FORTRESS PAPER LTD.

Q4 2010

FOR THE THREE MONTHS AND YEAR ENDED

DECEMBER 31, 2010

FORTRESS PAPER LTD.
MANAGEMENT'S DISCUSSION AND ANALYSIS

This Management's Discussion and Analysis ("MD&A") of the financial condition and results of operations of Fortress Paper Ltd. ("Fortress" or the "Company") has been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and should be read in conjunction with the audited consolidated financial statements and the notes thereto for the year ended December 31, 2010 (available on SEDAR at www.sedar.com). The MD&A provides a review of the significant developments that have impacted the Company's performance during the quarter ended December 31, 2010 relative to the previous quarter and prior year comparative quarter, and the year ended December 31, 2010 relative to the year ended December 31, 2009.

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

Throughout this discussion, reference is also made to EBITDA (defined as net income before interest, income taxes, depreciation, amortization, non-operating income and expenses and stock based compensation), which the Company considers to be an indicative measure of operating performance and a good metric to evaluate profitability. Reference is also made to Adjusted Net Income (Loss) (calculated as Net Income (Loss) less specific items affecting comparability with prior periods) and Adjusted Net Income (Loss) per Share (calculated as Adjusted Net Income (Loss) divided by the weighted average number of shares outstanding in the period). EBITDA, Adjusted Net Income (Loss) and Adjusted Net Income (Loss) per Share are not generally accepted earnings measures and should not be considered as an alternative to net income or cash flows as determined in accordance with Canadian GAAP. As there is no standardized method of calculating these measures, the Company's EBITDA, Adjusted Net Income (Loss) and Adjusted Net Income (Loss) per Share may not be directly comparable with similarly titled measures used by other companies. Reconciliations of EBITDA and Adjusted Net Income (Loss) to net income (loss) reported in accordance with GAAP are included in this MD&A.

The information in this report is as at March 11, 2011. All financial references are in Canadian dollars unless otherwise noted.

Description of Business

The Company was incorporated on May 30, 2006 under the laws of the Province of British Columbia. Fortress Paper Ltd. is an international producer of security and other specialty papers and products. The Company owns and operates three mills, the Landqart mill located in Switzerland, the Dresden mill located in Germany and the Fortress Specialty Cellulose mill located in Quebec, Canada. Fortress' security papers include banknote, passport and visa papers. The security papers produced at the Landqart mill incorporate internationally recognized overt and covert security features which are embedded into the paper and supplemented with customer-specific features. The Landqart mill has leveraged its extensive security papers competence to develop additional commercial applications using its in-house know-how and technology of security features to create innovative paper-based security products. Fortress' specialty papers business includes non-woven wallpaper base products, as well as graphic and technical papers. The Dresden mill produces coated and uncoated wallpaper base for wallpaper manufacturers. Fortress Paper's pulp business includes northern bleached hardwood kraft ("NBHK") produced at the Fortress Specialty Cellulose mill with plans to convert this capacity into dissolving pulp production along with the construction of a biomass based cogeneration plant.

Highlights

Fortress reported 2010 fourth quarter EBITDA of $3.2 million. For the three months ended December 31, 2009 EBITDA was $7.9 million and for the third quarter of 2010 EBITDA was $8.9 million.

Fortress reported adjusted net loss of $0.8 million for the fourth quarter of 2010 on sales of $83.5 million or diluted loss per share of $0.06. For the fourth quarter of 2009 the Company report adjusted net income of $4.8 million or diluted adjusted earnings per share of $0.46 on sales of $51.0 million. In the third quarter of 2010 the Company reported adjusted net income of $3.9 million on sales of $87.0 million or diluted adjusted earnings per share of $0.29. The primary reason for the decline is attributed to weaker NBHK pulp prices which remained below their June peak prices throughout the fourth quarter of 2010. In addition our Landqart mill underwent a significant portion of the paper-machine number 1 ("PM1") upgrade. The acceptance and production of lower margin banknote orders in preparation for increased capacity in 2011 also contributed to the decrease in net income compared to prior periods. Effective October 31, 2010 the last order of specialty papers was produced at Landqart. By the end of December the full conversion was substantially complete and production of saleable security paper on the rebuilt PM1 began in early January 2011. Both the NBHK pulp price impact at Fortress Specialty Cellulose and the conversion at Landqart overshadowed an excellent fourth quarter at Dresden.

EBITDA was $26.1 million for the year ended December 31, 2010 compared to $25.6 million for the year ended December 31, 2009. Excluding corporate costs, Dresden, Landqart and Fortress Specialty Cellulose combined mill EBITDA was $31.7 million and $29.1 million in the years ended December 31, 2010 and 2009, respectively. Despite significant EUR depreciation in the year the Dresden mill was able to contribute $21.9 million EBITDA which was in line with the previous year at $21.6 million. The Landqart mill produced significantly lower results ($0.5 million EBITDA) than the prior year ($7.5 million EBITDA) in large part due to the shut-down for the conversion of PM1. The Fortress Specialty Cellulose mill, purchased April 30, 2010, provided approximately $9.3 million of EBITDA.

Adjusted net income for the year ended December 31, 2010 was $10.4 million or $0.84 per share (diluted). Adjusted net income for the previous year comparative period was $13.8 million or $1.35 per share (diluted).

Management's Outlook

The fourth quarter of 2010 reflects continued strong profitability at our Dresden operations. At Landqart the Company completed the successful transformation of PM1 to a high security paper-machine. This comprehensive project had a negative impact on fourth quarter earnings as there was no commercial production on the PM1 for two months. The results at Fortress Specialty Cellulose reflect weakening NBHK prices that have come of their peaks from earlier in the year. The conversion of the Fortress Specialty Cellulose mill to a dissolving pulp producer remains on target for production in the third quarter of 2011. The underlying markets for dissolving pulp remain strong which continues to provide management with conviction in our attempts to expand further in this business segment.

Overall 2010 was another successful year for Fortress Paper Ltd. with the following significant accomplishments:

- The acquisition by Fortress Specialty Cellulose of the Thurso mill from Fraser Papers and its successful start-up as a NBHK pulp producer.
- Significant advancements with the conversion project of Fortress Specialty Cellulose to a dissolving mill scheduled for completion in the third quarter of 2011.
- Substantial completion of the rebuild of PM1 at Landqart by the end of 2010.
- Continued market share growth in the non-woven wallpaper market at the Dresden mill.

Subsequent Events

In January, 2011, Fortress completed the acquisition of the assets of the Bank of Canada's Optical Security Material (OSM) division (the "OSM Assets"), which produces the optically variable material for the security threads contained in various banknotes, including application in the Canadian banknotes. The Company paid a purchase price of $0.75 million for the OSM assets and granted the Bank of Canada a royalty-free license to use the intellectual property sold to the Company for Canadian banknote applications.

In February, 2011, Fortress completed a public offering of 967,000 common shares of the Company and the underwriters exercised their over-allotment option and purchased an additional 145,050 common shares at a price of $51.75 per share, resulting in aggregate gross proceeds under the offering of $57.5 million. Proceeds of the offering will be used to finance certain capital expenditures relating to its Fortress Specialty Cellulose Mill in Thurso, Quebec and the construction of a high security facility adjacent to the Fortress Specialty Cellulose Mill which will house the Company's OSM Assets recently acquired from the Bank of Canada, and for working capital and general corporate purposes.

In February, 2011, Fortress' wholly-owned subsidiary Dresden Papier GmbH ("Dresden") increased the current credit facility amounting to EUR18.5 million to EUR 22.15 million for the rebuild of Landqart's PM1 into a banknote paper-machine.

In February, 2011, the remaining $7 million principal amount of the Company's $15 million unsecured convertible debenture that was issued on April 30, 2010 has been converted. The Company has issued 350,000 common shares with this redemption.

Fourth Quarter 2010 Earnings Review

Three Months Ended December 31

Overview

Reported EBITDA for the Company was $3.2 million for the three months ended December 31, 2010. For the three months ended December 31, 2009 EBITDA was $7.9 million and for the third quarter of 2010 was $8.9 million.

Fortress reported adjusted net loss of $0.8 million for the fourth quarter of 2010 on sales of $83.5 million or diluted adjusted loss per share of $0.06. For the fourth quarter of 2009 the Company report adjusted net income of $4.8 million or diluted adjusted earnings per share of $0.46 on sales of $51.0 million. In the third quarter of 2010 the Company reported adjusted net income of $3.9 million on sales of $87.0 million or diluted adjusted earnings per share of $0.29.

Fortress reported net loss of $11.0 million for the fourth quarter of 2010 on sales of $83.5 million or loss per share of $0.87. For the fourth quarter of 2009 the Company reported net income of $3.7 million on sales of $51.0 million or basic and diluted earnings per share of $0.36 and $0.35, respectively. In the third quarter of 2010 the Company reported net income of $5.1 million on sales of $87.0 million or basic and diluted earnings per share of $0.43 and $0.38 respectively.

During the fourth quarter of 2010, as part of the Chief Executive Officer's new six year contract, the Company approved a special bonus payment comprised of $5 million cash and $10 million in additional long term incentive awards based on performance milestones and vesting periods. Of this amount $10.6 million ("Executive Award") was expensed consisting of $5 million cash ("Executive Cash Award") recorded in selling, general, and administrative and a further $5.6 million ("Executive Share Based Award") recognized in stock based compensation.

Analysis of Specific Items Affecting Comparability of Net Income

(thousands of dollars, except per share figures, unaudited)	Q4 2010	Q3 2010	Q4 2009
Net (loss) income	(10,953)	5,148	3,720
Foreign exchange (gain) loss	(1,099)	(1,294)	1,073
Executive Award	10,556	-	-
Write down at Landqart of PM1 legacy assets	745	-	-
Adjusted net (loss) income	(751)	3,854	4,793
Net (loss) income per share (EPS), as reported	(0.87)	0.43	0.36
Net (loss) income per share (EPS) diluted, as reported	(0.87)	0.38	0.35
Adjusted net (loss) income per share	(0.06)	0.32	0.47
Adjusted net (loss) income per share diluted	(0.06)	0.29	0.46

Total paper product shipments were lower than the prior quarter due to the conversion of PM1 at Landqart offset somewhat by increased shipments at Dresden.

Total NBHK pulp shipments in the fourth quarter of 2010 at Fortress Specialty Cellulose are in line with the previous quarter.

Cost of products sold were $71.8 million or 86.0% of sales for the three months ended December 31, 2010 compared to $37.3 million or 73.0% of sales for the three months ended December 31, 2009. In the previous quarter, cost of products sold were $69.8 million or 80.3% of sales for the three months. The increase in cost of products sold relative to the prior quarter was due in part to the acceptance and production of lower margin banknote orders in preparation for increased capacity in 2011. In addition, Fortress Specialty Cellulose achieved a lower sales price per tonne in the quarter relative to the previous quarter due to weakening commodity prices. Fortress Specialty Cellulose began production in late May 2010, which has increased the consolidated cost of sales percent of sales as typically NBHK pulp is a lower margin product than the paper products produced by Dresden and Landqart.

Selling, general and administrative expenses were $13.4 million (fourth quarter 2009, $5.9 million and third quarter 2010, $8.2 million) and were comprised primarily of sales commissions, marketing, corporate, administrative expenses and an executive award. Included in selling, general and administrative expenses in the fourth quarter of 2010 was the Executive Cash Award of $5 million. Excluding the Executive Cash Award and Fortress Specialty Cellulose expense of $2.6 million, selling, general and administrative expenses are in line with the prior year fourth quarter.

Stock-based compensation expense was $6.0 million during the period (fourth quarter 2009, $0.2 million and third quarter 2010, $0.6 million). Included in stock-based compensation in the fourth quarter of 2010 was a $5.6 million Executive Share Based Award.

Selected Financial Information and Statistics

(thousands of dollars, except shipments, unaudited)	Q4 2010	Q3 2010	Q4 2009
Sales	83,467	86,971	51,049
EBITDA[1]	3,237	8,930	7,885
Operating (loss) income	(10,775)	6,159	6,292
Net (loss) income	(10,953)	5,148	3,720
Adjusted net (loss) income	(751)	3,854	4,793
Paper Shipments (tonnes)	15,406	16,452	15,291
Pulp Shipments (tonnes)	62,038	60,469	-

[1]See net income to EBITDA reconciliation.

Net income to EBITDA reconciliation:

(thousands of dollars, unaudited)	Q4 2010	Q3 2010	Q4 2009
Net (loss) income	$ (10,953)	$ 5,148	$ 3,720
Income tax	1,305	2,243	1,199
Foreign exchange (gain) loss	(1,099)	(1,294)	1,073
Interest expense	(29)	62	300
Amortization	3,029	2,192	1,441
Stock based compensation	5,983	579	152
Executive Cash Award	5,000	-	-
EBITDA	$3,237	$ 8,930	$ 7,885

Operating Results by Business Segment

Thurso Mill

(thousands of dollars, except for shipments, unaudited)	Q4 2010	Q3 2010
Sales	35,006	37,219
Operating income (loss)	(266)	4,442
Shipments (tonnes)	62,038	60,469

During the fourth quarter of 2010, the Fortress Specialty Cellulose mill experienced NBHK pulp prices well off their highs for the year. Although costs per tonne have been stable, the lower realized prices on NBHK pulp have negatively impacted results. The mill is on target for its third quarter 2011 conversion from NBHK to dissolving pulp production.

Landqart Mill

(thousands of dollars, except for shipments, unaudited)	Q4 2010	Q3 2010	Q4 2009
Sales	16,489	19,531	19,464
Operating (loss) income	(4,453)	(45)	2,183
Shipments (tonnes)	3,286	4,791	3,673

The Landqart mill has undergone a significant conversion of its PM1 from a specialty paper- machine into an efficient bank note paper- machine. Effective October 31, 2010 the last of the specialty papers were produced. Shipments in the fourth quarter of 2010 consisted of primarily low margin specialty and security papers. Towards the end of December the full conversion was substantially complete with production of saleable security paper on the transformed PM1.

Dresden Mill

(thousands of dollars, except for shipments, unaudited)	Q4 2010	Q3 2010	Q4 2009
Sales	31,972	30,221	31,585
Operating income	6,329	4,205	5,110
Shipments (tonnes)	12,120	11,661	11,618

Shipments have remained strong and slightly increased from the previous quarter. Margins improved in the fourth quarter of 2010 relative to the prior period comparatives due to the lower costs associated with decreased NBHK pulp prices and a full quarter contribution of higher sales prices. The order book at the Dresden mill remains strong.

Year Ended December 31

Analysis of Specific Items Affecting Comparability of Net Income

(thousands of dollars, except per share figures, unaudited)	December 31, 2010	December 31, 2009	December 31, 2008
Net income as reported	34,753	12,697	12,680
Foreign exchange loss	1,624	1,149	597
Deferred acquisition expenses written off	476	-	-
Fair value gain on acquisition	(41,804)	-	-
Acquisition costs expensed	681	-	-
Acquisition costs associated with Fortress Specialty Cellulose mill	3,368	-	-
Executive Award	10,556	-	-
Write down of replaced Landqart PM1 legacy assets	745	-	-
Adjusted net income	10,399	13,846	13,277
Net income per share (EPS)	3.08	1.23	1.24
Impact of above item per share	2.16	0.11	0.06
Adjusted net income per share	0.92	1.34	1.30
Diluted adjusted net income per share	0.84	1.34	1.30

Selected Financial Information and Statistics for the Year Ended:

(thousands of dollars, except for shipments, unaudited)	December 31, 2010	December 31, 2009	December 31, 2008
Sales	281,287	198,310	189,002
EBITDA[1]	26,078	25,583	25,027
Operating income	1,023	19,715	19,994
Net income	34,753	12,697	12,680
Paper Shipments (tonnes)	64,568	56,499	53,221
Pulp Shipments (tonnes)	141,355	-	-

[1]See net income to EBITDA reconciliation.

Net income to EBITDA reconciliation:
(thousands of dollars, unaudited)

	December 31, 2010	December 31, 2009	December 31, 2008
Net income	34,753	12,697	12,680
Income tax	6,077	4,844	5,382
Foreign exchange loss	1,624	1,149	597
Fair value gain on acquisition	(41,804)	-	-
Start-up costs	3,368	-	-
Acquisition costs	681	-	-
Interest expense	373	1,025	1,335
Amortization	8,639	4,887	3,645
Stock based compensation	7,367	981	1,388
Executive Cash Award	5,000	-	-
EBITDA	$26,078	$25,583	$25,027

Overview

For the year ended December 31, 2010, Fortress Paper recorded net income of $34.8 million or $3.08 per share ($2.81 per share diluted) on sales of $281.1 million. For the year ended December 31, 2009, the Company recorded net income of $12.7 million or $1.23 per share (diluted) on sales of $198.3 million.

Adjusted net income for the year ended December 31, 2010 was $10.4 million or $0.92 per share ($0.84 per share diluted). Adjusted net income for the previous year comparative period was $13.8 million or $1.34 per share (diluted). Included in adjusted net income is amortization expense which was significantly higher in the current year ($8.6 million) relative to the prior year ($4.9 million) due to the addition of Fortress Specialty Cellulose mill and increased capital expenditures at Landqart. Included in the current year amortization is a $0.7 million write down of replaced PM1 legacy assets at Landqart.

EBITDA was $26.1 million for the year ended December 31, 2010 compared to $25.6 for the year ended December 31, 2009. Excluding corporate costs, Dresden, Landqart and Fortress Specialty Cellulose combined mill EBITDA was $31.7 million and $29.1 million in the years ended December 31, 2010 and 2009, respectively. Despite significant EUR depreciation in the year the Dresden mill was able to contribute $21.9 million EBITDA which was in line with the previous year at $21.6 million. The Landqart mill produced significantly lower results ($0.5 million EBITDA) than the prior year ($7.5 million EBITDA) in large part due to the conversion of PM1 as previously stated. The Fortress Specialty Cellulose mill, purchased April 30, 2010, provided approximately $9.3 million of EBITDA.

Total paper product shipments were higher to the prior comparative period due to capacity increases at the Dresden mill and the impact of the global financial crisis which resulted in lower shipments in early 2009.

Total NBHK pulp shipments reflect approximately seven months of sales as the Fortress Specialty Cellulose mill ramped up production in late May after having been idle for some time. The mill in Thurso was purchased April 30, 2010.

Included in operating income of $1.0 million for the year ended December 31, 2010 are start-up costs of $3.4 million and acquisition costs of $0.7 million related to Fortress Specialty Cellulose, an Executive award of $10.6 million, and $0.7 million write down of replaced PM1 legacy assets at Landqart. Operating income for the Company for the year ended December 31, 2010 adjusted for these amounts is $16.4 million. The operating income for the year ended December 31, 2009 was $19.7 million.

Acquisition of Thurso Pulp Mill

On April 30, 2010 the Company completed the purchase of a NBHK pulp mill located in Thurso, Quebec from Fraser Papers Inc. through a wholly-owned subsidiary, Fortress Specialty Cellulose Inc. ("Fortress Specialty Cellulose"), for $3 million or net proceeds of approximately $1.2 million. The Company is in the process of converting this mill into a specialty cellulose (dissolving pulp) operation and building a biomass-based cogeneration plant. The valuation of this acquisition for accounting purposes and the effect on the financial statements of the Company have been disclosed in the audited consolidated financial statements and the notes thereto for year ended December 31, 2010 and within this Management Discussion and Analysis.

Concurrent with this acquisition the Company finalized $102.4 million in project financing with a term of 10 years secured by the assets of Fortress Specialty Cellulose. Interest will be calculated at a fixed rate of 5.0% per annum for the first five years, followed by a rate of up to 5.5% for the remaining 5 years.

Also concurrent with this acquisition Fortress Paper issued a $15 million convertible debenture to a financial institution. The convertible debt matures in five years with an interest rate of 7% per annum. The debenture is convertible, in whole or in part, at the option of the holder into common shares of Fortress Paper at any time at a conversion price equal to $20.00 per share. Fortress Paper can redeem the debenture, in whole or in part, at any point after two years if the volume weighted average trading price of common shares on the TSX during 20 consecutive days, is not less than $25.00 per share.

On October 1, 2010 the holder elected to convert $8 million of the Convertible Note into 400,000 common shares. A gain of $0.2 million has been offset against selling general and administrative expenses and $0.2 million has been recognized as a decrease in retained earnings. Subsequent to December 31, 2010, the remaining $7 million of the Convertible Note was converted by the holder into 350,000 common shares.

The allocation of the purchase price to assets acquired and liabilities assumed is based upon estimated fair values at the date of acquisition. Fair values are estimated using market information where applicable; however, directly comparable information is not always readily available so significant estimates and judgment are used. The Company believes it has made reasonable assumptions with respect to determining the fair values recognized.

A gain of $41.8 million has been recognized as the estimated fair values of the net assets acquired exceed consideration paid. The gain has been included as other income in the statement of operations.

The acquisition has been accounted for as follows:

Assets acquired at fair values:	
Inventory	$ 6,019
Property, plant and equipment	58,915
	64,934
Liabilities assumed at fair values:	
Accounts payable	$ 3,652
Asset retirement obligations	562
Future income tax liabilities	15,916
	20,130
Net assets acquired at fair values	44,804
Consideration paid	3,000
Fair value adjustment gain on acquisition	$ 41,804

Operating Results by Business Segment

Fortress Specialty Cellulose Mill

(thousands of dollars, except for shipments, unaudited)	December 31, 2010
Sales	85,768
Operating income	3,052
Operating income adjusted for start-up and acquisition costs	7,101
Shipments (tonnes)	141,355

Results at Fortress Specialty Cellulose reflect sales and shipments beginning in late May. Operating income includes start-up costs of $3.4 million and acquisition costs of $0.7 million. Operating income adjusted for these amounts was $7.1 million which was influenced by the declining NBHK pulp prices. The strong pulp market experienced in June retreated throughout but stabilized towards the end of the third quarter through the end of fiscal 2010. The cost profile at Fortress Specialty Cellulose has remained stable and materially as projected.

Landqart Mill

(thousands of dollars, except for shipments, unaudited)	December 31, 2010	December 31, 2009	December 31, 2008
Sales	73,202	84,675	83,432
Operating income	(3,567)	4,895	4,011
Shipments (tonnes)	16,536	15,666	17,700

In the year ended December 31, 2010 security paper sales have been dominated by lower margin products. Operating income was further negatively impacted by higher cotton and linter prices. The specialty papers sales have been largely influenced by non-woven simplex wallpaper base production which has also been impacted by the significant increase in pulp prices relative to the prior year. In the year ended December 31, 2010 6,532 tonnes of non-woven simplex was shipped compared to 2,478 tonnes in the prior year. In addition, the PM1 was out of commercial production for the final two months of the year while it was being converted into a high security paper-machine.

Dresden Mill

(thousands of dollars, except for shipments, unaudited)	December 31, 2010	December 31, 2009	December 31, 2008
Sales	122,317	113,635	105,570
Operating income	19,540	19,282	20,007
Shipments (tonnes)	48,032	40,833	35,521

The significant depreciation of the EUR to the CAD has negatively impacted sales and operating income in the current year relative to prior year; however, the impact of the increased tonnes sold at the Dresden mill more than offset the negative impact of exchange on sales. Average pulp price increases also negatively impacted operating earnings. Despite these influences Dresden continues to perform well. The order book at the Dresden mill remains strong. Revenues and expenses continue to be denominated in EUR and therefore a depreciating currency relative to the CAD does not impact our operations or local currency profitability.

Tonnes shipped were 18% higher relative to the prior year due to a combination of the capital programs increasing capacity and the prior year global financial challenges experienced early in 2009.

Liquidity and Capital Resources

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

The Company constantly monitors and assesses its financial performance in order to ensure that its net debt levels are prudent, taking into account the anticipated direction of the Company and business cycle. The company continuously monitors the public and private debt markets and the public equity markets in order to assure that its capital structure is appropriately balanced. The Company's results can be materially influenced by changes in the relative value of the Swiss Franc, Euro and US dollar to the Canadian dollar.

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

Commitments for capital expenditures as at December 31, 2010 were $12.5 million primarily for the Fortress Specialty Cellulose mill conversion project and a Dresden mill project to increase capacity.

Approximately $15 million of the originally planned project capital expenditure of $153 million has been spent for the conversion of Fortress Specialty Cellulose mill from an NBHK producer to a high quality specialty cellulose mill and to construct a new co-generation facility. The Company has reviewed and evaluated capital expenditure to be incurred in year 2012 relating to the construction of the co-generation facility using new equipment instead of refurbished equipment as previously budgeted and which will result in increased costs in the range of $20 million to $25 million. Project financing of $102 million from Investissement Quebec, current cash, federal credits, cash from operations, and a subsequent public offering in February 2011 are expected to provide sufficient resources for completion.

In February, 2011 Fortress completed a public offering by way of short form prospectus ("2011 Prospectus") of 967,000, common shares of the Company and the underwriters exercised their over-allotment option and purchased an additional 145,050 common shares at a price of $51.75 per share, resulting in aggregate gross proceeds under the offering of $57.5 million. Proceeds of the offering will be used to finance certain capital expenditures relating to its Fortress Specialty Cellulose Mill in Thurso, Quebec and the construction of a high security facility adjacent to the Fortress Specialty Cellulose Mill which will house the Company's optical security material equipment recently acquired from the Bank of Canada, and for working capital and general corporate purposes.

In the 2011 Prospectus, the Company disclosed the following intended use of proceeds: (i) to finance certain capital expenditures relating to the Fortress Specialty Cellulose Mill (approximately $20 million); (ii) to finance certain capital expenditures relating to the Fortress Optical Facility and related expenditures (approximately $5 million); and (iii) the balance for working capital. Aggregate net proceeds are estimated to be approximately $55 million.

Principal debt and capital lease repayments as at December 31, 2010 are required as follows:

	Long term debt	Capital lease	Total
2011	$ 8,135	$ 196	$ 8,331
2012	9,570	—	9,570
2013	9,359	—	9,359
2014	10,412	—	10,412
2015	10,144	—	10,144
Thereafter	5,252	—	5,252
	$ 52,872	$ 196	$ 53,068

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

	2010
2011	$ 389
2012	167
2013	127
2014	32
2015	2
Thereafter	1
	$ 718

During 2010, the Dresden Papier mill received state and federal grants totaling EUR 1.2 million (2009: EUR 0.8 million). As of December 31, 2010 the Company has accrued $ nil as a repayment obligation under the terms of the grants for overpayments in prior years (2009 – EUR $0.1 million). There are no additional repayment obligations as of December 31, 2010.

The Company has performance bonds in the amount of EUR 0.6 million (2009: EUR 1.0 million).

Selected Cash Flow Items

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009	Year Ended December 31, 2010	Year Ended December 31, 2009
Cash provided before working capital changes	(3,438)	5,794	8,838	16,942
Non-cash working capital change	(626)	8,222	(11,600)	4,978
Cash provided from (used by) operating activities	(4,064)	14,016	(2,762)	21,920
Cash provided from financing activities	7,016	(6,102)	77,793	(2,412)
Additions to property, plant and equipment	(24,143)	(1,990)	(60,557)	(9,665)
Deferred expenses and other	(1,574)	13	(1,096)	(472)
Acquisition of Thurso Pulp Mill	-	-	(3,000)	-
Cash provided (used by) investing activities	(25,717)	(1,977)	(64,653)	(10,137)
Change in cash position	(22,765)	5,937	10,378	9,371
Foreign exchange (loss) gain on cash and cash equivalents	(633)	(1,100)	(1,024)	(2,353)

Financing Activities

In July 2010, Fortress Paper completed a public offering by way of short form prospectus ("Prospectus") of 1,739,000 common shares of the Company and the underwriters exercised their over-allotment option and purchased an additional 161,050 common shares at a price of $23.50 per share, resulting in aggregate gross proceeds under the offering of $44.7 million. Net of issuance costs, $42.3 million was received. In the 2010 Prospectus, the Company disclosed the following intended use of proceeds: (i) to finance certain capital expenditures relating to the Fortress Specialty Cellulose Mill (approximately $15 million); (ii) the rebuild of PM1 at its Landqart Mill (approximately $12 million); and (iii) the balance for working capital. The Company has deployed substantially all the proceeds from such offering in accordance with the disclosure contained in the 2010 Prospectus.

In April, 2010 the Company received $15 million in proceeds for an unsecured convertible note of the Company in the principal amount of $15 million that matures in April, 2015. The convertible note bears interest at an annual rate equal to 7%, calculated semi-annually. On October 1, 2010 the holder elected to convert $8 million of the Convertible Note into 400,000 common shares. Subsequent to December 31, 2010, the remaining $7 million of the Convertible Note was converted by the holder into 350,000 common shares.

By the end of 2010, the Company has utilized 15.6 million EUR of the 18.5 million EUR facility arranged by the Dresden mill with GE Capital Bank AG in connection with the rebuild of the Landqart mill's PM1to produce banknote papers.

Investing Activities

Capital expenditures in the fourth quarter of 2010 and year ended December 31, 2010 have primarily been incurred for the PM1 rebuild at Landqart and the Fortress Specialty Cellulose conversion to dissolving pulp project.

Acquisition related expenses (deferred expenses) in prior periods were capitalized. Effective April 1, 2010, the Company adopted Section 1582 of the Canadian Institute of Chartered Accountants Handbook which requires the Company to expense such costs.

Foreign Currency

The financial statements of the Company are susceptible to unrealized translation gains and losses when translating to Canadian dollars. Each mill has revenues and expenses in their own local currency, therefore these gains and losses are not realized for local cash flow purposes.

Outstanding Shares

The number of common shares outstanding at December 31, 2010 was 12,683,588. At the date of this report common shares outstanding were 14,145,638. The number of options outstanding at December 31, 2010 and the date of this report was 655,175. At December 31, 2010 and the date of this report there were 315,042 restricted share units. At December 31, 2010 and the date of this report there were 139,023 and 140,976 deferred share units outstanding, respectively.

Critical Accounting Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in Canada requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates are used for, but not limited to, the accounting for doubtful accounts, amortization, asset recoverability, derivative financial instruments, fair valuation of acquired assets, pensions and post-retirement obligations, asset retirement obligations, stock compensation, income taxes and contingencies. Actual results could differ from these estimates.

Changes in Accounting Policies

Current Year

i) Capitalization of interest expense

Effective January 1, 2010, the Company retroactively changed their accounting policy to allow for the capitalization of interest for borrowings related to the construction of property, plant and equipment. This change in policy did not significantly impact the consolidated financial statements for prior years.

ii) Business combinations

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1582, "Business Combinations". The section, which replaces the former Section 1581, "Business Combinations", established standards for the measurement of a business combination and the recognition and measurement of assets acquired and liabilities assumed. The section applies prospectively to business combinations for which the acquisition date is on or after the date of adoption. The effects of applying this section can be shown in note 4 of the December 31, 2010 Financial Statements relating to the acquisition of the Thurso mill.

Under Section 1581, companies had the option to capitalize acquisition related costs directly attributable to the business combination. Under Section 1582, the Company is required to account for acquisition related costs as expenses in the period in which the costs are incurred. As a result of this change the Company expensed $390 during 2010 related to the purchase of the Thurso mill which had previously been capitalized under Section 1581.

iii) Consolidated financial statements

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1601, "Consolidated Financial Statements". This section, which, together with the new Section 1602, replaces the former Section 1600, "Consolidated Financial Statements" carries forward existing guidance on aspects of the preparation of consolidated financial statements subsequent to acquisitions other than non-controlling interests. The adoption of this Section did not significantly impact the consolidated financial statements of the Company.

iv) Non-controlling interests

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1602, "Non controlling interests". This section carries forward existing guidance on aspects of accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. The adoption of this Section did not significantly impact the consolidated financial statements of the Company.

Internal Controls and Internal Controls Over Financial Reporting

The Company has established disclosure controls and procedures to ensure that information disclosed in this MD&A and the related financial statements was properly recorded, processed, summarized and reported to the Board of Directors and the Audit Committee. The Company's chief executive officer ("CEO") and chief financial officer ("CFO") have evaluated the effectiveness of these disclosure controls and procedures for the year ending December 31, 2010, and have concluded that they are effective.

The CEO and CFO acknowledge responsibility for the design of internal controls over financial reporting ("ICFR"), and confirm that there were no changes in these controls that occurred during the year ended December 31, 2010 which materially affected, or are reasonably likely to materially affect, the Company's ICFR. Based upon their evaluation of these controls for the year ended December 31, 2010, the CEO and CFO have concluded that these controls are operating effectively.

Conversion to International financial reporting standards (IFRS)

On February 13, 2008, the Accounting Standards Board announced that publicly accountable entities will be required to prepare financial statements in accordance with International Financial Reporting Standards (IFRS) for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The Company will rely mainly on internal resources to ensure compliance with IFRS. The Company intends to convert to these new standards according to the timetable set for these new rules.

The Company has identified significant accounting policy differences and their related areas of impact in terms of systems, procedures and financial statements. The Company is currently in the process of having the opening IFRS balance sheet as at January 1, 2010 audited. Differences between IFRS and Canadian generally accepted accounting principles accepted accounting principles (GAAP), in addition to those referenced below, may be identified based on further detailed analysis by the Company and other changes to IFRS prior to the release of the Companies first IFRS statements in 2011. The Company will continue to review all proposed and continuing projects of the International Accounting Standards Board to determine their impact and will continue to invest in training and resources throughout the transition period to facilitate a timely conversion

Set out below are some of the key areas where changes in accounting policies are expected that may materially impact the Company's consolidated financial statements. The list and comments should not be regarded as a complete list of changes that will result from a transition to IFRS. It is intended to highlight the more significant areas we have identified to date. Analysis of changes is still in process and not all decisions have been finalized where choices of accounting policies are available.

Accounting Policy Impact and Decisions

Employee Benefits

IAS 19, "Employee Benefits", permits a Company to recognize actuarial gains and losses immediately in other comprehensive income rather than amortized through earnings. IFRS 1 also provides an option to recognize immediately in equity all cumulative actuarial gains and losses existing as at the date of transition to IFRS. The Company currently plans on taking the exemption under IFRS 1.

IFRIC 14, "IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction", provides guidance on the size of an employee future benefit asset a company can recognize. Based on this guidance the employee future benefit recognized on the balance sheet of the Company will be $0.8 million as at January 1, 2010 and $1.7 million as at December 31, 2010.

Property, Plant and Equipment

IFRS 1 permits a Company to revalue individual items of property, plant and equipment at their fair value as at the date of transition to IFRS. The Company will be revaluing the land at both Landqart and Dresden. This is expected to increase PP&E by 16.8 million as at January 1, 2010.

Business Combinations

IFRS 1 provides an exemption that allows Companies transitioning to IFRS to not restate business combinations entered into prior to the date of transition. The Company currently plans to take this exemption. The Company chose to early adopt Canadian Handbook Section 1582, "Business Combinations" effective April 1, 2010. This section is converged with IFRS 3, "Business Combination". The Thurso acquisition on April 30, 2010 will have the same valuation under Canadian GAAP and IFRS.

Share Based Payments

IFRS 2, "Share-based Payment", governs the treatment for share based compensation. Under IFRS 2, when share based payment awards vest in installments over the vesting period (graded vesting), each installment is accounted for as a separate arrangement. This treatment is allowed under Canadian GAAP but is not currently used by the Company. The Company currently has a policy to recognize stock based compensation straight line over the vesting period. This change is not expected to be material to the Company.

Foreign Exchange Rates

IAS 21, "The Effects of Changes in Foreign Exchange Rates", requires that foreign denominated assets and liabilities are translated using the rates in effect at the balance sheet date. This will have an effect on any non-monetary items on the balance sheet translated using historical rates under Canadian GAAP. Using IAS 21, income and expense items for foreign operations are translated using the exchange rates in effect on the dates of the transactions. The Company is still determining the effect of these changes for the year ended December 31, 2010.

Provisions

IAS 37, "Provisions, Contingent Liabilities and Contingent Assets", requires a provision to be recognized when there is a present obligation as a result of a past transaction or event; it is probable that an outflow of resources will be required to settle the obligation; and a reliable estimate can be made of the obligation. The threshold of "probable" is a lower threshold than "likely", which is used in Canadian GAAP. Therefore, it is possible that there may be some contingent liabilities which would meet the recognition criteria under IFRS that were not recognized under Canadian GAAP. Other differences between IFRS and Canadian GAAP exist in relation to the measurement of provisions, such as the methodology for determining the best estimate where there is a range of equally possible outcomes (IFRS uses the midpoint of the range, whereas Canadian GAAP uses the low-end of the range), and the requirement under IFRS for provisions to be discounted where material.

Risks and Uncertainties

A comprehensive discussion of Risk Factors is included in the Company's 2009 annual information form available on SEDAR at www.sedar.com.

Classification of Financial Instruments

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

Financial Risk Management

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

Credit Risk

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

Cash and cash equivalents includes cash on deposit with an original maturity date of 90 days or less. In order to mitigate the risk of financial loss, cash on deposit is held with major Canadian and international financial institutions. The cash and cash equivalents balance at December 31, 2010 was $42.6 million (December 31, 2009 - $33.2 million). The Company does not have holdings in asset backed commercial paper.

The Company utilizes a combination of credit insurance and factoring to manage the risk associated with trade receivables. Approximately 92% of the outstanding trade receivables are covered under credit insurance. The majority of the balance is with large and financially sound customers. Accounts receivable aged greater than 90 days is $0.3 million and is considered collectable. The Company's trade receivable balance at December 31, 2010 was $10.6 million (December 31, 2009 - $18.0 million).

Liquidity Risk

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

At December 31, 2009, the Company's accounts payable and accrued liabilities totaled $38.9 million (December 31, 2009 - $22.4 million), all of which fall due for payment within one year of the balance sheet date.

The Company manages liquidity risk through ongoing review of accounts receivable balances and the management of its cash and debt positions.

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

Market Risk

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

Interest rate risk:

The Company is exposed to interest rate risk through its financial assets and financial obligations bearing variable interest rate. The Company believes that interest rate fluctuations would not have a significant impact on net income.

The Company manages interest rate risk by maximizing the interest earned on excess funds while maintaining the liquidity necessary to meet day-to-day operating cash flow requirements. The Company currently does not use derivative instruments to reduce its exposure to interest rate risk.

Currency risk:

The Company is exposed to foreign exchange risk primarily in Euros, Swiss Francs, and American dollars. The Company's products are sold globally with prices denominated primarily in Euros, Swiss Francs and American Dollars. The majority of the Company's expenditures are denominated in Euros, Swiss Francs and Canadian Dollars. In addition the Company holds financial assets and liabilities in the local operating currencies.

For the years ended December 31, 2009, the Company used derivative instruments to reduce its exposure to currency risk for sales not denominated in a local currency.

Sensitivity analysis:

The Company has completed a sensitivity analysis to estimate the impact on net income for the period which a change in foreign exchange rates or interest rates during the year ended December 31, 2010 would have had.

This sensitivity analysis includes the following assumptions:

- Changes in individual foreign exchange rates do not cause foreign exchange in other countries to alter
- Changes in market interest rates to do not cause a change in foreign exchange rates

The results of the foreign exchange sensitivity analysis can be seen in the following table:

	Impact on net income	
Change of +/- 1% in CHF foreign exchange rate	+/-	$ 19
Change of +/- 1% in EUR foreign exchange rate	+/-	$ 153
Change of +/- 1% in USD foreign exchange rate	+/-	$ 1,477

The above results arise due to the combined impact of foreign currency translation of the balance sheet and the effect of foreign exchange fluctuations on operations. The currency risk is partially mitigated by both revenues and expenses being denominated in local currencies in Landqart and Dresden. Fortress will continue to monitor and evaluate the future use of exchange contracts to limit exposure to exchange fluctuations.

Limitations of sensitivity analysis:

The financial position of the Company may vary at the time that a change in the factors occurs, causing the impact on the Company's results to differ from that shown above.

Selected Quarterly Information

(thousands of dollars, except per unit amounts, earnings per share ("EPS"), exchange rates and shares outstanding, unaudited)	Q4 2010	Q3 2010	Q2 2010	Q1 2010
Sales	83,467	86,971	60,544	50,304
Operating (loss) income	(10,775)	6,159	1,440	4,202
EBITDA	3,238	8,930	8,102	5,808
Net income	(10,953)	5,148	40,378	179
Basic EPS	($0.87)	$0.43	$3.94	$0.02
Diluted EPS	($0.87)	$0.38	$3.53	$0.02
Weighted average shares outstanding Basic (thousands)	12,626	12,003	10,237	10,234
Weighted average shares outstanding Diluted (thousands)	14,158	13,501	11,450	10,713
Average Swiss/Canadian exchange rate[1]	1.0397	1.0085	0.9278	0.9832
Average Euro/Canadian exchange rate[1]	1.3760	1.3438	1.3057	1.4381

(thousands of dollars, except per unit amounts, earnings per share ("EPS"), exchange rates and shares outstanding, unaudited)	Q4 2009	Q3 2009	Q2 2009	Q1 2009
Sales	51,049	51,000	49,638	46,623
Operating income	6,292	5,198	4,460	3,765
EBITDA	7,885	6,967	5,699	5,032
Net income	3,720	3,467	1,926	3,584
Basic EPS	$0.36	$0.34	$0.19	$0.35
Diluted EPS	$0.35	$0.34	$0.19	$0.35
Weighted average shares outstanding Basic (thousands)	10,234	10,234	10,234	10,234
Weighted average shares outstanding Diluted (thousands)	10,487	10,296	10,234	10,234
Average Swiss/Canadian exchange rate[1]	1.0341	1.0335	1.0498	1.0845
Average Euro/Canadian exchange rate[1]	1.5600	1.5699	1.5891	1.6226

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

FORTRESS PAPER LTD.

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2010 and 2009

(Canadian dollars, amounts in thousands)

PRICEWATERHOUSECOOPERS

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March 14, 2011

Independent Auditor's Report

To the Shareholders
of Fortress Paper Ltd.

We have audited the accompanying consolidated financial statements of Fortress Paper Ltd., which comprise the consolidated balance sheets as at December 31, 2010 and 2009 and the consolidated statements of operations and comprehensive income and retained earnings, and cash flows for the years then ended, and the related notes including a summary of significant accounting policies.

Management's responsibility for the consolidated financial statements
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Fortress Paper Ltd. as at December 31, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

(signed) PricewaterhouseCooper LLP

Chartered Accountants

FORTRESS PAPER LTD.
CONSOLIDATED BALANCE SHEETS

As at December 31
(Canadian dollars, amounts in thousands)

	2010	2009
ASSETS		
Current		
Cash and cash equivalents	$ 42,559	$ 33,205
Trade accounts receivable	10,619	18,034
Other accounts receivable	16,099	2,614
Inventories *(note 6)*	41,187	26,880
Prepaid expenses	1,752	873
	112,216	81,606
Restricted cash	1,362	45
Deferred expenses	–	476
Property, plant and equipment *(note 7)*	166,619	47,852
Employee future benefits *(note 13)*	10,569	9,888
Total assets	$ 290,766	$ 139,867
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	$ 38,876	$ 22,447
Income taxes payable	3,503	4,446
Current portion of long-term debt *(note 8)*	8,331	5,378
	50,710	32,271
Long-term debt *(note 8)*	42,645	18,984
Future income taxes *(note 15)*	16,960	2,028
Asset retirement obligation *(note 5)*	185	–
Total liabilities	110,500	53,283
Shareholders' equity *(note 9)*		
Share capital	111,069	59,083
Contributed surplus	10,197	3,088
Retained earnings	59,000	24,413
Total shareholders' equity	180,266	86,584
Total liabilities and shareholders' equity	$ 290,766	$ 139,867

Commitments and contingencies *(note 12)*
Subsequent events *(note 19)*

(See accompanying notes)

Approved by the Board of Directors:

"Chadwick Wasilenkoff" — Director

"Richard Whittall" — Director

FORTRESS PAPER LTD.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME AND RETAINED EARNINGS

Year ended December 31
(Canadian dollars, amounts in thousands)

	2010	2009
Sales	$ 281,287	$ 198,310
Costs and expenses		
Cost of products sold	230,198	150,308
Amortization	8,639	4,887
Selling, general and administration	34,060	22,419
Stock-based compensation *(note 10)*	7,367	981
Operating income	1,023	19,715
Other income (expense)		
Interest, net *(note 14)*	(373)	(1,025)
Fair value gain on acquisition *(note 4)*	41,804	–
Foreign exchange loss	(1,624)	(1,149)
Net income before income taxes	40,830	17,541
Income tax expense *(note 15)*	(6,077)	(4,844)
Net income and comprehensive income	$ 34,753	$ 12,697
Earnings per share		
Basic	$ 3.08	$ 1.24
Diluted	$ 2.81	$ 1.23
Weighted average number of shares outstanding		
Basic	11,283,646	10,233,500
Diluted	12,357,299	10,293,021

	2010	2009
Retained earnings		
Balance — beginning of year	$ 24,413	$ 11,716
Redemption of Convertible Note *(note 8)*	(166)	–
Net income	34,753	12,697
Balance — end of year	$ 59,000	$ 24,413
Accumulated other comprehensive earnings		
Balance — beginning and end of year	$ –	$ –

(See accompanying notes)

FORTRESS PAPER LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year ended December 31
(Canadian dollars, amounts in thousands)

	2010	2009
Cash flows (used by) from operating activities		
Net income	$ 34,753	$ 12,697
Items not affecting cash:		
Amortization	8,639	4,887
Future income taxes	(984)	(159)
Foreign exchange gain on long term debt	(302)	(3,817)
Foreign exchange loss on cash and cash equivalents	1,024	2,353
Fair value gain on acquisition *(note 4)*	(41,804)	–
Stock based compensation *(note 10)*	7,367	981
Prior period capitalized acquisition costs expensed	476	–
Non-cash interest on long term debt	(84)	–
Gain on conversion of convertible debt *(note 8)*	(247)	–
	8,838	16,942
Change in non-cash working capital items		
Accounts receivable	(6,070)	1,306
Inventories	(8,288)	5,088
Prepaid expenses	(879)	(500)
Other assets	(681)	1,686
Accounts payable and accrued liabilities	4,318	(2,602)
	(2,762)	21,920
Cash flows from (used by) financing activities		
Options exercised *(note 10)*	680	–
Repayment of long-term debt	(4,141)	(8,134)
Proceeds from long-term debt	39,444	6,022
Net proceeds from issuance of common shares	42,344	–
Deferred share units paid in cash *(note 10)*	(244)	–
Payment on capital leases	(290)	(300)
	77,793	(2,412)
Cash flows used by investing activities		
Additions to property, plant and equipment	(60,557)	(9,665)
Deferred expenses	–	(476)
Restricted cash	(1,317)	4
Proceeds on disposal of property, plant and equipment	221	–
Acquisition of Thurso pulp mill *(note 4)*	(3,000)	–
	(64,653)	(10,137)
Increase in cash position	10,378	9,371
Foreign exchange loss on cash and cash equivalents	(1,024)	(2,353)
Cash and cash equivalents, beginning of year	33,205	26,187
Cash and cash equivalents, end of year	$ 42,559	$ 33,205

Supplementary cash flow information *(note 17)*

(See accompanying notes)

1. NATURE OF OPERATIONS

Fortress Paper Ltd. (the "Company" or "Fortress") was incorporated on May 30, 2006 under the laws of the Province of British Columbia. From the date of incorporation to July 31, 2006, the Company was inactive. The Company's fiscal year-end is December 31. Fortress owns and operates two paper mills, the Landqart mill located in Switzerland and the Dresden mill located in Germany, and a pulp mill in Canada. Fortress' security papers include banknote, passport and visa papers. The security papers produced at the Landqart mill incorporate internationally recognized overt and covert security features which are embedded into the paper and supplemented with customer-specific features. The Landqart mill has leveraged its extensive security papers competence to develop additional commercial applications using its in-house know-how and technology of security features to create innovative paper-based security products. Fortress' specialty papers business includes non-woven wallpaper base products, as well as graphic and technical papers. The Dresden mill produces coated and uncoated wallpaper base for wallpaper manufacturers. The pulp mill, Fortress Specialty Cellulose, produces northern bleached hardwood kraft and is in the process of being converted into a dissolving pulp mill.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

All significant intercompany transactions and balances have been eliminated.

Revenue and Related Cost Recognition

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

Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in Canada requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates are used for, but not limited to, the accounting for doubtful accounts, amortization, asset recoverability, derivative financial instruments, fair valuation of acquired assets, pensions and post-retirement obligations, asset retirement obligations, stock compensation, income taxes and contingencies. Actual results could differ from these estimates.

Foreign Currency Translation

The subsidiaries are considered integrated operations; therefore, all foreign currencies are translated into Canadian dollars using average rates for the period for items included in the consolidated statements of operations, the rate in effect at the balance sheet date for monetary assets and liabilities, and historical rates for other assets included in the consolidated balance sheets. Translation gains or losses are included in the determination of income.

Cash and Cash Equivalents

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

Inventories

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

Property, Plant and Equipment

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

No amortization is charged on major improvements or expansions until the asset is ready for intended use. Betterments and replacements, including leasehold and other improvements that extend the assets' useful life or productive capabilities of major units of property and equipment are capitalized. Maintenance, repairs and minor replacements are expensed as incurred. The Company capitalizes interest incurred for construction-in-progress.

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

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

Impairment of long-lived assets

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

Employee future benefits

For the Company's defined contribution pension plan, contributions are recognized as employee benefit expense when they are due.

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

The Company has adopted the following policies:

- The measurement date used for accounting purposes is December 31;

- The cost of pensions earned by employees is actuarially determined using the projected benefit method prorated on service and management's estimate of expected plan investment performance, salary escalation and retirement ages of employees;

- For the purpose of calculating the expected return on plan assets, those assets are valued at fair value;

- The excess of the net actuarial gain (loss) over 10% of the greater of the benefit obligations and the fair value of plan assets is amortized over the average remaining service period of the active employees which is 8.8 years (2009 : 8.9 years).

Income taxes

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

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

Earnings per share

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

Stock-based compensation

The Company has a stock option plan as described in note 10. The Company uses the Black-Scholes option pricing model to estimate the fair value of each stock option at the date of the initial public offering ("IPO date") or grant date for options granted post IPO date. The value of stock options granted to directors and officers is recorded as stock-based compensation and credited to contributed surplus over the relevant vesting period. Any consideration received on the exercise of stock options is credited to share capital and the appropriate original fair value is reallocated from contributed surplus to share capital.

Performance options and share awards based on certain conditions are recognized when it is considered likely that the performance condition will be achieved.

3. CHANGES IN ACCOUNTING POLICIES

Current Year

i) Capitalization of interest expense

Effective January 1, 2010, the Company retroactively changed its accounting policy to allow for the capitalization of interest for borrowings related to the construction of property, plant and equipment. This change in policy did not significantly impact the consolidated financial statements for prior years.

ii) Business combinations

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1582, "Business Combinations". The section, which replaces the former Section 1581, "Business Combinations", establishes standards for the measurement of a business combination and the recognition and measurement of assets acquired and liabilities assumed. The section applies prospectively to business combinations for which the acquisition date is on or after the date of adoption. The effects of applying this section can be shown in note 4 for the acquisition of the Thurso mill.

Under Section 1581, companies had the option to capitalize acquisition related costs directly attributable to the business combination. Under Section 1582, the Company is required to account for acquisition related costs as expenses in the period in which the costs are incurred. As a result of this change, the Company expensed $390 during 2010 related to the purchase of the Thurso mill that had previously been capitalized under Section 1581.

iii) Consolidated financial statements

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1601, "Consolidated Financial Statements". This section, which, together with the new Section 1602, replaces the former Section 1600, "Consolidated Financial Statements", carries forward existing guidance on aspects of the preparation of consolidated financial statements subsequent to acquisitions other than non-controlling interests. The adoption of this section did not significantly impact the consolidated financial statements of the Company.

iv) Non-controlling interests

Effective April 1, 2010, the Company early adopted the Canadian Institute of Chartered Accountants' Handbook Section 1602, "Non-controlling interests". This section carries forward existing guidance on aspects of accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. The adoption of this section did not significantly impact the consolidated financial statements of the Company.

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

4. ACQUISITION OF THURSO PULP MILL

On April 30, 2010, the Company completed the purchase of a northern bleached hardwood kraft pulp mill located in Thurso, Quebec from Fraser Papers Inc. through a wholly-owned subsidiary, Fortress Specialty Cellulose Inc. ("Fortress Specialty Cellulose" or "FSC"), for $3 million. The Company is in the process of converting the Thurso operations into a dissolving pulp mill.

The recognition of assets acquired and liabilities assumed is based upon estimated fair values at the date of acquisition. Fair values are estimated using market information where applicable; however, directly comparable information is not always readily available so significant estimates and judgment are used. The Company believes it has made reasonable assumptions with respect to determining the fair values recognized.

A gain of $41,804 has been recognized as the estimated fair values of the net assets acquired exceed consideration paid. The gain has been included as other income in the statement of operations.

The acquisition has been accounted for as follows:

Assets acquired at fair values:	
Inventory	$ 6,019
Property, plant and equipment	58,915
	64,934
Liabilities assumed at fair values:	
Accounts payable	$ 3,652
Asset retirement obligations	562
Future income tax liabilities	15,916
	20,130
Net assets acquired at fair values	44,804
Consideration paid	3,000
Fair value gain on acquisition	$ 41,804

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

5. ASSET RETIREMENT OBLIGATION

The Company has costs associated with containment and ongoing maintenance relating to landfill sites. These costs are measured at fair value which approximates the cost a third party would incur in performing the tasks associated with the landfill sites. These obligations represent estimated undiscounted future payments of $747 to remediate the landfills at the end of their useful lives. These payments are expected to occur within the next 14 months and have been recorded in accounts payable.

During the year ended December 31, 2010, the Company opened a new landfill site that is expected to be closed at the end of 2011.

The following table reflects changes in the reserve for environmental remediation and asset retirement obligations:

	2010
Assumed as part of Thurso pulp mill acquisition *(note 4)*	$ 562
Additions due to new landfill cell being opened	185
Balance at end of year	747
Less: current portion	562
Long-term asset retirement obligation	$ 185

The expected timing of remediation payments is as follows:

2011	$ 562
2012	185
	$ 747

6. INVENTORIES

	2010	2009
Raw materials	$ 32,471	$ 18,844
Work in progress	1,502	519
Finished goods	7,214	7,517
	$ 41,187	$ 26,880

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

7. PROPERTY, PLANT AND EQUIPMENT

	2010		
	Cost	Accumulated Amortization	Net Book Value
Land and building	$ 40,243	$ 2,084	$ 38,159
Production and other equipment	80,029	16,775	63,254
Construction-in-progress	65,206	–	65,206
	$ 185,478	$ 18,859	$ 166,619

	2009		
	Cost	Accumulated Amortization	Net Book Value
Land and building	$ 10,254	$ 989	$ 9,265
Production and other equipment	46,554	10,008	36,546
Construction-in-progress	2,041	–	2,041
	$ 58,849	$ 10,997	$ 47,852

The net book value and accumulated amortization of capital leases included in production and other equipment was $140 and $792 respectively at December 31, 2010 and $952 and $774 respectively at December 31, 2009.

Included in amortization for 2010 was an additional amount of $745 relating to assets made redundant due to the rebuild of the paper machine in Landqart.

Included in property, plant and equipment were capitalized borrowing costs of $1,715 (2009: nil).

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

8. LONG-TERM DEBT

Long-term debt

	2010	2009
Credit agreement with bank maturing 2014; interest at 2.65% secured by current assets (EUR 2,431; 2009 : EUR 3,223)	$ 3,238	$ 4,835
Credit agreement with lender maturing 2018; interest at 6.2% and 7.1% secured by fixed assets (EUR 15,637; 2009 : nil) (a)	20,481	–
Credit agreement with bank maturing 2012; interest at 4.8% unsecured (CHF 3,140; 2009 : CHF 4,710)	3,344	4,760
Credit agreement with bank maturing 2011, 2013 and 2018; interest up to 3.1% and 4.9% secured by fixed assets (CHF 12,870; 2009 : CHF 14,130)	13,700	14,281
Capital leases; interest at 4.0% (EUR 147; 2009 : EUR 324)	196	486
Credit agreement with lender maturing 2015; interest at 7% unsecured (b)	6,248	–
Credit agreement with lender maturing 2014; interest up to 5.5% secured by assets (c)	3,769	–
	50,976	24,362
Less: Current portion	(8,331)	(5,378)
	$ 42,645	$ 18,984

Principal repayments as at December 31, 2010 are required as follows:

	Long-term debt	Capital lease	Total
2011	$ 8,135	$ 196	$ 8,331
2012	9,570	—	9,570
2013	9,359	—	9,359
2014	10,412	—	10,412
2015	10,144	—	10,144
Thereafter	5,252	—	5,252
	$ 52,872	$ 196	$ 53,068

Borrowings under the above agreements require maintenance of certain financial and non-financial covenants. The Company has been in compliance with all covenants for the year ended December 31, 2010.

(a) The credit agreement is a facility for up to EUR 18.5 million, of which EUR 15.6 million has been drawn as at December 31, 2010. The facility bears interest at a rate of 6.2% up until the commercial production of the rebuilt paper machine at the Landqart facility. At the time of commercial production as defined in the credit agreement, the loan is repayable in equal installments over 7 years and bears interest at a rate of 7.1%.

Transaction costs of $483 have been netted against the proceeds of the loan. Interest has been calculated at 7.6% using the effective interest rate method. The accretion and net gain recorded as a result of the change in cash flow timing, recorded as an increase in the long-term debt for the year ended December 31, 2010, was $136 (2009: nil).

(b) The convertible debt ("Convertible Note") is an unsecured convertible note of the Company in the principal amount of $15,000 that matures in April 2015. The Convertible Note bears interest at an annual rate equal to 7%, calculated semi-annually with the first installment due on October 31, 2010.

Commencing April 30, 2010, the holder of the Convertible Note (the "Holder") may, at its option, convert the Convertible Note into common shares at any time until the close of business on the last business day prior to maturity. The conversion price shall be equal to $20.00 per share.

The Company may redeem the Convertible Note on or after April 30, 2012, at its option and repay in advance this option in whole or in part at par plus accrued and unpaid interest if the volume weighted average trading price of common shares on the TSX during 20 consecutive trading days, is not less than $25.00 per share.

The Company has initially recorded a liability portion of $12,969 and an equity portion of $2,031 in contributed surplus. The liability portion was valued using a 10.8% initial interest rate. Transaction costs of $270 have been netted against the liability portion of the loan and will be amortized at an effective interest rate of 16.3% assuming a two year expected life of the loan. Accretion of $555 has been recorded as an increase in the long-term debt for the year ended December 31, 2010.

On October 1, 2010, the Holder elected to convert $8,000 of the Convertible Note into 400,000 common shares. A gain of $247 has been offset against selling, general and administrative expenses and $166 has been recognized as a decrease in retained earnings.

(c) The credit agreement is a facility for up to $102.4 million, granted to Fortress Specialty Cellulose to support the conversion to dissolving pulp and co-generation capital expenditure programs. At December 31, 2010, $4.7 million has been drawn on this facility. The facility bears interest at a rate of 5% for the first five years of the loan and at a rate of up to 5.5% for the second five years of the loan. Commencing after two years, the facility is repayable in equal quarterly installments up to June 30, 2020.

Transaction costs of $891 have been netted against the proceeds of the loan. Interest has been calculated at 5.6% using the effective interest rate method. Interest capitalized and added to the principal amounted to $62. The accretion and net gain resulting from the change in cash flow timing was recorded as a decrease in the long-term debt for the year ended December 31, 2010 in the amount of $42 (2009: nil).

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

9. SHAREHOLDERS' EQUITY

(a) **Authorized:**

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

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

	Number of Shares	Share Capital	Contributed Surplus
Balance, December 31, 2008	10,233,500	$ 59,083	$ 2,107
Stock-based compensation	—	—	981
Balance, December 31, 2009	10,233,500	59,083	3,088
Equity portion of convertible debt (*note 8*)	—	—	2,031
Private placement	1,900,050	42,344	—
Deferred share units paid in cash	—	—	(93)
Restricted share units vested (*note 10*)	65,038	684	(684)
Stock-based compensation	—	—	7,216
Options exercised (*note 10*)	85,000	958	(278)
Shares issued on redemption of Convertible Note (*note 8*)	400,000	8,000	(1,083)
Balance, December 31, 2010	12,683,588	$ 111,069	$ 10,197

During the year ended December 31, 2010, the Company completed a private placement of 1,900,050 shares for total net proceeds of $42,344 after transaction costs of $2,308.

10. STOCK-BASED COMPENSATION

During 2006, the Company adopted a stock incentive plan. The exercise price of options granted under the stock option plan shall be as determined by the Board of Directors when such options are granted, subject to any limitations imposed by any relevant stock exchange or regulatory authority.

At the Company's annual general meeting held April 30, 2009, shareholders approved a long-term incentive plan which provides for the grant of restricted share units, performance share units and deferred share units to key employees and directors of the Company. The aggregate number of shares issuable under the long-term incentive plan in respect of awards, together with shares reserved for issuance under all of the Company's other security-based compensation arrangements, shall not exceed ten percent of the Company's issued and outstanding shares.

Stock Options

In June 2009, options were granted for 35,000 shares which vest over two years to an employee and officer of the Company. The weighted average fair value of the options granted in 2009 was $2.98 an option at the grant date using the Black Scholes option pricing model. No options were granted in 2010. Option pricing models require the input of highly subjective assumptions including the expected volatility. Changes in the assumptions can materially affect the fair value estimate, and, therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company's stock options. Assumptions used in the pricing model are as follows:

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

	2009
Risk-free interest rate	1.78%
Expected life of options	5 years
Annualized volatility	53%
Dividend rate	Nil

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

	Number of options	Exercise Price
Balance, December 31, 2008	1,012,675	$ 8.00
Forfeited	(25,000)	8.00
Cancelled	(282,500)	8.00
Granted	35,000	8.00
Balance, December 31, 2009	740,175	8.00
Exercised	(85,000)	8.00
Balance, December 31, 2010	655,175	$ 8.00

As at December 31, 2010, 643,508 stock options were exercisable (2009: 486,842). During 2010, 85,000 (2009: nil) were exercised at $8.00 an option. The stock options issued have various vesting dates that range from one to three years from the IPO or grant dates. The weighted average remaining expected life of the stock options issued as at December 31, 2010 is 1.8 years (2009: 2.8 years). The Company recorded $223 in stock compensation expense and contributed surplus relating to options.

Deferred Share Unit Awards

A Deferred Share Unit ("DSU") is a right granted to a non-employee director to receive one common share of the Company, from treasury, on a deferred basis. The value of the DSUs, when redeemed, is equal to the market value of the shares on the redemption date, including the value of dividends paid on the Company's common shares, if any, as if they had been reinvested in additional DSUs on each payment date. The DSUs may only be redeemed upon a director's retirement from the Company. The Company recognizes the expense at the time of grant.

DSU transactions and the number of DSUs outstanding are summarized as follows:

	Number of DSUs	Expense recognized
Balance, December 31, 2008	—	$ —
Granted	26,000	185
Balance, December 31, 2009	26,000	185
Granted	121,481	5,134
Redeemed	(8,458)	151
Balance, December 31, 2010	139,023	$ 5,285

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

Restricted Share Unit Awards

A Restricted Share Unit ("RSU") is a right granted to a key employee to receive one common share of the Company, from treasury, on a time vested basis. The fair value of restricted share awards is determined based upon the number of shares granted and the quoted price of the Company's stock on the date of grant. Restricted shares generally vest over three years. The Company recognizes the expense on a straight-line basis over the vesting period.

RSU transactions and the number of RSUs outstanding are summarized as follows:

	Number of RSUs
Balance, December 31, 2008	—
Granted	157,626
Balance, December 31, 2009	157,626
Granted	222,454
Vested	(65,038)
Balance, December 31, 2010	315,042

For the year ended December 31, 2010, $1,859 (2009: $117) was recorded as stock compensation expense and contributed surplus. As at December 31, 2010, the total remaining unrecognized compensation cost related to RSUs amounted to $7,106 (2009: $1,027), which will be amortized over their remaining vesting period.

Included in RSUs at year-end were performance related RSUs that have been accrued for at December 31, 2010, but will not vest until 2011.

11. CAPITAL DISCLOSURES

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

The Company constantly monitors and assesses its financial performance in order to ensure that its net debt levels are prudent taking into account the anticipated direction of the business cycle. The Company continuously monitors the public and private debt markets and the public equity markets in order to assure that its capital structure is appropriately balanced. The Company can be materially influenced by changes in the relative value of the Canadian dollar, Swiss Franc, and Euro.

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

The Company's capital comprises net debt and shareholders' equity:

	2010	2009
Cash and cash equivalents	$ 42,559	$ 33,205
Less total debt	50,976	(24,362)
Net (debt) cash	$ (8,417)	$ 8,843
Shareholders' equity	$ 180,266	$ 86,584

The Company is in compliance with all externally imposed capital requirements.

12. COMMITMENTS AND CONTINGENCIES

The minimum operating lease commitment over the next five years and thereafter is as follows:

	2010
2011	$ 389
2012	167
2013	127
2014	32
2015	2
Thereafter	1
	$ 718

During 2010, the Dresden Papier mill received state and federal grants totaling EUR 1,229 (2009: EUR 794). As of December 31, 2010, the Company has accrued $nil as a repayment obligation under the terms of the grants for overpayments in prior years (2009: EUR 73). There are no additional repayment obligations as of December 31, 2010.

The Company has purchase obligations of $12,525 (2009: $903) for the future purchase of equipment.

The Company has performance bonds in the amount of EUR 585 (2009: EUR 1,006).

13. EMPLOYEE FUTURE BENEFITS

The Company maintains a defined contribution pension plan in Canada. The total cost recognized in 2010 for the company's contribution to the plan was $ 639.

The Company maintains a defined benefit pension plan in Switzerland providing pension benefits based on either length of service or earnings and length of service. The Company measures its accrued benefit obligations and fair value of plan assets for accounting purposes as at December 31 of each year. The most recent actuarial valuation for the plan was December 31, 2010.

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

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

	2010	2009
Accrued benefit obligation		
Beginning of year	$ 56,905	$ 64,654
Service cost	1,491	1,520
Interest cost on accrued obligation	1,798	1,892
Benefit payments	(3,357)	(4,707)
Contributions by plan participants	1,114	1,237
Actuarial loss and other	1,297	—
Foreign exchange	3,206	(7,691)
End of year	$ 62,454	$ 56,905
Plan assets		
Fair value, beginning of year	$ 60,499	$ 65,030
Actual return on plan assets	1,598	5,565
Employer contributions	1,114	1,237
Employee contributions	1,114	1,237
Benefit payments	(3,356)	(4,707)
Foreign exchange	3,253	(7,864)
End of year	$ 64,222	$ 60,498
Funded status — plan surplus	$ 1,768	$ 3,593
Unamortized net actuarial loss	8,801	6,295
Accrued benefit asset	$ 10,569	$ 9,888

	2010	2009
Expense		
Current service cost	$ 1,491	$ 1,519
Interest cost	1,799	1,892
Actual return on plan assets	(1,598)	(5,565)
Expenses before adjustments	1,692	(2,154)
Difference between expected return and actual return on plan assets	(749)	3,228
Difference between net actuarial loss recognized and actual loss on benefit obligations	27	483
Net expense	$ 970	$ 1,557

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

	2010	2009
Significant actuarial assumptions used are as follows	%	%
Discount rate to determine benefit obligations at end of year	2.9	3.3
Discount rate to determine benefit expense (income) for the year	2.9	3.3
Expected rate of return on plan assets	4.0	4.0
Rate of increase in future compensation	1.5	1.5
Plan assets at fair value at the end of the year	%	%
Liquid assets	6.0	3.7
Bonds	50.2	51.1
Equity — World	24.8	26.0
Real estate	19.0	19.2
	100.0	100.0

14. INTEREST, NET

	2010	2009
Interest expense	$ (688)	$ (1,121)
Interest expense on capital lease	(24)	(47)
Interest income	339	143
	$ (373)	$ (1,025)

15. INCOME TAXES

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

	2010	2009
Future income tax assets (liabilities)		
Pension benefit	$ (1,776)	$ (2,028)
Non-capital loss carryforward	4,302	3,318
Property, plant and equipment	(13,763)	1,905
Share issue costs	731	539
Capital loss carryforward	62	—
Investments	1,750	1,750
Other	395	205
	(8,299)	5,689
Valuation allowance	(8,661)	(7,717)
Net future income tax liability	$ (16,960)	$ (2,028)

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

Non-capital loss carryforwards consist of approximately $3,716 from the Landqart operations, which expire beginning in 2011 through 2017 and $14,427 from Corporate, which expire beginning in 2026 through 2030.

The components of income tax expense are as follows:

	2010	2009
Current	$ 7,062	$ 5,003
Future	(985)	(159)
	$ 6,077	$ 4,844

The reconciliation of income taxes calculated at the statutory rate of 28.50% to the actual income tax provision is as follows:

	2010	2009
Net income before income taxes	$ 40,830	$ 17,541
Income tax at statutory rates	11,637	5,262
Stock compensation and other non-deductible expenses	1,540	303
Rate differentials between foreign jurisdictions, capital gains and future tax rates	(8,137)	(447)
Tax loss carryforward expired	295	260
Change in valuation allowance	742	(534)
Income tax expense	$ 6,077	$ 4,844

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

16. SEGMENTED INFORMATION

The segmentation of the Company's manufacturing operations by mill is based on a number of factors, including production, production processes, and economic characteristics. The Landqart mill produces specialty and security papers while the Dresden mill produces non-woven wallpaper base products. Fortress Specialty Cellulose had a pulp purchase and sale agreement with an exclusive distributor who had placed 100% of the mill's sales. During the year ended December 31, 2010, the Company earned revenue from one customer of $85,768 representing approximately 31% of sales. During the year ended December 31, 2009, the Company earned revenue from one customer of $20,337 representing 10.2% of sales.

	2010				
	Dresden Mill (Germany)	**Landqart Mill** (Switzerland)	**FSC Mill** (Canada)	**Corporate** (Canada)	**Fortress Paper Consolidated**
Sales	$ 122,317	73,202	85,768	—	$ 281,287
Operating income (loss)	$ 19,540	(3,567)	3,052	(18,002)	$ 1,023
Amortization[1]	$ (2,310)	(4,076)	(2,253)	—	$ (8,639)
Stock-based compensation[1]	$ —	—	—	(7,367)	$ (7,367)
Capital expenditures	$ 4,708	46,768	15,249	—	$ 66,725
Property, plant and equipment	$ 22,604	71,556	72,459	—	$ 166,619
Sales by geographic area	%	%	%		%
Germany	39.9	30.5	6.7		27.3
Switzerland	—	15.6	—		4.1
Other Western Europe	24.5	34.7	35.3		30.4
Eastern Europe and Asia	33.1	12.6	39.4		29.7
North America	—	—	18.6		5.7
Other	2.5	6.6	—		2.8
Total	100.0	100.0	100.0	—	100.0

[1]Stock-based compensation and amortization are included in operating earnings (loss).

	2009			
	Dresden Mill (Germany)	**Landqart Mill** (Switzerland)	**Corporate** (Canada)	**Fortress Paper Consolidated**
Sales	$ 113,635	84,675	—	$ 198,310
Operating income (loss)	$ 19,282	4,895	(4,462)	$ 19,715
Amortization[1]	$ (2,313)	(2,574)	—	$ (4,887)
Stock-based compensation[1]	$ —	—	(981)	$ (981)
Capital expenditures	$ 5,865	3,336	—	$ 9,201
Property, plant and equipment	$ 20,206	27,646	—	$ 47,852
Sales by geographic area	%	%		%
Germany	44.8	16.1		32.5
Switzerland	—	22.6		9.6
Other Western Europe	24.0	41.4		31.5
Eastern Europe	28.7	11.7		21.5
Other	2.5	8.2		4.9
Total	100.0	100.0	—	100.0

[1]Stock-based compensation and amortization are included in operating earnings (loss).

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

17. SUPPLEMENTARY CASH FLOW INFORMATION

Supplemental information	2010	2009
Interest paid	$ 686	$ 1,068
Income taxes paid	$ 7,625	$ 5,398

Non-cash items

Change in non-cash property, plant and equipment purchases included in accounts payable was $6,953 at December 31, 2010 and $462 at December 31, 2009.

During the year ended December 31, 2010, a gain of $41,804 has been recognized as the estimated fair values of the net assets acquired exceed consideration paid for the investment in Fortress Specialty Cellulose *(note 4).*

During the year ended December 31, 2010, 400,000 common shares of the Company were issued as part of the redemption of the Convertible Note (note 8). A gain of $247 was recognized as part of the conversion.

18. FINANCIAL INSTRUMENTS

Classification of Financial Instruments

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

Financial Risk Management

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

Credit Risk

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

Cash and cash equivalents includes cash on deposit with an original maturity date of 90 days or less. In order to mitigate the risk of financial loss, cash on deposit is held with major Canadian and international financial institutions. The cash and cash equivalents balance at December 31, 2010 was $42.6 million (2009: $33.2 million). The Company does not have holdings in asset backed commercial paper.

The Company utilizes a combination of credit insurance and factoring to manage the risk associated with trade receivables. Approximately 92% of the outstanding trade receivables are covered under credit insurance. The majority of the balance is with large and financially sound customers. Accounts receivable aged greater than 90 days are $0.3 million and are considered collectable. The Company's trade receivable balance at December 31, 2010 was $10.6 million (2009: $18.0 million).

Liquidity Risk

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

At December 31, 2010, the Company's accounts payable and accrued liabilities totaled $38.9 million (2009: $22.4 million), all of which fall due for payment within one year of the balance sheet date.

The Company manages liquidity risk through ongoing review of accounts receivable balances and the management of its cash and debt positions.

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

Market Risk

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

Interest rate risk:

The Company is exposed to interest rate risk through its financial assets and financial obligations bearing variable interest rates. The Company believes that interest rate fluctuations would not have a significant impact on net income.

The Company manages interest rate risk by maximizing the interest earned on excess funds while maintaining the liquidity necessary to meet day-to-day operating cash flow requirements. The Company currently does not use derivative instruments to reduce its exposure to interest rate risk.

Currency risk:

The Company is exposed to foreign exchange risk primarily in Euros, Swiss Francs, and American dollars. The Company's products are sold globally with prices denominated primarily in Euros, Swiss Francs and American dollars. The majority of the Company's expenditures are denominated in Euros, Swiss Francs and Canadian dollars. In addition, the Company holds financial assets and liabilities in the local operating currencies.

For the year ended December 31, 2009, the Company used derivative instruments to reduce its exposure to currency risk for sales not denominated in a local currency.

Sensitivity analysis:

The Company has completed a sensitivity analysis to estimate the impact on net income for the year that a change in foreign exchange rates or interest rates during the year ended December 31, 2010 would have had.

This sensitivity analysis includes the following assumptions:

- Changes in individual foreign exchange rates do not cause foreign exchange in other countries to alter
- Changes in market interest rates do not cause a change in foreign exchange rates

The results of the foreign exchange sensitivity analysis can be seen in the following table:

	Impact on net income	
Change of +/- 1% in CHF foreign exchange rate	+/-	$ 19
Change of +/- 1% in EUR foreign exchange rate	+/-	$ 153
Change of +/- 1% in USD foreign exchange rate	+/-	$ 1,477

The above results arise due to the combined impact of foreign currency translation of the balance sheet and the effect of foreign exchange fluctuations on operations. The currency risk is partially mitigated by both revenues and expenses being denominated in local currencies in Landqart and Dresden. Fortress will continue to monitor and evaluate the future use of exchange contracts to limit exposure to exchange fluctuations.

Limitations of sensitivity analysis

The financial position of the Company may vary at the time that a change in the factors occurs, causing the impact on the Company's results to differ from that shown above.

19. SUBSEQUENT EVENTS

In January 2011, Fortress completed the acquisition of the assets of the Bank of Canada's Optical Security Material (OSM) division (the "OSM Assets"), which produces the optically variable material for the security threads contained in various banknotes, including application in the Canadian banknotes. The Company paid a purchase price of $750 for the OSM assets and granted the Bank of Canada a royalty-free license to use the intellectual property sold to the Company for Canadian banknote applications.

In February 2011, Fortress completed a public offering of 967,000 common shares of the Company and the underwriters exercised their over-allotment option and purchased an additional 145,050 common shares at a price of $51.75 per share, resulting in aggregate gross proceeds under the offering of $57,549. Proceeds of the offering will be used to finance certain capital expenditures relating to its Fortress Specialty Cellulose mill in Thurso, Quebec and the construction of a high security facility adjacent to the Fortress Specialty Cellulose mill that will house the Company's optical security material equipment recently acquired from the Bank of Canada, and for working capital and general corporate purposes.

In February 2011, Fortress' wholly-owned subsidiary Dresden Papier GmbH ("Dresden") increased the current credit agreement amounting to EUR 18.5 million *(note 8)* to EUR 22.15 million for the rebuild of Landqart's paper-machine 1 into a banknote paper-machine.

In February 2011, the Company issued 350,000 common shares to convert the remaining $7,000 principal amount of its $15,000 unsecured Convertible Note.