of amounts recognized in our Consolidated Balance Sheets is as follows:

| <i>(In millions)</i> | Pension Plans | | Other Postretirement Plans | |
|--|-------------------|-------------------|----------------------------|-------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Change in benefit obligation: | | | | |
| Benefit obligation at beginning of year | \$ 2,288.4 | \$ 1,968.4 | \$ 300.0 | \$ 300.1 |
| Service cost | 42.2 | 36.4 | 3.9 | 4.4 |
| Interest cost | 118.7 | 116.3 | 15.8 | 17.4 |
| Amendments | 5.2 | 38.2 | (0.2) | (1.3) |
| Actuarial (gain) loss | (0.3) | 185.6 | (35.7) | 8.2 |
| Participant contributions | 11.6 | 10.4 | 3.2 | 2.6 |
| Curtailments, settlements and special termination benefits | (13.6) | 0.1 | (6.3) | (15.0) |
| Benefits paid | (148.5) | (119.5) | (17.3) | (18.4) |
| Effect of foreign currency exchange rate changes | 4.7 | 52.5 | 0.4 | 2.0 |
| Benefit obligation at end of year | \$ 2,308.4 | \$ 2,288.4 | \$ 263.8 | \$ 300.0 |
| Change in Plan assets: | | | | |
| Fair value of Plan assets at beginning of year | \$ 1,711.5 | \$ 1,468.5 | \$ | \$ |
| Actual return on Plan assets | 149.5 | 219.6 | | |
| Employer contributions | 127.3 | 91.4 | 14.1 | 15.8 |
| Participant contributions | 11.6 | 10.4 | 3.2 | 2.6 |
| Settlements | | (0.6) | | |
| Benefits paid | (148.5) | (119.5) | (17.3) | (18.4) |
| Effect of foreign currency exchange rate changes | 2.7 | 41.6 | | |
| Fair value of Plan assets at end of year | \$ 1,854.1 | \$ 1,711.4 | \$ | \$ |
| Reconciliation of funded status: | | | | |
| Funded status deficiency | \$ (454.3) | \$ (577.0) | \$ (263.8) | \$ (300.0) |
| Post-measurement date contributions | 37.4 | 25.3 | 3.3 | 3.7 |
| | (416.9) | (551.7) | (260.5) | (296.3) |
| Unrecognized actuarial loss | 375.1 | 467.4 | 98.6 | 142.6 |
| Unrecognized transition amount | | | 0.2 | 0.5 |
| Unrecognized prior service cost (benefit) | 42.7 | 54.9 | (15.6) | (21.2) |
| Net liability recognized before adoption of SFAS 158 | \$ 0.9 | \$ (29.4) | \$ (177.3) | \$ (174.4) |
| Amounts recognized in the Consolidated Balance Sheets before adoption of SFAS 158 consist of: | | | | |
| Prepaid benefit cost | \$ 78.4 | \$ 30.4 | \$ | \$ |
| Accrued benefit liability | (277.3) | (366.0) | (177.3) | (174.4) |
| Intangible asset | 21.1 | 52.1 | | |
| Accumulated other comprehensive loss | 178.7 | 254.1 | | |
| Net liability recognized before adoption of SFAS 158 | \$ 0.9 | \$ (29.4) | \$ (177.3) | \$ (174.4) |
| Amounts recognized in the Consolidated Balance Sheets after adoption of SFAS 158 consist of: | | | | |
| Other assets | \$ 0.5 | N/A | \$ | N/A |

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| | | | | |
|--|------------|-----|------------|-----|
| Accounts payable and accrued liabilities | (11.3) | N/A | (15.5) | N/A |
| Pension and other postretirement benefit obligations | (406.1) | N/A | (245.0) | N/A |
| Net liability recognized after adoption of SFAS 158 | \$ (416.9) | N/A | \$ (260.5) | N/A |

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A detail of amounts included in accumulated other comprehensive loss can be found in the Comprehensive Loss section of Note 2. We estimate that \$5.3 million of prior service benefits and \$33.6 million of net actuarial losses will be amortized from accumulated other comprehensive loss into our Consolidated Statement of Operations in 2007.

The sum of the projected benefit obligations and the sum of the fair value of Plan assets for pension Plans with projected benefit obligations in excess of plan assets were \$2,283.6 million and \$1,829.0 million, respectively, as of December 31, 2006, and were \$2,264.3 million and \$1,686.4 million, respectively, as of December 31, 2005. The sum of the accumulated benefit obligations and the sum of the fair value of Plan assets for pension Plans with accumulated benefit obligations in excess of Plan assets were \$1,683.7 million and \$1,380.8 million, respectively, as of December 31, 2006, and were \$1,969.9 million and \$1,584.6 million, respectively, as of December 31, 2005. The total accumulated benefit obligation for all pension plans was \$2,148.6 million and \$2,090.3 million at December 31, 2006 and 2005, respectively.

The components of our net periodic benefit cost consist of:

| <i>(In millions)</i> | Pension Plans | | | Other Postretirement Plans | | |
|---|----------------|----------------|----------------|----------------------------|----------------|----------------|
| | 2006 | 2005 | 2004 | 2006 | 2005 | 2004 |
| Components of net periodic benefit cost: | | | | | | |
| Service cost | \$ 42.2 | \$ 36.4 | \$ 36.3 | \$ 3.9 | \$ 4.4 | \$ 4.4 |
| Interest cost | 118.7 | 116.3 | 107.8 | 15.8 | 17.4 | 16.8 |
| Expected return on Plan assets | (121.5) | (114.1) | (107.0) | | | |
| Amortization of prior service cost | 5.3 | 2.7 | 2.0 | (6.0) | (5.6) | (6.2) |
| Recognized net actuarial loss | 37.0 | 16.8 | 10.5 | 8.2 | 8.5 | 9.3 |
| Curtailments, settlements, and special termination benefits | 13.6 | 0.1 | 4.0 | (5.7) | (5.4) | |
| Net periodic benefit cost | \$ 95.3 | \$ 58.2 | \$ 53.6 | \$ 16.2 | \$ 19.3 | \$ 24.3 |

Since the measurement date of our Plans is 90 days prior to the end of our year, curtailment and settlement gains and losses that arise during the year are recorded on a 90-day lag.

In January 2006, Bowater announced its plans to permanently close the Thunder Bay A kraft pulp line in the second quarter of 2006 and eliminate approximately 225 positions. Impairment and severance related charges were recorded in the fourth quarter of 2005. In 2006, we recorded a pension plan curtailment loss of \$4.6 million and an OPEB plan curtailment gain of \$0.2 million in connection with the employee downsizing. Additionally, we recorded special termination benefits of approximately \$0.9 million related to employees accepting a voluntary portion of the severance plan in April 2006. The elimination of employees resulted in a partial plan termination, which will result in a pension plan settlement loss of approximately \$7 million in the next year or two (upon settlement of the assets and liabilities).

In May 2006, Bowater approved changes to its defined benefit pension plan for its U.S. salaried employees. Benefits for certain employees will be frozen effective January 1, 2007 and will be replaced by a Company contribution to a defined contribution plan. Accordingly, we recorded a curtailment loss of \$3.9 million.

In June 2006, Bowater approved changes to its defined benefit pension plan for its Canadian salaried employees. Benefits for certain employees will be frozen effective January 1, 2008 and will be replaced by a Company contribution to a defined contribution plan. This action resulted in a curtailment loss of approximately \$1.7 million. Also in June 2006, Bowater approved changes to its other postretirement plan for Canadian salaried employees. The plan was redesigned to phase out Bowater's costs by the end of 2010 by increasing the retirees

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contributions from 20% to 100% over a four-year period beginning January 1, 2007. This action resulted in a curtailment gain of approximately \$5.5 million.

In August 2006, accrued benefits from the director's retirement plan were converted to the director's deferred fee plan for certain directors in the form of stock based units. This conversion was treated as a settlement, and therefore, a settlement gain of approximately \$0.1 million was recorded.

Also in 2006, certain employees received lump-sum payouts from the supplemental executive retirement plan. Accordingly, we recorded settlement losses of \$2.6 million.

In October 2006, Bowater approved changes to its other postretirement plan for its U.S. salaried employees. Benefits for employees were either eliminated or reduced depending on whether the employee met certain age and years of service criteria. A curtailment gain of \$3.2 million will be recorded in the first quarter of 2007.

The OPEB curtailment gain of \$5.4 million recorded in 2005 is associated with changes to certain postretirement benefits in Canada.

The following weighted average assumptions were used to determine the projected benefit obligation at the measurement date and the net periodic benefit cost for the year:

| | Pension Plans | | | Other Postretirement Plans | | |
|-------------------------------|---------------|------|------|----------------------------|------|------|
| | 2006 | 2005 | 2004 | 2006 | 2005 | 2004 |
| Projected benefit obligation: | | | | | | |
| Discount rate | 5.9% | 5.3% | 6.0% | 5.8% | 5.3% | 6.0% |
| Rate of compensation increase | 2.9% | 3.6% | 3.9% | 3.0% | 3.8% | 3.9% |
| Net periodic benefit cost: | | | | | | |
| Discount rate | 5.2% | 6.0% | 6.0% | 5.4% | 6.0% | 6.0% |
| Expected return on assets | 8.1% | 7.8% | 7.8% | | | |
| Rate of compensation increase | 3.5% | 3.9% | 3.9% | 4.0% | 3.9% | 3.9% |

The discount rate for our Plans is determined by considering the timing and amount of projected future benefit payments and is based on a portfolio of long-term high quality corporate bonds of a similar duration or, for our Canadian plans, a model that matches the plan's duration to published yield curves. To develop the expected long-term rate of return on assets assumption, we considered the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. In determining the rate of compensation increase, we reviewed historical salary increases and promotions while considering the impact of current industry conditions and future industry outlook. For the health care cost inflation rate, we considered historical trends in these types of costs in the U.S. and Canada.

The assumed health care cost trend rates used to determine the projected benefit obligation for the other postretirement benefit plans as of December 31, 2006 and 2005 are as follows:

| | 2006 | 2005 |
|---|------|------|
| Health care cost trend rate assumed for next year | 8.5% | 9.4% |
| Rate to which the cost trend rate is assumed to decline (ultimate rate) | 4.7% | 4.7% |
| Year that the rate reaches the ultimate trend rate | 2011 | 2011 |

Variations in this health care cost trend rate can have a significant effect on the amounts reported. A 1% change in this assumption would have the following impact to our 2006 obligations and costs:

| (In millions) | 1% Increase | 1% Decrease |
|--|-------------|-------------|
| Accumulated postretirement benefit costs | \$ 29.9 | \$ (24.9) |

Service and interest costs

2.5 13% **(2.0)** (10%)

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The allocation of fair value by asset category for Plan assets held by our pension plans as of the measurement date were as follows:

| Asset Category | Weighted Average Target Allocation | 2006 | 2005 |
|-------------------|--|------|------|
| Equity securities | 64% | 63% | 63% |
| Debt securities | 34% | 35% | 35% |
| Real estate | 2% | 2% | 2% |
| | 100% | 100% | 100% |

Our investment strategy for our Plans is to maximize the long-term rate of return on Plan assets within an acceptable level of risk in order to secure our obligation to pay pension benefits to qualifying employees while minimizing and stabilizing pension benefit costs and contributions. The asset allocation for each plan is reviewed periodically and rebalancing toward target asset mix is made when asset classes fall outside of a predetermined range. Risk is managed for each plan through diversification of asset classes, specific constraints imposed within asset classes, annual review of the investment policies to assess the need for changes and monitoring of fund managers for compliance with mandates as well as performance measurement. A series of permitted and prohibited investments are listed in our respective investment policies. Prohibited investments include investments in the equity securities of Bowater or its affiliates as well as investments in our debt securities.

During 2007, Bowater expects to contribute approximately \$94.6 million to our pension plans and approximately \$15.6 million to our other postretirement plans.

The following benefit payments are expected to be paid from the Plans' net assets. The other postretirement plans' projected benefit payments have been reduced by expected Medicare subsidy receipts associated with the Medicare Prescription Drug, Improvement and Modernization Act of 2003.

| (In millions) | Pension Plans | Other Postretirement Plans | Expected Subsidy Receipts |
|-------------------|------------------|----------------------------------|---------------------------------|
| 2007 | \$ 127.5 | \$ 15.6 | \$ 1.1 |
| 2008 | 164.1 | 14.4 | 1.9 |
| 2009 | 130.2 | 14.5 | 1.1 |
| 2010 | 137.8 | 14.5 | 1.2 |
| 2011 | 137.4 | 14.4 | 1.4 |
| Years 2012 - 2015 | 790.4 | 71.0 | 7.4 |

Note 17. Income Taxes

The components of Loss before income taxes, minority interest, and cumulative effect of accounting changes consist of the following for the years ended December 31, 2006, 2005, and 2004:

| (In millions) | 2006 | 2005 | 2004 |
|---|------------|-----------|------------|
| United States | \$ 193.6 | \$ 188.3 | \$ 50.3 |
| Foreign | (304.9) | (278.9) | (198.7) |
| Loss before income taxes, minority interest and cumulative effect of accounting changes | \$ (111.3) | \$ (90.6) | \$ (148.4) |

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The income tax (provision) benefit consists of:

| <i>(In millions)</i> | 2006 | 2005 | 2004 |
|----------------------|-----------|-----------|---------|
| Federal: | | | |
| Current | \$ 6.1 | \$ (0.6) | \$ 16.5 |
| Deferred | (46.0) | (48.8) | (20.9) |
| | (39.9) | (49.4) | (4.4) |
| State: | | | |
| Current | (1.1) | (0.3) | (0.8) |
| Deferred | 9.3 | (5.8) | |
| | 8.2 | (6.1) | (0.8) |
| Foreign: | | | |
| Current | 0.9 | (9.6) | (11.4) |
| Deferred | 11.5 | 25.8 | 71.4 |
| | 12.4 | 16.2 | 60.0 |
| Total: | | | |
| Current | 5.9 | (10.5) | 4.3 |
| Deferred | (25.2) | (28.8) | 50.5 |
| | \$ (19.3) | \$ (39.3) | \$ 54.8 |

The components of deferred income taxes at December 31, 2006 and 2005, in the accompanying Consolidated Balance Sheets are as follows:

| <i>(In millions)</i> | 2006 | 2005 |
|---|------------|------------|
| Timber and timberlands | \$ (27.5) | \$ (40.2) |
| Fixed assets, net | (438.0) | (510.7) |
| Deferred gains | (118.5) | (121.4) |
| Other assets | (46.8) | (60.8) |
| Deferred tax liabilities | (630.8) | (733.1) |
| Current assets | 3.9 | 4.7 |
| Current liabilities | 14.4 | 9.3 |
| Employee benefits and other long-term liabilities | 247.1 | 159.3 |
| United States tax credit carryforwards | 85.8 | 112.4 |
| Canadian investment tax credit carryforwards | 57.1 | 63.8 |
| Ordinary loss carryforwards | 155.0 | 214.7 |
| Valuation allowance | (237.6) | (178.9) |
| Deferred tax assets | 325.7 | 385.3 |
| Net deferred tax liability | \$ (305.1) | \$ (347.8) |

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The net deferred tax liabilities are reflected in the accompanying Consolidated Balance Sheets as follows:

| <i>(In millions)</i> | 2006 | 2005 |
|--|------------|------------|
| Other current assets | \$ 7.9 | \$ |
| Accounts payable and accrued liabilities | | (18.4) |
| Deferred income taxes | (313.0) | (329.4) |
| | \$ (305.1) | \$ (347.8) |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

We have significant deferred tax assets in the U.S. and Canada related to tax credit carryforwards and ordinary loss carryforwards. The carrying value of our deferred tax assets (tax benefits expected to be realized in the future) assumes that we will be able to generate, based on certain estimates and assumptions, sufficient future taxable income in certain tax jurisdictions to utilize these deferred tax benefits, or in the absence of sufficient future taxable income, that we would implement tax planning strategies to generate sufficient taxable income. If these tax planning strategies, estimates and related assumptions change in the future, we may be required to reduce the value of our deferred tax assets, resulting in additional income tax expense. During 2005, based on operating losses for our Canadian operations and current evaluation of available tax planning strategies, in accordance with SFAS 109, we recorded a tax charge to establish a valuation allowance against most of our remaining net Canadian deferred tax assets that arose during all tax years 2005 and prior, which are primarily for loss carryforwards and tax credits in Canada. In connection with this requirement, the income tax benefits that were generated by our 2006 Canadian operations losses were entirely offset by a tax charge in order to establish a valuation allowance. Additionally, any income tax benefit recorded on any future operating losses generated in these Canadian operations will probably be offset by establishing a 100% valuation allowance (tax charge). This would have a negative impact on our overall effective income tax rate in future periods.

During 2006, we recorded a goodwill impairment charge of \$200 million related to Thunder Bay, which is included in our Canadian operations, for which no tax benefit was recorded. In addition, certain Canadian assets were sold in 2006 which had \$25.2 million of associated goodwill. No tax benefit was recorded on this portion of the net gain recognized.

On a consolidated basis, unrealized statutory foreign currency exchange gains and losses are substantially offset by certain foreign currency exchange adjustments on which the Company receives no tax benefit.

The following is a reconciliation of the United States federal statutory and effective tax rates as a percentage of income (loss) before income taxes, minority interests, and cumulative effect of accounting changes:

| | 2006 | 2005 | 2004 |
|---|---------|---------|-------|
| United States federal statutory income tax rate | 35.0% | 35.0% | 35.0% |
| State income taxes, net of federal income tax benefit | (4.5) | (6.0) | (0.6) |
| Foreign taxes | 32.0 | 18.5 | 4.6 |
| Canadian investment tax credits | 4.1 | 4.4 | 2.2 |
| Foreign exchange | (4.6) | 1.2 | (9.6) |
| Tax reserve adjustment | 11.8 | 9.5 | 4.6 |
| Valuation allowance | (24.0) | (107.0) | 0.7 |
| Goodwill | (69.0) | | |
| Other, net | 1.9 | 0.9 | |
| Effective income tax rate | (17.3)% | (43.5)% | 36.9% |

At December 31, 2006, we had state net operating loss carryforwards of \$798.3 million and Canadian federal and provincial net operating loss carryforwards of \$154.2 million and \$328.4 million, respectively. In addition, \$56.2 million of Canadian investment tax credit carryforwards and \$85.8 million of U.S. tax credit carryforwards were available to reduce future income taxes. The state loss carryforwards expire at various dates up to 2026. The Canadian non-capital loss and investment tax credit carryforwards expire at various dates between 2007 and 2016. Of the U.S. tax credit carryforwards, \$68.9 million consists of alternative minimum tax credits that have no expiration.

The American Jobs Creation Act of 2004 (the "AJCA") introduced a special one-time dividend-received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision) provided certain criteria are met. During the third quarter of 2005, we determined that we would not repatriate any foreign earnings under the provisions of the AJCA.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At December 31, 2006 and December 31, 2005, we had unremitted earnings of our subsidiaries outside the United States totaling \$124.8 million and \$107.9 million, respectively, which, notwithstanding the AJCA, have been deemed to be permanently invested. No deferred tax liability has been recognized with regard to such earnings. It is not practicable to estimate the income tax liability that might be incurred if such earnings were remitted to the United States.

In the normal course of business, we are subject to audits from the Federal, state, Canadian provincial and other tax authorities regarding various tax liabilities. The Federal statute of limitations for pre-2003 tax years expired on September 15, 2006; however, the IRS may adjust our reported tax liabilities for these years to the extent of refunds generated by operating loss carrybacks from subsequent years. We are not currently under audit by the IRS and have not been contacted by the taxing authorities regarding an audit of the post-2002 tax years. The Canadian taxing authorities are auditing years 2002 through 2003 for our Canadian entities. There were no material adjustments to the company's tax liabilities arising from any audits over the last three years.

Any audits may alter the timing or amount of taxable income or deductions, or the allocation of income among tax jurisdictions. The amount ultimately paid upon resolution of issues raised may differ from the amount accrued. We believe that taxes accrued on the Consolidated Balance Sheet fairly represent the amount of future tax liability due.

During 2006 we reversed income tax reserves of \$18.7 million related to the expiration of the statute of limitations of previous tax years and \$2.7 million related to the conclusion of an examination by a taxing authority. Certain of these reserves, in the amount of \$3.9 million, were related to a previous acquisition and, therefore, reduced goodwill. During 2005, we reversed income tax reserves of \$8.6 million related to the expiration of the statute of limitations of previous tax years.

Note 18. Acquisition of Minority Interest

In December 2006, Bowater acquired the entire minority interests in BMI. The purchase of the 25% interest from Oji Paper Co., Ltd. and the 8% interest from Mitsui & Co., Ltd was settled for \$2.6 million in cash. The acquisition was accounted for under the purchase method of accounting, whereby the purchase price is allocated to the assets acquired and liabilities assumed based on their fair value at the acquisition date.

The purchase price was allocated to fixed assets (\$18.3 million), pension and other postretirement benefit obligations (\$14.1 million) and minority interest (\$1.6 million). The transaction resulted in \$1.8 million of negative goodwill, which was used to reduce the amount allocated to fixed assets.

Note 19. Commitments and Contingencies

LEGAL ITEMS

We are involved in various legal proceedings relating to contracts, commercial disputes, taxes, environmental issues, employment and workers compensation claims and other matters. We periodically review the status of these proceedings with both inside and outside counsel. Although the final outcome of any of these matters is subject to many variables and cannot be predicted with any degree of certainty, we establish reserves for a matter when we believe an adverse outcome is probable and the amount can be reasonably estimated. We believe that the ultimate disposition of these matters will not have a material adverse effect on our financial condition, but it could have a material adverse effect on the results of operations in any given quarter or year.

On March 17, 2006, Weyerhaeuser Company Limited and Weyerhaeuser Company (collectively "Weyerhaeuser") gave notice of a claim for arbitration against Bowater Incorporated and one of our subsidiaries, Bowater Canadian Forest Products, Inc. ("BCFPI"), in the amount (as revised in September 2006) of CDN \$60.1

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

million. This contractual claim relates to the cost of remediating certain environmental conditions existing at the pulp and paper facility in Dryden, Ontario, which Bowater sold to Weyerhaeuser in August 1998. We maintain a reserve for this claim, which we believe to be adequate, but substantially less than the claim amount. On January 29, 2007, we commenced an arbitration for CDN \$2.5 million plus interest against Weyerhaeuser pertaining to other aspects of the sale of the Dryden facility. While we do not believe that these arbitrations, the decisions for which are expected by June 2007, will have a material adverse effect on our financial position or results of operations, we can make no assurances about the arbitrators' decisions.

On April 26, 2006, we received a notice of violation from the U.S. Environmental Protection Agency (EPA) alleging four violations of the Clean Air Act (CAA) at our Calhoun mill for which penalties in excess of \$100,000 could be imposed. We have strong arguments that the Calhoun mill did not violate the CAA and continue to discuss these issues with the EPA.

On September 30, 2005, the Ministry of Justice of the Province of Québec (MOJ) cited BCFPI in connection with effluent water quality of the Dolbeau mill. BCFPI is contesting the fine of \$0.3 million (CDN \$0.4 million) levied by the MOJ. The Dolbeau mill has taken steps to improve its effluent quality and has only experienced two further exceedences since January 1, 2005. We expect BCFPI to reach a settlement with the MOJ in the first half of 2007.

Since late 2001, Bowater, several other paper companies, and numerous other companies have been named as defendants in asbestos personal injury actions. These actions generally allege occupational exposure to numerous products. We have denied the allegations and no specific product of ours has been identified by the plaintiffs in any of the actions as having caused or contributed to any individual plaintiff's alleged asbestos-related injury.

These suits have been filed by approximately 1,809 claimants who sought monetary damages in civil actions pending in state courts in Delaware, Georgia, Illinois, Mississippi, Missouri, New York, Tennessee, and Texas. Approximately 1,039 of these claims have been dismissed, either voluntarily or by summary judgment, and approximately 770 claims remain. Insurers are defending these claims, and we have not settled or paid any of these claims. We believe that all of these asbestos-related claims are covered by insurance, subject to any applicable deductibles and our insurers' rights to dispute coverage. While it is not possible to predict with certainty the outcome of these matters, we do not expect these claims to have a material adverse impact on our business, financial position or results of operations.

LUMBER DUTIES

Lumber duties imposed by the U.S. Department of Commerce (DOC) were effective for lumber shipments from Canada to the U.S. beginning May 22, 2002. Between May 22, 2002, and October 12, 2006, we paid duties totaling approximately \$113 million to cover the various duty rates then in effect. Lumber duties were included as a component of distribution costs on our Consolidated Statements of Operations.

On October 12, 2006, an agreement regarding Canada's softwood lumber exports to the U. S. became effective. The agreement provides for the return of approximately \$4.5 billion in accumulated cash deposits to Canadian industry with the remaining \$1 billion to U.S. interests. Through an arrangement with Export Development Corporation (EDC), which the government of Canada designated as its agent to expedite the refund of duties, we recovered approximately \$103.9 million on November 10, 2006. The refund consisted of a return of \$92.5 million of the duties paid and \$11.4 million in interest due the company. We do not expect to recover any additional amounts.

The SLA provides for softwood lumber to be subject to one of two ongoing border restrictions, depending upon the province of first manufacture with several provinces, including Nova Scotia, being exempt from these

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

border restrictions. The provincial governments of Ontario and Québec selected a border restriction defined as Option B in the SLA based upon input from the manufacturers within those provinces. Option B provides for a volume quota to be established for each company within a province. These volume quotas are based on historical production and are not transferable between provinces. For our sawmills in Québec, the volume quota is in line with historical production, and we anticipate our 2007 production to be similar to what we produced in 2006. The provincial government of Ontario also based its quota allocation on historical production, but did not provide for a mechanism that addressed the needs of new entrants. As a result, the volume that we were allocated is insufficient to operate both our Ignace and Thunder Bay, Ontario sawmills; therefore, we decided to indefinitely shut our Ignace sawmill in December 2006. Based on Thunder Bay's allocated quota, production in 2007 will be limited to approximately 65% of its annual capacity. U.S. composite prices would have to rise above \$355 per thousand board feet before the quota volume restrictions would be lifted. Our average transaction price for lumber in the fourth quarter of 2006 was \$280 per thousand board feet.

In 2005, the province of Québec mandated that the annual harvests of softwood timber on Crown-owned land would be reduced 20% below 2004 levels. The 20% reduction was required to be achieved, on average, for the period 2005 to 2008. In December 2006, the province of Québec increased that reduction to 23.8% below 2004 levels for the period 2008 to 2013. These requirements did not have any material impact on our results of operations or financial condition during 2006 and are not expected to have a material impact for 2007.

LETTERS OF CREDIT

There were outstanding letter of credit commitments totaling \$100.3 million at December 31, 2006 (primarily for employee benefit programs, certain debt obligations and other purchase commitments), reducing availability under the revolving credit facility.

EMPLOYEES

As of December 31, 2006, Bowater employed approximately 7,400 people, of whom approximately 5,100 were represented by bargaining units. Our unionized employees in the U.S. are represented predominantly by the United Steelworkers Union and in Canada predominantly by the Communications, Energy and Paper Union. Labor agreements covering approximately 380 employees in the U.S. paper mills expire in 2007. A labor agreement covering approximately 150 employees at our Mokpo facility expires in 2007.

During the second quarter of 2006, labor agreements covering approximately 100 employees at our Saint-Félicien sawmill facility expired. Discussions between Bowater and the unions are continuing, and we can provide no assurance regarding the outcomes or the timing of these negotiations or their effect on our operations. Any protracted work stoppage at any of our facilities could result in a disruption of our operations, which could negatively impact our ability to timely deliver certain products to our customers and thus adversely affect our results.

ENVIRONMENTAL MATTERS

Bowater may be a potentially responsible party with respect to three hazardous waste sites that are being addressed pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (Superfund) or the Resource Conservation and Recovery Act (RCRA) corrective action authority. The first two sites are on CNC timberland tracts in South Carolina. One was contaminated when acquired, and subsequently, the prior owner remediated the site and continues to monitor the groundwater. On the second site, several hundred steel drums containing textile chemical residue were discarded by unknown persons. The third site, at our mill in Coosa Pines, Alabama, contained buried drums and has been remediated pursuant to RCRA. We continue to monitor the groundwater. We believe we will not be liable for any significant amounts at any of these sites.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

We currently have recorded \$19.7 million for environmental liabilities. Approximately \$18.2 million of this \$19.7 million relates to environmental reserves established in connection with prior acquisitions. The majority of these liabilities are recorded at undiscounted amounts and are included in other long-term liabilities on the Consolidated Balance Sheets. The \$19.7 million represents management's estimate based on an assessment of relevant factors and assumptions of the ultimate settlement amounts for these liabilities. The amount of these liabilities could be affected by changes in facts or assumptions not currently known to management. Approximately \$17.6 million of the \$18.2 million relates to two previously owned Canadian mills for costs primarily associated with soil remediation, air compliance and landfill closure and one U.S. mill for costs primarily associated with soil testing and monitoring.

The following tables summarize the activity for the liabilities associated with environmental costs related to prior acquisitions or dispositions:

| <i>(In millions)</i> | Balance at beginning of year | Payments Against Reserve | Increase to Reserve | Foreign Exchange | Balance at end of year |
|-------------------------------------|---|---|--------------------------------|-----------------------------|---------------------------------------|
| Year ended December 31, 2006 | \$ 18.9 | \$ (1.5) | \$ 0.7 | \$ 0.1 | \$ 18.2 |
| Year ended December 31, 2005 | \$ 18.6 | \$ (0.7) | \$ 0.4 | \$ 0.6 | \$ 18.9 |
| Year ended December 31, 2004 | \$ 17.8 | \$ (1.2) | \$ 0.8 | \$ 1.2 | \$ 18.6 |

Note 20. Cumulative and Redeemable Preferred Stock

Bowater is authorized to issue 10.0 million shares of serial preferred stock, \$1 par value. As of December 31, 2006, no preferred shares were issued or outstanding.

Note 21. Share-Based Compensation

We maintain incentive stock plans that provide for grants of stock options, equity participation rights (EPRs) and restricted stock units to our directors, officers and key employees. Until December 31, 2006, we also maintained a Mid-Term Incentive Plan (MTIP) that was tied to the performance of our common stock. These plans are described more fully below.

ADOPTION OF NEW ACCOUNTING GUIDANCE AND TRANSITION

On November 8, 2005, the Human Resources and Compensation Committee of the Board of Directors, pursuant to the authority granted to them under Bowater's 1997, 2000 and 2002 stock option plans, approved the accelerated vesting to December 15, 2005 of all unvested stock options granted to employees on January 27, 2004, January 25, 2005 and May 10, 2005. The January 2004 stock option awards, one-half of which had already vested, were granted at an exercise price of \$45.02. The remaining unvested half covering 419,000 shares would have vested on January 27, 2006. The January 2005 awards covering 738,750 shares were granted at an exercise price of \$37.30. One-half would have vested on January 25, 2006 and one-half would have vested on January 25, 2007. Two small awards (15,000 total shares) were granted at an exercise price of \$32.07 and would have vested one-half on May 10, 2006, and one-half on May 10, 2007. The closing market price on November 8, 2005 was \$28.35, well below the exercise price for substantially all the unvested grants. The decision to accelerate the vesting of these options was to reduce non-cash compensation expense that would have been recorded in the Consolidated Statement of Operations in future periods upon the adoption of SFAS 123R in January 2006. We estimate that, as a result of this action and based on the options' market value as of the date of the grant, approximately \$2.7 million of compensation expense was eliminated from our 2006 results and a significantly lesser amount of compensation expense will be eliminated from our 2007 results. Of the 1,172,750 total stock options for which vesting was accelerated, 547,500 were held by executive officers of Bowater. Options held by non-employee directors were excluded from the vesting acceleration.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Prior to January 2006, we accounted for our incentive stock plans under the recognition and measurement provisions of APB 25 as permitted by SFAS 123. Under APB 25:

Compensation expense was generally not recognized for stock options if the exercise price equaled or exceeded the market value of the underlying common stock on the date of grant. As of December 31, 2005, all existing and outstanding stock options were fully vested.

The restricted stock units granted were measured at fair value, which was determined as the average of the high and low trading price of the stock on the date of the grant, and amortized over the vesting period. As of December 31, 2005, all restricted stock unit grants awarded prior to that date were fully amortized.

A liability for the EPRs was recorded based on its intrinsic value. At December 31, 2005, the EPRs base price was higher than Bowater's stock price on that date; therefore, no liability was recorded.

A liability for the MTIP was recorded when the performance criteria were met. At December 31, 2005, we did not meet the performance criteria of the MTIP cycles outstanding; therefore, no liability was recorded.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123R using the modified-prospective transition method. Under that method, compensation cost recognized in 2006 includes (a) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 and (b) compensation cost for all share-based payments granted on or subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. We recognize compensation costs on a straight-line basis over the requisite service period for the award in accordance with the provisions of SFAS 123R.

Prior to the adoption of SFAS 123R, we presented the tax benefit of deductions arising from the exercise of stock options and the lapsing of restrictions on restricted stock units as operating cash flows in the Consolidated Statements of Cash Flows. SFAS 123R requires that we classify the cash flows resulting from the tax benefit that arises when the tax deductions exceed the compensation cost recognized for equity awards (excess tax benefits) as financing cash flows. There were no excess tax benefits arising from equity awards for the year ended December 31, 2006.

The adoption of SFAS 123R resulted in a cumulative effect of accounting change of \$2.6 million, net of tax, (or \$0.05 per share) that we recorded in the first quarter of 2006. This cumulative charge represents the fair value of the EPR obligation at January 1, 2006, net of tax. The assumptions used to calculate the fair value at January 1, 2006 are included in the Equity Participation Rights section of this note.

On November 10, 2005, the FASB issued Staff Position (FSP) No. FAS 123R-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. FSP FAS 123R-3 provides a practical elective alternative transition method related to accounting for the tax effects of share-based payment awards to employees. Per FSP FAS 123R-3, a company must follow either the transition guidance in SFAS 123R to determine the additional-paid-in-capital (APIC) pool or the alternative transition method described in FSP FAS 123R-3. We have elected to adopt the alternative transition method provided in FSP FAS 123R-3 for calculating the tax effects of share-based compensation. The APIC pool represents the excess tax benefits related to share-based compensation that are available to absorb future tax deficiencies. If the amount of future tax deficiencies is greater than the available APIC pool, we will record the excess as income tax expense in our Consolidated Statements of Operations. For the year ended December 31, 2006, we had a sufficient APIC pool to cover any tax deficiencies recorded; as a result, these deficiencies did not affect our results of operations.

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VALUATION AND EXPENSE INFORMATION UNDER SFAS 123R

The following table details the share-based compensation expense (excluding the cumulative effect of accounting change) recorded in the Consolidated Statements of Operations by award for the years ended December 31:

| <i>(In millions)</i> | 2006 | 2005 | 2004 |
|----------------------------------|--------|--------|--------|
| Stock Options | \$ 0.6 | \$ | \$ 0.1 |
| Restricted Stock Units | 8.1 | 0.1 | 0.9 |
| EPRs | (3.1) | | |
| MTIP | | | |
| Share-based compensation expense | \$ 5.6 | \$ 0.1 | \$ 1.0 |

The following table details the tax (benefit) provision by award for the years ended December 31:

| <i>(In millions)</i> | Twelve Months Ended December 31, | | |
|------------------------|-------------------------------------|----------|----------|
| | 2006 | 2005 | 2004 |
| Stock Options | \$ (0.2) | \$ | \$ |
| Restricted Stock Units | (1.9) | (0.1) | (0.4) |
| EPRs | 0.9 | | |
| MTIP | | | |
| Tax Benefit | \$ (1.2) | \$ (0.1) | \$ (0.4) |

As required by SFAS 123R, we now estimate forfeitures of employee stock awards and recognize compensation cost only for those awards expected to vest. Forfeiture rates are determined based on historical experience. Estimated forfeitures are adjusted to actual forfeiture experience as needed. Compensation expense for performance-based awards is recognized when it is probable that the performance criteria will be met.

STOCK PLANS

We currently have awards outstanding under four share-based compensation plans: the 1997 Stock Option Plan, the 2000 Stock Option Plan, the 2002 Stock Option Plan, and the 2006 Stock Option and Restricted Stock Plan. All of these plans were approved by our shareholders. These plans authorized the grant of up to 8.4 million shares of our common stock in the form of incentive stock options, non-qualified stock options, restricted stock units and equity participation rights. At December 31, 2006, approximately 2.4 million shares were available for grant under these Plans.

Stock Options

Stock options granted generally become exercisable over a period of two to three years. Unless terminated earlier in accordance with their terms, all options expire 10 years from the date of grant. Our Board of Directors approved the issuance of 350,630 stock options in May 2006, which either cliff vest after 32 months (100,630 shares) or vest ratably over 36 months (250,000 shares).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A summary of option activity under our stock plans as of December 31, 2006, and the changes during the year ended December 31, 2006, is presented below:

| | Number Of Shares (000 s) | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (years) | Aggregate Intrinsic Value (\$000) |
|----------------------------------|-----------------------------|---------------------------------------|---|--|
| Outstanding at December 31, 2005 | 5,067 | \$ 44.21 | | |
| Granted during the period | 351 | 27.12 | | |
| Exercised during the period | | | | |
| Canceled during the period | (436) | 39.10 | | |
| Outstanding at December 31, 2006 | 4,982 | \$ 43.45 | 4.8 | \$ |
| Exercisable at December 31, 2006 | 4,678 | \$ 44.50 | 4.5 | \$ |

In accordance with SFAS 123R, we estimated the fair value of each stock option on the date of grant using a Black-Scholes option-pricing formula, applying the following weighted-average assumptions, and amortize that value to expense over the option's requisite service period using the straight-line attribution approach:

| Assumptions: | |
|--|---------|
| Expected dividend yield | 2.95% |
| Expected volatility | 32.1% |
| Risk-free interest rate | 5.1% |
| Expected life (in years) | 6.1 |
| Weighted average fair value of options granted | \$ 8.00 |

The expected dividend yield is based on the projected annual dividend payment per share divided by the stock price on the measurement date. The expected life represents the period over which the share-based awards are expected to be outstanding; therefore, the expected life has been determined using historical experience. The risk-free rate of interest is based on a zero-coupon U.S. Treasury instrument with a remaining term approximating the expected life of the stock option. The expected volatility is based on an equal weighting of the historical volatility of our common stock (measured over a term approximating the expected life) and implied volatility from traded options on our common stock having a life of more than one year.

During the year ended December 31, 2006, all vested options had a strike price greater than the closing price of our common stock (i.e., were out-of-the-money). As a result, there were no stock option exercises during 2006. The total intrinsic value of stock options exercised in 2005 was \$0.9 million.

As of December 31, 2006, there was \$1.9 million of unrecognized compensation cost related to stock option awards granted under our stock plans. The unrecognized cost is expected to be recognized over a weighted-average period of 2.3 years.

Restricted Stock Units

On May 10, 2006, we issued four separate grants of restricted stock units totaling 775,529 shares, of which 43,530 shares were performance-based awards. The performance-based awards cliff vest after 32 months. The remaining shares, which were service-based awards, cliff vest after 32 months (178,342 shares), 20 months (503,657 shares) or 12 months (50,000 shares). On August 7, 2006 and September 27, 2006, we issued grants of restricted stock units totaling 20,000 shares and 10,000 shares, respectively. These awards were all service-based awards that cliff vest after 36 months. No restricted stock units were granted in 2005.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A summary of the status of our restricted stock units as of December 31, 2006, and changes during the year ended December 31, 2006, is presented below:

| | Number Of Shares (000 s) | Weighted Average Fair Value at Grant Date |
|----------------------------------|--------------------------------|--|
| Outstanding at December 31, 2005 | | \$ |
| Granted during the period | 806 | 26.20 |
| Vested during the period | (86) | 26.39 |
| Forfeited during the period | (55) | 26.39 |
| Outstanding at December 31, 2006 | 665 | \$ 26.16 |

As of December 31, 2006, there was \$10.8 million of unrecognized compensation cost related to restricted stock units granted under our stock plans. The unrecognized cost is expected to be recognized over a weighted-average period of 1.3 years. The total fair value of restricted stock units vested during 2006 was \$1.0 million.

We have a policy of issuing shares of Bowater common stock to satisfy share option exercises and the vesting of restricted stock units. The right to dividends declared are accrued during the vesting period and paid in cash to the employee upon the vesting of the restricted stock units, in accordance with our stock plans.

Equity Participation Rights

EPRs confer the right to receive cash based on the appreciation of Bowater's common stock price, but no right to acquire stock ownership. The rights have a vesting period of two years and, unless terminated earlier in accordance with their terms, expire 10 years after the grant date. The base price is the fair market value of our common stock on the day of grant. The rights may be redeemed only for cash, and the amount paid to the employee at the time of exercise is the difference between the base price and the average high/low of our common stock on the day of settlement. There have been no grants of EPRs since January 2003.

The EPR awards are classified as liability awards under SFAS 123R since the EPRs are cash settled. In accordance with SFAS 123R, liability awards are remeasured at fair value at each reporting period and the income or expense included in the consolidated statement of operations.

Information with respect to rights granted under the EPR Plan as of December 31, 2006 is as follows:

| | Number of Rights (000 s) | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|----------------------------------|-----------------------------|---------------------------------------|---|---------------------------------|
| Outstanding at December 31, 2005 | 2,173 | \$ 47.55 | | |
| Granted during the period | | | | |
| Settled during the period | | | | |
| Canceled during the period | (163) | 43.14 | | |
| Outstanding at December 31, 2006 | 2,010 | \$ 47.91 | 3.5 | \$ |
| Exercisable at December 31, 2006 | 2,010 | \$ 47.91 | 3.5 | \$ |

As of December 31, 2006, the fair value of our EPRs liability is \$0.6 million. The fair value of each of our EPRs was estimated using a Black-Scholes option pricing model that uses the assumptions noted in the table below. The expected life of each EPR is based on a

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weighted-average of the observed historical exercise patterns and the midpoint of the remaining term of the EPR. Expected volatility is based on an equal weighting of the historical volatility of our common stock (measured over a term approximating the expected life) and implied

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

volatility from traded options on our common stock having a life of more than six months or one year, as appropriate. The risk-free rate of interest is based on a zero-coupon U.S. Treasury instrument with a remaining term approximating the expected life of the EPR. The expected dividend yield is based on the projected annual dividend payment per share divided by the stock price on the measurement date. These assumptions are evaluated and revised, as necessary, at each reporting date.

The fair value of each EPR was estimated using the following assumptions:

| | December 31, 2006 | | January 1, 2006 | |
|--------------------------------------|------------------------------|-----------|----------------------------|-----------|
| Assumptions: | | | | |
| Dividend yield | | 3.6% | | 2.6% |
| Expected volatility | 31.6 | 33.2% | 30.0 | 33.0% |
| Weighted average expected volatility | | 32.5% | | 30.1% |
| Risk-free interest rate | 4.7 | 5.0% | 4.1 | 4.4% |
| Expected EPR life in years | 0.8 | 3.1 | 0.1 | 3.6 |
| Weighted average fair value of EPRs | \$ | 0.31 | \$ | 1.70 |
| Fair value range of each EPR grant | \$ | 0.01 1.18 | \$ | 0.01 4.60 |

Mid-Term Incentive Plan

In 2003, we implemented a MTIP with rolling three-year plan cycles. The MTIP plans are classified as liability plans under SFAS 123R since we have typically paid the award in cash. In accordance with SFAS 123R, liability plans are remeasured at fair value at each reporting period and the related income or expense is included in the consolidated statement of operations. The fair value of each award is estimated using a Monte Carlo Simulation approach and includes ranges of assumptions for stock price volatility, risk-free interest rates, and expected dividends. Expected volatility is based on an equal weighting of the historical volatility of our common stock and implied volatility from traded options on our common stock measured over an expected term approximating the average life of the award and ranged from 27% to 32%. The risk-free rate of interest is based on a zero-coupon U.S. Treasury instrument with a remaining term approximating the expected term of the MTIP and was approximately 5%. The expected dividend yield of 2% to 3% is based on the projected annual dividend payment per share divided by the stock price on the grant date. The fair value at January 1, 2006 was nominal. As of December 31, 2006, we have canceled the MTIP plans. No payout was earned for any of the cycles outstanding through that date; thus, the fair value of the MTIP liability at December 31, 2006 is zero.

Note 22. Exchangeable Shares

In conjunction with the 1998 acquisition of Avenor, Bowater's indirect wholly-owned subsidiary, Bowater Canada Inc. (BCI), issued 3,773,547 shares (\$183.6 million) of no par value exchangeable shares (Exchangeable Shares). Since 1998, BCI has issued an additional 1,359,620 Exchangeable Shares (\$66.2 million) upon the redemption of Avenor's debentures and 5,505 Exchangeable Shares (\$0.3 million) for conversions prior to the redemption. BCI issued an additional 856,237 Exchangeable Shares (\$39.9 million) in connection with the 2001 acquisition of Alliance.

The Exchangeable Shares are exchangeable at any time, at the option of the holder, on a one-for-one basis for shares of Bowater common stock. Through December 31, 2006, 4,565,555 Exchangeable Shares (\$222.1 million) had been exchanged for the same number of Bowater common shares and 5,524 Exchangeable Shares (\$0.3 million) have been cancelled. Holders of Exchangeable Shares have voting rights substantially equivalent to holders of Bowater common stock and are entitled to receive dividends equivalent, on a per-share basis, to dividends paid by Bowater on its common stock.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Note 23. Treasury Stock

At December 31, 2006 Bowater held 11,600,717 shares of its common stock as treasury stock to pay for employee and director benefits and to fund our dividend reinvestment plan. The shares are valued at their acquisition cost of \$485.7 million. As of December 31, 2005, we held 11,605,074 shares at a cost of \$485.8 million.

Note 24. Timberland Leases, Operating Leases and Purchase Obligations

Bowater controls 0.1 million acres of timberlands under long-term leases expiring 2023 to 2058 for which aggregate lease payments were \$0.4 million each year in 2006, 2005 and 2004. These lease costs are capitalized as part of timberlands and are charged against income at the time the timber is harvested. In addition, we lease certain office premises, office equipment and transportation equipment under operating leases. Total rental expense for operating leases was \$8.5 million in 2006, \$9.4 million in 2005 and \$9.1 million in 2004. Bowater also enters into various supply and cutting rights agreements, guarantees and purchase commitments in the normal course of business. Total expenses for these agreements, guarantees and purchase commitments were \$75.5 million in 2006, \$78.2 million in 2005 and \$72.7 million in 2004. We manage approximately 27.9 million acres of Crown-owned land in Canada on which we have cutting rights. We make payments to various Canadian provinces based on the amount of timber harvested.

At December 31, 2006, the future minimum rental payments under timberland leases and operating leases and commitments for purchase obligations are as follows:

| <i>(In millions)</i> | Timberland Lease Payments | Operating Leases, Net | Purchase Obligations⁽¹⁾ |
|----------------------|--------------------------------------|----------------------------------|---|
| 2007 | \$ 0.4 | \$ 10.2 | \$ 43.8 |
| 2008 | 0.4 | 9.0 | 41.6 |
| 2009 | 0.4 | 7.9 | 39.5 |
| 2010 | 0.4 | 6.6 | 28.6 |
| 2011 | 0.5 | 6.0 | 27.6 |
| Thereafter | 10.5 | 37.1 | 232.1 |
| | \$ 12.6 | \$ 76.8 | \$ 413.2 |

(1) Purchase obligations include, among other things, a fiber supply contract for our Coosa Pines operation with commitments totaling \$84.7 million through 2014 and a steam supply contract for our Dolbeau operations with commitments totaling \$191.0 million through 2023.

Note 25. Segment Information

During the third quarter of 2006, we announced that we were realigning our organizational structure to move from a divisional organization to functional organization that supports and focuses on our multi-product line manufacturing and sales across our mill base. As a result of this organizational realignment, we now manage our business based on the products that we manufacture and sell to external customers and, therefore, our reportable segments have been changed. Our new reportable segments are coated papers, specialty papers, newsprint, market pulp, and lumber. The segment information presented herein reflects our new reportable segments. Prior year information has been recast to the current year presentation.

None of the income or loss items following *Operating income* in our Consolidated Statements of Operations are allocated to our segments, since they are reviewed separately by Bowater's management. For the same reason, impairments, severance, gains on dispositions of assets and other discretionary charges or credits are not allocated to the segments. Share-based compensation expense is, however, allocated to our segments. We also allocated depreciation expense to our segments, although the related fixed assets are not allocated to our segment assets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Only assets which are identifiable by segment and reviewed by our management are allocated to segment assets. Allocated assets include trade accounts receivable, finished goods inventory at our paper mills and all inventory at our sawmills. Goodwill was allocated by segment in 2006, but information needed to recast the 2005 and 2004 goodwill to our new segments is not readily available. Therefore, the goodwill for 2005 and 2004 is included in Corporate and Other. All other assets are not identifiable by segment and are included in Corporate and Other.

The following tables summarize information about segment profit and loss and segment assets for the three years ended December 31, 2006, 2005 and 2004:

| <i>(In millions)</i> | Coated Papers | Specialty Papers | Newsprint | Market Pulp | Lumber | Corporate and Other | Consolidated Total |
|--|------------------|---------------------|------------|----------------|----------|------------------------|-----------------------|
| Sales | | | | | | | |
| 2006 | \$ 612.2 | \$ 569.7 | \$ 1,437.6 | \$ 559.4 | \$ 331.6 | \$ 19.3 | \$ 3,529.8 |
| 2005 | 625.3 | 476.8 | 1,428.8 | 534.3 | 385.1 | 33.5 | 3,483.8 |
| 2004 | 494.9 | 409.5 | 1,340.8 | 543.3 | 370.2 | 31.6 | 3,190.3 |
| Depreciation, amortization and cost of timber harvested | | | | | | | |
| 2006 | \$ 41.7 | \$ 64.6 | \$ 137.0 | \$ 53.3 | \$ 18.0 | \$ 8.6 | \$ 323.2 |
| 2005 | 43.8 | 56.9 | 141.9 | 58.1 | 19.1 | 9.6 | 329.4 |
| 2004 | 49.7 | 52.7 | 147.8 | 57.6 | 18.5 | 8.9 | 335.2 |
| Operating Income (loss)⁽¹⁾ | | | | | | | |
| 2006 | \$ 76.3 | \$ (35.4) | \$ 79.5 | \$ 36.6 | \$ 63.0 | \$ (178.8) | \$ 41.2 |
| 2005 | 114.2 | 2.2 | 72.3 | 7.7 | 14.4 | (112.0) | 98.8 |
| 2004 | 11.6 | (7.7) | 31.1 | 37.1 | 17.8 | (60.4) | 29.5 |
| Capital Expenditures | | | | | | | |
| 2006 | \$ 13.6 | \$ 65.1 | \$ 65.5 | \$ 40.4 | \$ 4.0 | \$ 10.5 | \$ 199.1 |
| 2005 | 13.4 | 49.0 | 54.0 | 23.6 | 14.3 | 13.1 | 167.4 |
| 2004 | 5.0 | 12.8 | 19.6 | 22.4 | 12.1 | 12.2 | 84.1 |
| Assets | | | | | | | |
| 2006 | \$ 62.4 | \$ 143.1 | \$ 782.9 | \$ 107.5 | \$ 92.5 | \$ 3,457.5 | \$ 4,645.9 |
| 2005 | 56.5 | 60.2 | 239.2 | 93.8 | 109.9 | 4,592.8 | 5,152.4 |
| 2004 | 47.7 | 67.4 | 211.1 | 84.5 | 103.9 | 4,935.4 | 5,450.0 |

(1) Corporate and other operating loss includes net gains from dispositions of assets of \$185.7 million, \$65.8 million and \$6.9 million for the years ended December 31, 2006, 2005 and 2004, respectively and impairment and other related charges of \$252.5 million and \$82.6 million for the years ended December 31, 2006 and 2005, respectively. Operating income for Lumber includes a refund of lumber duties of \$92.5 million for the year ended December 31, 2006.

Sales to our joint venture partners, which are transacted at arm's length, were \$359.4 million, \$326.3 million and \$337.8 million in 2006, 2005 and 2004, respectively. Amounts due from joint venture partners were \$51.3 million and \$43.1 million at December 31, 2006 and 2005, respectively, and are included in Accounts receivable, net on the Consolidated Balance Sheets.

| <i>(In millions)</i> | Sales by Country ⁽¹⁾ | | |
|--------------------------------|---------------------------------|------------|------------|
| | 2006 | 2005 | 2004 |
| United States | \$ 2,493.0 | \$ 2,483.8 | \$ 2,310.7 |
| Foreign Countries | | | |
| Canada | 235.1 | 270.6 | 242.9 |
| Korea | 105.6 | 104.4 | 106.1 |
| Mexico | 93.0 | 71.4 | 66.7 |
| Italy | 74.5 | 73.0 | 53.7 |
| Other countries ⁽²⁾ | 528.6 | 480.6 | 410.2 |
| | 1,036.8 | 1,000.0 | 879.6 |

\$ 3,529.8 \$ 3,483.8 \$ 3,190.3

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| <i>(In millions)</i> | Long-Lived Assets by Country ⁽³⁾ | | |
|----------------------|---|------------|------------|
| | 2006 | 2005 | 2004 |
| United States | \$ 1,549.1 | \$ 1,716.5 | \$ 1,853.9 |
| Canada | 1,252.9 | 1,357.1 | 1,568.4 |
| Korea | 135.4 | 146.3 | 149.5 |
| | \$ 2,937.4 | \$ 3,219.9 | \$ 3,571.8 |

(1) Sales are attributed to countries based on the location of the customer. No single customer, related or otherwise, accounted for 10% or more of Bowater's 2006, 2005 or 2004 consolidated sales.

(2) No country in this group exceeded 2% of consolidated sales.

(3) Excludes goodwill, financial instruments and deferred tax assets.

Note 26. Subsequent Event

In January 2007, Bowater and Abitibi-Consolidated Inc. (Abitibi) announced a definitive agreement to combine in an all-stock merger of equals (with the newly merged company herein referred to as AbitibiBowater). Under the terms of the transaction, each common share of Abitibi will be exchanged for 0.06261 common share of AbitibiBowater, and each Bowater common share will be exchanged for 0.52 common share of AbitibiBowater. The exchange ratio will result in 48% of AbitibiBowater being owned by former Abitibi shareholders and 52% of AbitibiBowater being owned by former Bowater shareholders. This combination has been approved unanimously by the Boards of Directors of both companies, which received fairness opinions from their respective financial advisors. The combination is subject to approval by the shareholders of both companies, regulatory approvals, and customary closing conditions. It is expected to be completed in the third quarter of 2007. Abitibi and Bowater will continue to operate separately until the transaction closes. In connection with this announced merger, we have approved a retention and severance program for approximately 320 Bowater employees who may be impacted by the pending merger with Abitibi. This program provides a retention bonus for employees who remain with Bowater through the closing of the merger or its cancellation and an additional retention bonus for employees who remain with Bowater for a transition period following closing of the merger.

Note 27. Quarterly Information (Unaudited)

Year ended December 31, 2006

| <i>(In millions, except per-share amounts)</i> | First | Second | Third | Fourth | Year |
|--|----------|----------|----------|----------|------------|
| Sales | \$ 893.2 | \$ 899.4 | \$ 875.9 | \$ 861.3 | \$ 3,529.8 |
| Operating income (loss) ⁽¹⁾ | 39.8 | 67.4 | (179.3) | 113.3 | 41.2 |
| (Loss) income before cumulative effect of accounting changes | (16.2) | (10.6) | (216.1) | 107.2 | (135.7) |
| Net (loss) income | (18.8) | (10.6) | (216.1) | 107.2 | (138.3) |
| Basic (loss) income per common share: | | | | | |
| (Loss) income before cumulative effect of accounting changes | (0.28) | (0.18) | (3.76) | 1.87 | (2.36) |
| Net (loss) income | (0.33) | (0.18) | (3.76) | 1.87 | (2.41) |
| Diluted (loss) income per common share: | | | | | |
| (Loss) income before cumulative effect of accounting changes | (0.28) | (0.18) | (3.76) | 1.86 | (2.36) |
| Net (loss) income | (0.33) | (0.18) | (3.76) | 1.86 | (2.41) |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Year ended December 31, 2005

| <i>(In millions, except per-share amounts)</i> | First | Second | Third | Fourth | Year |
|--|--------------|---------------|--------------|---------------|-------------|
| Sales | \$ 837.0 | \$ 897.5 | \$ 872.9 | \$ 876.4 | \$ 3,483.8 |
| Operating income (loss) ⁽²⁾ | 36.8 | 40.8 | 45.0 | (23.8) | 98.8 |
| Income (loss) before cumulative effect of accounting changes | 0.9 | (3.6) | (16.0) | (101.4) | (120.1) |
| Net income (loss) | 0.9 | (3.6) | (16.0) | (101.9) | (120.6) |
| Basic income (loss) per common share: | | | | | |
| Income (loss) before cumulative effect of accounting changes | 0.02 | (0.06) | (0.28) | (1.77) | (2.09) |
| Net income (loss) | 0.02 | (0.06) | (0.28) | (1.78) | (2.10) |
| Diluted income (loss) per common share: | | | | | |
| Income (loss) before cumulative effect of accounting changes | 0.02 | (0.06) | (0.28) | (1.77) | (2.09) |
| Net income (loss) | 0.02 | (0.06) | (0.28) | (1.78) | (2.10) |

- (1) Includes gains on dispositions of assets of \$28.8 million in the first quarter, \$71.7 million in the second quarter, \$54.0 million in the third quarter and \$31.2 million in the fourth quarter; severance of \$4.4 million in the first quarter, \$6.9 million in the third quarter and \$5.0 million in the fourth quarter; goodwill impairment of \$200.0 million in the third quarter; asset impairment and other related charges of \$46.4 million in the third quarter and \$6.1 million in the fourth quarter; and a refund of lumber duties of \$92.5 million in the fourth quarter.
- (2) Includes gains on dispositions of assets of \$11.0 million in the first quarter, \$9.8 million in the second quarter, \$9.9 million in the third quarter and \$35.1 million in the fourth quarter; severance of \$13.3 million in the fourth quarter; and asset impairment and other related charges of \$11.9 million in the second quarter and \$70.7 million in the fourth quarter.

Management's Report on Financial Statements and Assessment of Internal Control over Financial Reporting

Financial Statements

Management of Bowater Incorporated is responsible for the preparation of the financial information included in this Annual Report on Form 10-K. The accompanying Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles and include amounts that are based on the best estimates and judgments of management.

Assessment of Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Bowater Incorporated'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 U.S. generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that:

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of Bowater Incorporated;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles;

provide reasonable assurance that receipts and expenditures of Bowater Incorporated are being made only in accordance with the authorizations of management and directors of Bowater Incorporated; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use 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 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.

Management assessed the effectiveness of Bowater Incorporated's internal control over financial reporting as of December 31, 2006. Management based this assessment on the criteria for effective internal control over financial reporting described in *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 Bowater Incorporated'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, 2006, Bowater Incorporated's internal control over financial reporting was effective.

KPMG LLP, the independent registered public accounting firm which audited and reported on the Consolidated Financial Statements of Bowater Incorporated included in this Form 10-K, has issued an attestation report on management's assessment of internal control over financial reporting. KPMG LLP's report follows this report.

Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting

The Board of Directors of Bowater Incorporated:

We have audited management's assessment, included in the section Assessment of Internal Control Over Financial Reporting in the accompanying Management's Report on Financial Statements and Assessment of Internal Control Over Financial Reporting, that Bowater Incorporated's (the Company) internal control over financial reporting was effective as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Bowater Incorporated'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. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness 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, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and 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.

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, management's assessment that Bowater Incorporated's internal control over financial reporting was effective as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Bowater Incorporated maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Bowater Incorporated and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, capital accounts and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated March 1, 2007 expressed an unqualified opinion on those consolidated financial statements.

Greenville, South Carolina

March 1, 2007

Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements

The Board of Directors of Bowater Incorporated:

We have audited the accompanying consolidated balance sheets of Bowater Incorporated and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, capital accounts and cash flows for each of the years in the three-year period ended December 31, 2006. In connection with our audits of the consolidated financial statements, we also have audited financial statement schedule II. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits 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 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. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Bowater Incorporated and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in notes 1 and 2 to the consolidated financial statements, in 2006 the Company (i) changed its method of quantifying errors; (ii) changed its method of accounting for share-based payment; and (iii) changed its method of accounting for pensions and other postretirement benefits plans. In addition, in 2005 the Company changed its method of accounting for conditional asset retirement obligations.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Bowater Incorporated's internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 1, 2007, expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

Greenville, South Carolina

March 1, 2007

Part IV

Item 15. Exhibits and Financial Statement Schedules

(a)(1) Financial Statements

The following are included at the indicated page of this Amendment:

| | Page(s) |
|--|----------------|
| Consolidated Statements of Operations for Each of the Years in the Three-Year Period Ended December 31, 2006 | 28 |
| Consolidated Balance Sheet at December 31, 2006 and 2005 | 29 |
| Consolidated Statements of Capital Accounts for Each of the Years in the Three-Year Period Ended December 31, 2006 | 30 |
| Consolidated Statements of Cash Flows for Each of the Years in the Three-Year Period Ended December 31, 2006 | 31 |
| Notes to Consolidated Financial Statements | 32-71 |
| Management's Report on Financial Statements and Assessment of Internal Control over Financial Reporting | 72 |
| Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting | 73 |
| Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements | 74 |

(2) Financial Statement Schedules

None

(3) Exhibits

The following exhibits are filed with this Amendment:

23.1 Consent of Independent Registered Accounting Firm

31.1 Certification of CEO pursuant to Section 302

31.2 Certification of CFO pursuant to Section 302

32.1 Certification of CEO pursuant to Section 906

32.2 Certification of CFO pursuant to Section 906

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Bowater has duly caused this amendment to be signed on its behalf by the undersigned, thereunto duly authorized.

BOWATER INCORPORATED

Date: June 5, 2007

By: /s/ David J. Paterson
David J. Paterson
Chairman, President and Chief Executive Officer

EXHIBIT INDEX

| Exhibit No. | Description |
|--------------------|---|
| 23.1 | Consent of Independent Registered Public Accounting Firm. |
| 31.1 | Certification of CEO pursuant to Section 302. |
| 31.2 | Certification of CFO pursuant to Section 302. |
| 32.1 | Certification of CEO pursuant to Section 906. |
| 32.2 | Certification of CFO pursuant to Section 906. |

(b) The above-referenced exhibits are being filed with this report.

(c) None.