

ALGOMA STEEL INC.

Financial Statements

For the period ended December 31, 2007



KPMG LLP
Chartered Accountants
Yonge Corporate Centre
4100 Yonge Street, Suite 200
Toronto, Ontario M2P 2H3
Canada

Telephone (416) 228-7000
Fax (416) 228-7123
Internet www.kpmg.ca

AUDITORS' REPORT

To the Shareholder of Algoma Steel Inc.

We have audited the consolidated balance sheet of Algoma Steel Inc. (the "Successor") as at December 31, 2007, and the consolidated statements of income and comprehensive income and retained earnings and cash flows of the Successor for the period from April 12, 2007 (Date of Incorporation) to December 31, 2007, and the consolidated balance sheet of Algoma Steel Inc. (the "Predecessor") as at December 31, 2006, and the consolidated statements of income and comprehensive income and retained earnings and cash flows of the Predecessor for the period from January 1, 2007 to June 19, 2007, and for the year ended December 31, 2006. These consolidated financial statements are the responsibility of the Successor's and the Predecessor's management. 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 plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of Algoma Steel Inc. (the "Successor") as at December 31, 2007, and the consolidated statements of income and comprehensive income and retained earnings and cash flows for the period from April 12, 2007 (Date of Incorporation) to December 31, 2007, and the consolidated balance sheet of Algoma Steel Inc. (the "Predecessor") as at December 31, 2006 and the consolidated statements of income and comprehensive income and retained earnings and cash flows for the period from January 1, 2007 to June 19, 2007, and for the year ended December 31, 2006 in accordance with Canadian generally accepted accounting principles.

Chartered Accountants, Licensed Public Accountants

Toronto, Canada
February 26, 2008

Algoma Steel Inc.**Consolidated Statements of Income and Comprehensive Income and Retained Earnings**

Expressed in millions of Canadian dollars,

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31, 2006
Sales	\$ 933.7	\$ 911.4	\$ 1,939.7
Operating expenses			
Cost of sales	888.2	779.1	1,486.1
Administrative and selling	28.5	32.2	70.4
Amortization	112.1	30.2	58.7
	<u>1,028.8</u>	<u>841.5</u>	<u>1,615.2</u>
Income (loss) from operations	(95.1)	69.9	324.5
Transaction related expenses (note 22)	2.4	21.2	-
Financial expense (income)			
Interest on long-term liabilities	44.7	-	0.2
Change in the fair value of embedded derivatives (note 10)	4.9	-	-
Interest on short-term liabilities	8.5	1.3	1.8
Foreign exchange (gain) loss	(76.2)	13.4	(1.8)
Premium on redemption of 11% Notes	-	-	7.9
Currency contract gains (note 4)	(17.0)	-	-
Currency contract premiums (note 4)	9.8	-	-
Investment income	(0.3)	(3.3)	(12.3)
	<u>(25.6)</u>	<u>11.4</u>	<u>(4.2)</u>
Income (loss) before income taxes	(71.9)	37.3	328.7
Provision for (recovery of) income taxes (note 17)	(74.6)	22.5	106.9
Net income and comprehensive income	\$ 2.7	\$ 14.8	\$ 221.8
Retained earnings			
Balance, beginning of period	\$ -	\$ 393.3	\$ 346.0
Net income	2.7	14.8	221.8
Dividend equivalents paid on exercising of share options	-	(0.4)	-
Purchase and cancellation of shares	-	-	(174.5)
Balance, end of period	<u>\$ 2.7</u>	<u>\$ 407.7</u>	<u>\$ 393.3</u>

See accompanying notes to consolidated financial statements

Algoma Steel Inc.**Consolidated Balance Sheets**

Expressed in millions of Canadian dollars

	Successor December 31, 2007	Predecessor December 31, 2006
Assets		
Current		
Cash and cash equivalents	\$ 15.9	\$ 29.4
Restricted cash	8.0	-
Short-term investments	-	145.7
Accounts receivable (note 19)	236.8	216.0
Income and other taxes receivable	23.5	-
Inventories (note 5)	318.0	420.4
Prepaid expenses (note 18)	17.2	19.1
Future income taxes (note 17)	0.8	1.7
	<u>620.2</u>	<u>832.3</u>
Property, plant and equipment (note 6)	1,823.9	648.8
Assets held for sale (note 23)	89.0	-
Accrued pension asset (note 11)	-	22.6
Intangible assets, net (note 7)	124.3	-
Other assets	4.4	1.7
	<u>\$ 2,661.8</u>	<u>\$ 1,505.4</u>
Liabilities and shareholder's equity		
Current		
Bank indebtedness (note 9)	\$ 220.5	\$ -
Accounts payable and accrued liabilities (note 8)	161.6	148.5
Accounts payable related to assets held for sale (note 23)	8.5	-
Income and other taxes payable	-	58.4
Accrued pension liability and post-employment benefit obligation (notes 11 and 12)	36.1	16.5
Payable to related parties (note 23)	8.0	-
Current portion of long-term debt	1.6	-
Future income tax liability (note 17)	1.2	1.0
	<u>437.5</u>	<u>224.4</u>
Long-term debt (note 10)	740.5	-
Deposit from related party (note 23)	44.1	-
Accrued pension liability (note 11)	111.2	-
Accrued post-employment benefit obligation (note 12)	379.8	258.0
Other long-term liabilities (note 21)	8.6	7.7
Future income tax liabilities on assets held for sale (note 17 and 23)	4.2	-
Future income tax liabilities (note 17)	317.5	130.2
	<u>1,605.9</u>	<u>395.9</u>
Non-controlling interest (note 23)	<u>38.3</u>	<u>-</u>
Contingencies and commitments (notes 17 and 18)		
Shareholder's equity		
Capital stock (notes 13 and 14)	531.8	253.6
Contributed surplus (notes 16 and 23)	45.6	238.2
Retained earnings	2.7	393.3
	<u>580.1</u>	<u>885.1</u>
Total liabilities and shareholder's equity	<u>\$ 2,661.8</u>	<u>\$ 1,505.4</u>

See accompanying notes to consolidated financial statements

Algoma Steel Inc.**Consolidated Statements of Cash Flows**

Expressed in millions of Canadian dollars

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31, 2006
Operating activities			
Net income	\$ 2.7	\$ 14.8	\$ 221.8
Adjustments and items not affecting cash:			
Amortization	112.1	30.2	58.7
Future income tax expense (recovery) (note 17)	(56.6)	(6.6)	4.2
Pension expense in excess of current funding	20.2	21.2	37.4
Prepayment of pension funding (note 11)	-	-	(85.0)
Post-employment benefit expense in excess of payments	6.9	8.7	16.2
Foreign exchange gain on long-term debt and accrued interest	(75.3)	-	-
Change in the fair value of embedded derivatives	4.9	-	-
Loss (gain) on disposal of capital assets	(0.1)	0.4	-
Premium on redemption of 11% Notes	-	-	7.9
Stock-based compensation (note 14)	-	7.3	3.8
Other	0.7	0.3	(1.7)
	<u>15.5</u>	<u>76.3</u>	<u>263.3</u>
Changes in non-cash operating working capital (note 20)	<u>62.9</u>	<u>(32.7)</u>	<u>(63.5)</u>
	<u>78.4</u>	<u>43.6</u>	<u>199.8</u>
Investing activities			
Acquisition of property, plant and equipment	(96.2)	(35.1)	(67.4)
Proceeds on sale of property, plant and equipment	1.6	0.3	1.5
Business acquisition, net of cash acquired of \$41.2 million	(1,797.2)	-	-
Restricted cash	(7.8)	-	-
Proceeds from sale of 49.9% interest in Algoma Energy LP (note 23)	82.8	-	-
Deposit from related party (note 23)	44.1	-	-
Decrease in short-term investments	142.1	3.6	116.4
	<u>(1,630.6)</u>	<u>(31.2)</u>	<u>50.5</u>
Financing activities			
Bank indebtedness	220.5	-	-
Proceeds of long-term notes and bank term loan, net (note 10)	939.1	-	-
Repayment of bank term loan	(128.1)	-	-
Issuance of shares	531.8	-	-
Advances from related parties, net (note 23)	8.4	-	-
Financing costs, bank indebtedness	(4.6)	(0.3)	-
Dividend equivalents paid on exercising of options	-	(0.4)	-
Redemption of 11% Notes	-	-	(153.3)
Purchase and cancellation of shares	-	-	(240.1)
Other	1.0	0.1	(0.1)
	<u>1,568.1</u>	<u>(0.6)</u>	<u>(393.5)</u>
Cash and cash equivalents			
Change during period	15.9	11.8	(143.2)
Balance, beginning of period	-	29.4	172.6
Balance, end of period	<u>\$ 15.9</u>	<u>\$ 41.2</u>	<u>\$ 29.4</u>
Supplemental information			
Income taxes paid	\$ 8.6	\$ 87.3	\$ 92.3
Interest paid	\$ 46.9	\$ 0.7	\$ 1.0

See accompanying notes to consolidated financial statements

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

1. BASIS OF PRESENTATION

On June 20, 2007, pursuant to a plan of arrangement (the “Transaction” or “Acquisition”), Algoma Steel Inc. (the “Predecessor”) was acquired by Algoma Acquisition Corp. (the “Successor”), which was an indirect wholly-owned subsidiary of Essar Steel Holdings Limited (“Essar”), incorporated on April 12, 2007 solely for the purpose of the Acquisition. On June 23, 2007, Algoma Steel Inc. and Algoma Acquisition Corp. were amalgamated and continued operating as Algoma Steel Inc. The term “Predecessor” refers to Algoma Steel Inc. and its subsidiaries on a consolidated basis prior to the Acquisition, and the term “Company” refers to the Predecessor prior to the Acquisition and to the combined Predecessor and Successor companies after the Acquisition. The Company is a wholly owned subsidiary of Essar Group.

These consolidated financial statements of the Successor include the results of operations and cash flows of the Successor for the period from April 12, 2007 to December 31, 2007 and include the results of the acquired business for the period from June 20, 2007 to December 31, 2007. Other than activities in connection with the Acquisition, the Successor had no activities prior to the Acquisition. The consolidated financial statements of the Predecessor are provided for the period from January 1, 2007 to June 19, 2007 and for the year ended December 31, 2006.

The consolidated financial statements of the Predecessor for the comparative period of 2006 are not comparable in all respects to the consolidated financial statements of 2007 as a result of the Transaction which resulted in a comprehensive revaluation of its assets and liabilities at June 20, 2007, as a result of the application of business combinations accounting and the significant acquisition financing.

2. NATURE OF OPERATIONS

Algoma Steel Inc. is an integrated steel producer with its active operations located entirely in Canada. The Company produces sheet and plate products that are sold primarily in Canada and the United States.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared by the Company in accordance with Canadian generally accepted accounting principles.

Basis of consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned and controlled subsidiaries. Algoma Steel Inc.’s interest in the equity of its subsidiaries is 100% except for Algoma Energy LP (‘AELP’), where Algoma Steel Inc.’s interest is 50.1% at December 31, 2007 (2006 – 100%). The outside equity holders’ interests are shown as ‘Non-controlling Interest’ (see note 23).

Cash and cash equivalents and restricted cash

Cash and cash equivalents include cash on deposit and term deposits maturing within 90 days of acquisition and are valued at cost plus accrued interest, which approximates fair value.

Restricted cash represents cash held in an escrow account in order to secure and fund certain future obligations.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Short-term investments

Short-term investments include Canadian dollar bankers' acceptances and commercial paper with remaining maturities greater than 90 days at acquisition.

Revenue recognition

Revenue is recognized on the sale of manufactured products when risks of ownership and legal title pass to the customer, which generally occurs at the time of shipment. Revenues are recorded net of provisions for returns, customer claims and other adjustments. Amounts billed to customers in a sale transaction related to shipping and handling are recorded as revenue. The Company reflects freight costs associated with shipping its products to customers as a component of cost of sales.

Inventories

Inventories are valued at the lower of average cost and net realizable value. Average cost for finished goods and work in process is comprised of direct costs and an allocation of production overheads, excluding amortization expense.

Property, plant and equipment

Property, plant and equipment of the Successor is recorded at its estimated fair value on June 20, 2007 pursuant to the Transaction. Property, plant and equipment purchased after June 20, 2007 is recorded at cost. Interest incurred in connection with the construction of major new facilities is capitalized. The amortization of property, plant and equipment begins when assets are ready for their intended use.

Amortization is calculated generally by the straight-line method based on estimated remaining useful lives as follows:

Buildings	5 to 40 years
Machinery and equipment	5 to 20 years
Computer hardware and software	5 years
Mill rolls	1 to 15 years

Capital costs related to extending the useful life of the blast furnace are amortized over its estimated life on a unit of production basis.

The Company incurs maintenance costs on all of its major equipment. Costs that extend the life of the asset or increase the utility of the asset are capitalized as property, plant and equipment are depreciated over the estimated useful life. All other repair and maintenance costs are expensed as incurred.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Intangible assets

As a result of the accounting for the Transaction, the Company allocated a substantial portion of the purchase price to intangible assets that include customer relationships, technology, in-process research and development, supply agreements and order backlogs. Finite lived intangible assets are amortized on a straight-line basis over their estimated remaining useful lives, as follows:

Customer relationships	Over expected life, ranging from 12 to 14 years
Technology	Over expected useful life, ranging from 5 to 10 years
In-process research & development	Over expected useful life, ranging from 5 to 10 years
Supply agreements	Over terms of specific agreements, ranging from 1 to 20 years
Order backlogs	Over expected completion period, less than one year

Finite lived intangible assets which are subject to amortization are evaluated for impairment when events or conditions indicate that the carrying value may be impaired by comparing the carrying value to future undiscounted cash flows. For intangible assets with indefinite lives and which are not amortized, an impairment test is performed at least annually which compares the carrying value of intangible assets to fair value. If impairment is determined to have occurred, an impairment loss is recognized for the excess of the carrying amount of the intangible asset over its fair value.

Income taxes

The Company follows the liability method of income tax allocation. Future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using enacted or substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are provided to the extent that it is not more likely than not that the future income tax assets will be realized. Investment tax credits related to research and development are recognized in earnings as a reduction of such expenses when the Company has made the qualifying expenditures and to the extent that there is reasonable assurance that the credits will be realized. Income tax benefits relating to uncertain tax positions are recognized when they are considered by management to be probable of realization and are measured at management's best estimate of the amount to be realized. Such tax benefits are derecognized and related tax liabilities recorded when management considers realization to no longer be more likely than not.

Translation of foreign currencies

The Company's functional currency is the Canadian dollar and other currencies are accounted for as foreign currencies. Foreign currency monetary assets and liabilities are translated at period-end exchange rates. All non-monetary assets and liabilities are translated using historical rates. Revenue and expenses are translated using average exchange rates prevailing during the period. All gains and losses resulting from foreign currency translation are included in the determination of net income as incurred.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Pensions and other post-employment benefits

The Company measures its accrued benefit obligation and the fair value of plan assets for accounting purposes at November 30 (the measurement date) each year. The accrued benefit obligations and the benefit costs are actuarially determined using the projected benefit method pro-rated on services. The past service costs resulting from negotiated benefit changes are amortized over the term of the collective bargaining agreement which is generally three years. Cumulative gains and losses (such as adjustments arising from experience gains and losses and changes in assumptions) in excess of 10% of the greater of the accrued benefit obligation and the market value of plan assets are amortized over the expected average remaining service period of active members expected to receive the benefits under the plans and over the average remaining life expectancy of 15 years for plans where all, or almost all, of the employees are no longer active. The expected average remaining service period of active members of the pension plans at the measurement date of November 30, 2007 was 9 to 10 years.

The Company also provides for other post-employment benefits upon retirement for employees and their dependents. The cost of these benefits is accrued over the service lives of the employees based on actuarial estimates. The expected average remaining service period of active members related to the other post-employment benefits at the measurement date of November 30, 2007 was 11 years.

The pension and post-employment benefit plans of the Predecessor were assumed by the Successor with no changes to the plans as a result of the Transaction.

Environmental costs

For environmental liabilities that can be estimated, the Company accrues its best estimate of the costs to be incurred.

Financial instruments

On January 1, 2007, the Predecessor retroactively adopted, without restatement of prior periods, CICA Handbook Section 1530, "Comprehensive Income", Section 3251, "Equity", Section 3861, "Financial Instruments – Disclosure and Presentation", "Section 3855, "Financial Instruments – Recognition and Measurement", and Section 3865, "Hedges".

Section 1530, "Comprehensive Income" introduces the concept of comprehensive income, which consists of Net Income and Other Comprehensive Income (OCI). OCI represents changes in Shareholders' Equity during a period arising from transactions and other events with non-owner sources and includes unrealized gains and losses resulting from changes in fair value of certain financial instruments. Cumulative changes in OCI are included in Accumulated Other Comprehensive Income, which is presented as a new category of Shareholders' Equity on the Consolidated Balance Sheet. Section 3251, "Equity", replaces Section 3250, "Surplus", and incorporates amendments resulting from the issuance of Section 1530.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Section 3855, “Financial Instruments – Recognition and Measurement”, and Section 3861, “Financial Instruments – Disclosure and Presentation”, establish standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives and related disclosures. Section 3855 requires that financial assets and financial liabilities, including derivatives, be recognized on the balance sheet when the Company becomes a party to the contractual provisions of the financial instrument or non-financial derivative contract. Under this standard, all financial instruments are required to be measured at fair value on initial recognition except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables or other financial liabilities. Held-for-trading financial instruments are subsequently measured at fair value and changes in fair value are recognized in net income in the period in which they occur. Available-for-sale financial instruments are subsequently measured at fair value with changes in fair value recorded in other comprehensive income until the instrument is derecognized or impaired, at which time, the amounts would be recognized in net income. Held-to-maturity investments, loans and receivables and other financial liabilities are subsequently measured at amortized cost.

Upon adoption of Section 3855, the Company designated its cash and cash equivalents and short-term investments as held-for-trading and its accounts receivable as loans and receivables. Accounts payable and accrued liabilities were designated as other financial liabilities.

The Company selected January 1, 2003 as its transition date for separation of embedded derivatives in financial instruments or contracts. An embedded derivative is a component of a financial instrument or another contract of which the characteristics are similar to a derivative. Certain contracts and instruments entered into prior to this transition date and not subsequently modified have not had embedded derivatives separated.

Section 3865, “Hedges”, specifies the criteria that must be satisfied in order for hedge accounting to be applied and the accounting for each of the permitted hedging strategies: fair value hedges, cash flow hedges and hedges of foreign currency exposures of net investments in self-sustaining foreign operations. Hedge accounting is discontinued prospectively when the derivative no longer qualifies as an effective hedge, or the derivative is terminated or sold, or upon the sale or early termination of the hedged item.

To manage risks associated with future variability in cash flows attributable to certain commodity purchases, the Company uses natural gas swap contracts with maturities of twelve months or less. The Company also utilizes steel swap contracts with maturities of twelve months or less to manage the risks associated with future variability in steel prices. The Company does not utilize derivative financial instruments for trading or speculative purposes.

Where hedge accounting is intended to be used, the Company formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives to forecasted transactions. The Company also formally assesses, both at the hedge’s inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in the cash flows of the hedged items. Where hedging instruments are not demonstrated to be highly effective or when hedge accounting is not used, these derivative instruments are recorded at fair value on the balance sheet with unrealized gains and losses recorded in earnings as they occur. At December 31, 2007, the fair value of natural gas swap contracts was a liability of \$0.3 million which is included in accounts payable and accrued liabilities. The Company had no steel swap contracts outstanding at December 31, 2007.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Fair value of financial instruments

The fair value of short-term investments, accounts receivable, bank indebtedness, accounts payable and accrued liabilities and income and other taxes payable approximates carrying value due to the short-term nature of these instruments. The fair value of the Company's variable rate bank term loan was approximately \$298.8 million at December 31, 2007. The fair value of the Senior Subordinated Notes, including the embedded call options, was approximately \$365.8 million at December 31, 2007 based on market pricing for the Notes on or about that date.

Financing costs

Financing costs associated with the Revolving Facility (note 9) are amortized on a straight-line basis over the five year term of the facility as a component of interest expense. Financing costs related to the bank term loan and the Senior Notes are recorded as a component of the carrying amount of the related debt and are amortized to income using the effective interest rate method. Financing costs related to equity issues are accounted for as a reduction of capital stock.

Stock-based compensation plans

The Predecessor had three stock-based compensation plans as described in note 11 to the Predecessor's 2006 Consolidated Financial Statements. The Predecessor accounted for its grants under those plans in accordance with the fair value based method of accounting for stock-based compensation. As a result of the Transaction, all stock-based compensation awards vested and were settled and the plans were cancelled.

Impairment of long-lived assets

On an annual basis, the Company reviews whether there are any indicators of impairment of its long-lived assets. If such indicators are present, the Company assesses the recoverability of the long-lived assets or group of assets by determining whether the carrying value of such assets can be recovered through undiscounted future cash flows. If the sum of undiscounted future cash flows is less than the carrying amount, the excess of the carrying amount over the estimated fair value, based on discounted future cash flows, is recorded as a charge to net income.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the years. In addition to items discussed elsewhere, significant items subject to such estimates and assumptions include the carrying amount of property, plant and equipment; measurement of inventories; the tax benefits related to scientific research and experimental development claims; valuation allowances for receivables and future income taxes; and assets and obligations related to employee future benefits. Actual results could differ from those estimates.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

Asset retirement obligations

The Company recognizes the fair value of a future asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that results from the acquisition, construction, development, and/or normal use of the assets. The Company concurrently recognizes a corresponding increase in the carrying amount of the related long-lived asset that is amortized over the life of the asset. The fair value of the asset retirement obligation is estimated using the expected cash flow approach that reflects a range of possible outcomes discounted at a credit-adjusted risk-free interest rate. Subsequent to the initial measurement, the asset retirement obligation is adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. Changes in the obligation due to the passage of time are recognized in income as an operating expense using the interest method. Changes in the obligation due to changes in estimated cash flows are recognized as an adjustment of the carrying amount of the related long-lived asset that is amortized over the remaining life of the asset.

Comparative figures

Certain items in the Predecessor's prior years' consolidated financial statements have been reclassified from statements previously presented to conform to the presentation adopted in the current year.

Impact of New Accounting Pronouncements on Future Reporting Periods

In December 2006, the CICA issued three new accounting standards: Section 1535, "Capital Disclosures", Section 3862, "Financial Instruments Disclosure" and Section 3863, "Financial Instruments Presentation".

Section 1535 establishes guidelines for the disclosure of information regarding a business' capital and how it is managed. The standard requires enhanced disclosures with respect to (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; and (iii) whether the entity has complied with any capital requirements, and if it has not complied, the consequences of such non-compliance.

Section 3862 and Section 3863 replace Section 3861, "Financial Instruments – Disclosure and Presentation". Section 3862 requires increased disclosures regarding the risks associated with financial instruments such as credit risk, liquidity risk and market risks and the techniques used to identify, monitor and manage these risks. Section 3863 carries forward standards for presentation of financial instruments and non-financial derivatives and provides additional guidance for the classification of financial instruments, from the perspective of the issuer, between liabilities and equity.

These standards are effective for fiscal years beginning on or after October 1, 2007 and therefore the Company will implement them in the first quarter of 2008.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(continued)*

The new Section 3031, "Inventories", was issued in June 2007 and will replace existing Section 3030 of the same title. It provides guidance with respect to the determination of cost and requires inventories to be measured at the lower of cost and net realizable value. The cost of inventories includes the costs to purchase and other costs incurred in bringing the inventories to their present location. Costs such as storage costs and administrative overheads that do not contribute to bringing the inventories to their present location and condition are specifically excluded from the cost of inventories and expensed in the period incurred. Reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of the inventories is now required. The cost of the inventories should be based on a first-in, first-out or a weighted average cost formula. Techniques used for the measurement of cost of inventories, such as the retail method, may be used for convenience if the results approximate cost. The new standard also requires additional disclosures including the accounting policies used in measuring inventories, the carrying amount of the inventories, amounts recognized as expense during the period, write-downs and the amount of any reversal of any reversal of write-downs recognized as a reduction in expenses.

The standard is effective for fiscal years beginning on or after January 1, 2008. The difference in the measurement of opening inventory may be applied to the opening inventory for the period, with an adjustment to opening retained earnings with no prior periods restated, or retrospectively with a restatement to prior periods in accordance with Section 1506, "Accounting Changes".

The standard is applicable to the Company for the first quarter of 2008. The Company is currently assessing the implications of this standard to identify differences between the current accounting and the new guidance in the standard. It is likely that the carrying amounts of inventories will increase as a result of adopting Section 3031 since amortization of property, plant and equipment is currently not included in production overheads allocated to inventory cost. In addition, the Company is reviewing the additional presentation and disclosure requirements which will be required in the consolidated financial statements and in the accompanying notes.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

4. ACQUISITION OF THE COMPANY

The Company accounted for the Transaction as a business combination using the purchase method. All consideration for shares and other equity instruments was paid in cash. The following table summarizes the fair value of the assets acquired and liabilities assumed at the date of acquisition:

	Acquisition of Predecessor
Current assets, including acquired cash of \$41.2	\$ 895.6
Current future income taxes	3.5
Property, plant and equipment	1,847.6
Intangible assets:	
Customer asset	99.6
Technology	10.4
In-process research and development	4.5
Supply agreements	76.7
Order backlogs	7.2
	<u>198.4</u>
Total assets acquired	<u>2,945.1</u>
Current liabilities assumed	(206.2)
Pension and other post-employment benefits	(500.0)
Other long-term liabilities	(7.3)
Long-term future income taxes	(393.2)
Total liabilities assumed	<u>(1,106.7)</u>
Net assets acquired	<u><u>\$1,838.4</u></u>

The total cost of the acquisition was \$1,838.4 million, including amounts paid or payable to shareholders and holders of stock options and other equity-based awards of \$1,827.0 million and acquisition costs of \$11.4 million. At the closing of the Transaction, a shareholder of the Predecessor, holding approximately 2.3 million common shares, exercised their dissent rights in opposition to the Transaction. As a result, an amount due to this shareholder pursuant to the Transaction totalling approximately \$130.8 million was not distributed at close. In July 2007, the shareholder withdrew their dissent and accordingly, the Company paid the amount outstanding related to the Transaction.

To fund the Transaction, the Successor entered into various debt facilities as described in notes 9 and 10. The total amount drawn on the long-term debt facilities at the close of the Transaction consisted of \$482.75 million (U.S. \$450 million) on the bank term loan facility and \$482.75 million (U.S. \$450 million) from Senior Subordinated Notes, less total related financing costs of \$26.4 million. Drawings on the Revolving Credit Agreement of \$82.8 million less related financing costs of \$4.7 million, cash from equity financing of \$531.8 million and \$142.1 million from short-term investments of the Predecessor were also used to fund the Transaction.

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

4. ACQUISITION OF THE COMPANY *(continued)*

Prior to the Acquisition, Algoma Acquisition Corp. entered into foreign exchange forward and option contracts to purchase Canadian dollars with U.S. dollars in order to manage the currency exchange risk associated with funding the Canadian dollar purchase price with U.S. dollars. These contracts were not accounted for as hedges and, for the period April 12 to June 30, 2007, the Successor recorded a gain of \$17.0 million on settlement and related premium expense of \$9.8 million on these foreign exchange option and forward contracts.

5. INVENTORIES

	Successor December 31 2007	Predecessor December 31 2006
Raw materials and supplies	\$ 161.8	\$ 202.9
Work in process	76.6	136.1
Finished products	79.6	81.4
	\$ 318.0	\$ 420.4

6. PROPERTY, PLANT AND EQUIPMENT

	Successor December 31, 2007			Predecessor December 31, 2006		
	Cost	Accumulated Amortization	Net book Value	Cost	Accumulated Amortization	Net book Value
Land	\$ 20.1	\$ -	\$ 20.1	\$ 2.5	\$ -	\$ 2.5
Buildings	190.9	11.2	179.7	15.5	3.5	12.0
Machinery and equipment	1,607.1	74.8	1,532.3	805.8	231.0	574.8
Computer hardware & software	43.3	4.2	39.1	6.4	1.3	5.1
Mill rolls	23.9	4.1	19.8	33.6	12.6	21.0
Construction in progress	32.9	-	32.9	33.4	-	33.4
	\$1,918.2	\$ 94.3	\$1,823.9	\$ 897.2	\$ 248.4	\$ 648.8

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

7. INTANGIBLE ASSETS

	Successor December 31, 2007			Predecessor December 31, 2006
	Cost	Accumulated Amortization	Net book Value	Net book Value
Customer relationships	\$ 99.6	\$ 4.0	\$ 95.6	\$ -
Technology	10.4	0.6	9.8	-
In-process research and development	4.5	0.3	4.2	-
Supply agreements	20.1	5.4	14.7	-
Order backlogs	7.2	7.2	-	-
	\$141.8	\$ 17.5	\$124.3	\$ -

8. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

	Successor December 31 2007	Predecessor December 31 2006
Trade payables	\$ 71.6	\$ 55.6
Accrued liabilities	39.9	37.9
Wages and employee deductions payable	19.3	26.1
Accrued vacation pay	30.8	28.9
	\$ 161.6	\$ 148.5

9. BANKING FACILITIES

In order to facilitate the Transaction and refinance the Company, on June 20, 2007, the Successor entered into a five-year Revolving Credit Agreement (“Agreement”). The Agreement provides the Company with a revolving credit facility (“Revolving Facility”) equal to the lesser of U.S. \$425 million and a borrowing base determined by the levels of the Company’s accounts receivable and inventories, less certain reserves. The Revolving Facility is secured by substantially all of the Company’s assets. Under the General Security Agreement, the Revolving Facility has priority claim on the accounts receivable and inventory of the Company, while the bank term loan has priority claim on the rest of the Company’s assets.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

9. BANKING FACILITIES (continued)

Borrowings can be made in either Canadian or United States funds. Canadian borrowings bear interest at either the Canadian bankers' acceptance rate plus a margin of 1.25% – 2.0% or Canadian prime rate plus a margin of 0.25% – 1.0%. United States borrowings bear interest at either London Inter-Bank Overnight Rate ("LIBOR") plus a margin of 1.25% – 2.0%, or the lender's corporate base rate plus a margin of 0.25% – 1.0%. The applicable margin is dependent on the average excess availability under the Revolving Facility for the preceding fiscal quarter.

The Revolving Facility also provides for payment to the lenders of an unused line fee on the average daily excess availability of 0.25% per annum, a commitment fee of 0.25% of the full amount of the Revolving Facility, a funding fee of 0.75% of the full amount of the Revolving Facility and a letter of credit fee ranging from 1.25% to 2.00%, depending on the average excess availability under the Revolving Facility. Fees totaling \$4.7 million were incurred to establish the Revolving Facility and are being amortized to expense over its five year term.

At December 31, 2007, there was \$220.5 million outstanding under the Revolving Facility and \$116.3 million of unused availability after taking into account \$27.3 million of outstanding letters of credit. In addition, the Company had \$15.9 million of unrestricted cash at December 31, 2007.

Under the terms of the Agreement, the Company is required to be in compliance with various restrictive covenants, including a maximum leverage ratio and a minimum interest coverage ratio. In addition, the facilities contain certain restrictive covenants which, among other things, limit the incurrence of additional indebtedness, limit investments, capital expenditures and dividends and restrict transactions with affiliates, permitted acquisitions, asset sales, liens and encumbrances and other matters customarily restricted in such agreements. The Company anticipates that it will remain in compliance with its debt covenants and terms of its lending agreements throughout 2008. However, changes in market conditions or costs of raw materials which are outside of our control can influence the Company's results and may impact the Company's ability to comply with the debt covenants.

10. LONG-TERM DEBT

	Successor December 31 2007	Predecessor December 31 2006
Bank term loan denominated in U.S. dollars, bearing interest at LIBOR plus 2.5% or the lender's corporate base rate plus 1.5%, due June 15, 2013	\$ 316.1	\$ -
Senior Subordinated Notes denominated in U.S. dollars, bearing interest at 9.875%, due June 15, 2015	450.6	-
	766.7	-
Less unamortized financing costs	24.6	-
	742.1	-
Less current portion	1.6	-
	\$ 740.5	\$ -

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

10. LONG-TERM DEBT *(continued)*

The aggregate amount of principal repayments in each of the next five years and thereafter at current exchange rates is as follows:

2008	1.6
2009	3.2
2010	3.2
2011	3.2
2012	3.2
Thereafter	752.3
	<u>\$ 766.7</u>

On December 28, 2007 the Company made a payment on the term loan of U.S. \$130.0 million. The term loan has a remaining principal amount of U.S. \$318.9 million (CDN \$316.1 million), is secured by substantially all of the Company's assets and is subject to various restrictive covenants, including a maximum leverage ratio and a minimum interest coverage ratio. It is repayable in quarterly payments of U.S. \$0.8 million beginning September 30, 2008, with the balance of U.S. \$303.6 million due at maturity.

Financing costs related to the bank term loan and the Senior Subordinated Notes (the "Notes") totaled \$26.4 million and are recorded as a component of the carrying amount of the related debt and are amortized to income using the effective interest rate method. The unamortized balance at December 31, 2007 was \$24.6 million.

The U.S. \$450 million Senior Subordinated Notes are unsecured and are subordinated in right of payment to all existing and future secured indebtedness of the Company to the extent of the assets securing such indebtedness.

Subject to certain conditions, at any time prior to June 15, 2010, the Company may redeem up to 35% of the principal amount of the Notes at a redemption price of 109.875% of the principal amount plus accrued and unpaid interest with the proceeds of a public equity offering. At any time prior to June 15, 2011, the Company may also redeem all or a part of the Notes at a redemption price equal to 100% of the principal amount of Notes redeemed plus accrued and unpaid interest and a specified premium. On or after June 15, 2011, the Company may redeem all or a part of the Notes at the following redemption prices, plus accrued and unpaid interest:

2011	104.938%
2012	102.469%
2013	100.000%

Under Canadian generally accepted accounting principles, the prepayment options in the Notes are required to be accounted for as embedded call option derivative instruments which require bifurcation and are accounted for at fair value. The embedded call options were included in the carrying amount of the Notes and had an estimated fair value of \$4.9 million on issuance of the Notes and have an estimated fair value of \$nil at December 31, 2007.

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

11. PENSION BENEFITS**Defined contribution pension plan**

The Company initiated a defined contribution plan in 2004 for non-unionized employees joining the Company after January 1, 2003. Under the plan, the Company provides a base contribution of 3% of salary and also matches employee contributions to a maximum of 4%, depending on years of service. The pension expense under this plan is equal to the Company's contribution. The 2007 pension expense was \$0.2 million (Predecessor 2006 – \$0.2 million).

Defined benefit pension plans

The Company maintains non-contributory defined benefit pension plans that cover substantially all employees (including pensioners retiring after January 1, 2002, which is the date that the Ontario Pension Benefit Guarantee Fund assumed some of the assets and obligations of the pension plans). The Benefits are based on years of service and average earnings for a defined period prior to retirement.

The Company also maintains a closed plan for pensioners who retired prior to January 1, 2002. This plan provides the pensioners with a pension benefit in excess of the limits provided by the Ontario Pension Benefit Guarantee Fund.

Components of net periodic pension cost

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Current service cost	\$ 12.7	\$ 12.2	\$ 24.0
Interest cost	26.4	20.5	42.6
Actual loss (return) on plan assets	3.5	15.4	(69.0)
Actuarial loss (gain) on benefit obligation	22.1	(67.7)	28.2
Plan amendments, past service	64.1	1.5	-
Costs arising in the period	<u>128.8</u>	<u>(18.1)</u>	<u>25.8</u>
Differences between costs arising in the period and costs recognized in the period in respect of:			
Return on plan assets	(29.5)	(37.6)	30.2
Actuarial (loss) gain	(22.1)	71.3	(18.6)
Plan amendments/prior service costs	(56.7)	5.9	15.6
Net periodic pension cost	<u><u>\$ 20.5</u></u>	<u><u>\$ 21.5</u></u>	<u><u>\$ 53.0</u></u>

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

11. PENSION BENEFITS *(continued)***Changes in accrued benefit obligation**

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Accrued benefit obligation at beginning of measurement period	\$ 823.0	\$ 873.9	\$ 808.1
Current service cost	12.7	12.2	24.0
Interest cost	26.4	20.5	42.6
Actuarial loss (gain)	(22.1)	(67.7)	28.2
Benefits paid	(13.7)	(17.4)	(29.0)
Plan amendments	64.1	1.5	-
Accrued benefit obligation at end of measurement period	\$ 890.4	\$ 823.0	\$ 873.9

During July 2007, the Company negotiated a new three year collective bargaining agreement with its trade unions. Under the new agreement the Company agreed to pension plan amendments which resulted in an increase of \$64.1 million in actuarially estimated pension obligations related to past service. These costs are being amortized over the three year collective agreement term.

Change in defined benefit pension plan assets

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Market value at beginning of measurement period	\$ 713.7	\$ 625.4	\$ 521.3
Actual return on plan assets	(3.5)	15.4	69.0
Employer contributions	0.2	90.3	64.1
Benefits paid	(13.7)	(17.4)	(29.0)
Market value at end of measurement period	\$ 696.7	\$ 713.7	\$ 625.4

The assets of the pension plans are held by an independent trustee. Based on their fair value at November 30, 2007, the plan assets were comprised of 22% Canadian equity, 29% global equity, 48% bonds and 1% other.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

11. PENSION BENEFITS (continued)

Reconciliation of funded status

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Funded status (deficit) at measurement date	\$ (193.7)	\$ (109.3)	\$ (248.5)
Unamortized actuarial loss	7.2	106.1	170.6
Employer contributions after measurement date:			
Regular funding	-	-	5.0
Prepayment	-	-	85.0
Unamortized past service costs	56.9	4.6	10.5
Accrued pension asset (liability)	\$ (129.6)	\$ 1.4	\$ 22.6

Composition of accrued pension asset (liability) on consolidated balance sheets

	Successor December 31 2007	Predecessor December 31 2006
Current portion	\$ (18.4)	\$ -
Accrued pension asset	-	91.7
Accrued pension liability	(111.2)	(69.1)
	\$ (129.6)	\$ 22.6

The significant weighted-average assumptions are as follows:

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Accrued benefit obligation:			
Discount rate	5.72%	5.63%	4.97%
Rate of compensation increase	4.00%	4.00%	4.00%
Net periodic pension costs:			
Discount rate	5.63%	4.97%	5.21%
Expected long-term rate of return on plan assets	6.89%	6.95%	6.95%
Rate of compensation increase	4.00%	4.00%	4.00%

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

11. PENSION BENEFITS *(continued)***Cash flow information**

Total pension funding during the twelve months ended December 31, 2006 was \$100.6 million, which included \$85 million of pre-funding of the 2007 year's pension contributions. Pension funding in 2007 was \$0.6 million. Contributions to the pension plans for 2007 were based on actuarial valuations at September 1, 2006. Actuarial valuations for funding purposes at August 1, 2007 are currently being completed for all plans.

The actuarially estimated future pension benefit payments to retirees for the next ten years based on the September 1, 2006 valuation are as follows:

2008	41.9
2009	46.8
2010	48.9
2011	51.6
2012	54.2
2013 – 2017	366.2

12. OTHER POST-EMPLOYMENT BENEFITS

The Company offers post-employment life insurance, health care and dental care to some of its retirees. These obligations are not pre-funded.

Components of net periodic post-employment benefit cost

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Current service cost	\$ 2.2	\$ 2.0	\$ 3.8
Interest cost	11.9	9.1	19.4
Actuarial loss (gain)	(4.8)	(7.5)	13.9
Plan amendments	6.0	-	-
Costs arising in the period	<u>15.3</u>	<u>3.6</u>	<u>37.1</u>
Differences between costs arising in the period and costs recognized in the period in respect of:			
Actuarial (loss) gain	4.8	10.8	(7.4)
Plan amendments	(5.4)	0.7	2.0
Net periodic post-employment benefit cost	<u>\$ 14.7</u>	<u>\$ 15.1</u>	<u>\$ 31.7</u>

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

12. OTHER POST-EMPLOYMENT BENEFITS *(continued)***Change in post-employment benefit obligation**

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Benefit obligation at beginning of period	\$ 390.6	\$ 394.5	\$ 373.0
Current service cost	2.2	2.0	3.8
Interest cost	11.9	9.1	19.4
Actuarial loss	(4.8)	(7.5)	13.9
Benefits paid	(6.7)	(7.5)	(15.6)
Plan amendments	6.0	-	-
Benefit obligation at end of period	\$ 399.2	\$ 390.6	\$ 394.5

Reconciliation of funded status

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Funded status at measurement date	\$ (399.2)	\$ (390.6)	\$ (394.5)
Unamortized actuarial loss (gain)	(4.8)	106.7	117.6
Unamortized past service costs	5.4	0.7	1.3
Benefits paid after measurement date	1.1	-	1.1
Accrued post-employment benefit obligation	\$ (397.5)	\$ (283.2)	\$ (274.5)

Allocation of accrued post-employment benefit obligation on consolidated balance sheets

	Successor December 31 2007	Predecessor December 31 2006
Current portion	\$ (17.7)	\$ (16.5)
Accrued post-employment benefit obligation	(379.8)	(258.0)
	\$ (397.5)	\$ (274.5)

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

12. OTHER POST-EMPLOYMENT BENEFITS *(continued)*

The significant weighted-average assumptions are as follows:

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Accrued benefit obligation:			
Discount rate	5.75%	5.65%	5.00%
Rate of compensation increase	4.00%	4.00%	4.00%
Initial health care rate	7.48%	9.41%	6.60%
Ultimate health care rate	5.00%	4.50%	4.50%
Year ultimate rate reached	2019	2015	2013
Net periodic benefit costs:			
Discount rate	5.65%	5.00%	5.25%
Rate of compensation increase	4.00%	4.00%	4.00%
Initial health care rate	9.41%	8.50%	6.90%
Ultimate health care rate	4.50%	4.50%	4.50%
Year ultimate rate reached	2015	2013	2013

Increasing the health care trend by 1% would change the accrued benefit obligation at December 31, 2007 by approximately \$57.9 million and the post-employment benefit cost for the period from June 20, 2007 to December 31, 2007 by approximately \$2.1 million. Decreasing the trend by 1% would change the accrued benefit obligation at December 31, 2007 by approximately \$47.2 million and the post-employment benefit cost for the period from June 20, 2007 to December 31, 2007 by approximately \$1.7 million.

Cash flow information

Payments made for other post-employment benefits were \$14.2 million for the year ended December 31, 2007 (2006 - \$15.6 million), and are on a pay-as-you-go basis.

The actuarially estimated future benefit payments for the next ten years are as follows:

2008	17.7
2009	18.9
2010	20.0
2011	20.9
2012	21.8
2013 – 2017	123.8

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

13. CAPITAL STOCK

Authorized – Unlimited common shares

The following table summarizes the share capital transactions of the Successor since incorporation on April 12, 2007:

	Common shares <u>Issued and Outstanding</u>	
	<u># shares</u>	<u>Stated capital</u>
Common shares issued on incorporation	10,000	\$ -
Common shares issued during the period from April 12 to December 31, 2007	<u>500,000,000</u>	<u>\$ 531.8</u>
Balance at December 31, 2007	<u>500,010,000</u>	<u>\$ 531.8</u>

14. STOCK-BASED COMPENSATION PLANS

The Predecessor had three stock based compensation plans consisting of a share award plan, a stock option plan and restricted share unit plan that were terminated as a result of the Transaction. The Successor does not have any stock based compensation plans.

During the year ended December 31 2006, 7,781 shares of the Predecessor were awarded under the share award plan and there were 413,360 options and 2,500 restricted share units granted. During the period from January 1 to June 19, 2007, 5,807 shares of the Predecessor were awarded under the share award plan and there were no options or restricted share units granted.

The compensation expense recognized for all awards granted under these plans was nil for the period from June 19 to December 31, 2007 and \$7.3 million for the period from January 1 to June 19, 2007 (January 1 to December 31, 2006 - \$3.8 million).

15. PROFIT SHARING PLAN

The Company has a profit sharing plan for substantially all employees. The amount of profit sharing is based on a percentage of annual income from operations adjusted for the effects of the purchase accounting adjustments required under generally accepted accounting principles as a result of the Acquisition, as defined in the Collective Bargaining Agreements as follows:

<u>Annual Income from Operations</u>	<u>Profit Sharing Percentage</u>
\$0 - \$ 50 million	0%
\$50 - \$100 million	6%
\$100 - \$150 million	8%
Greater than \$150 million	10%

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

16. CONTRIBUTED SURPLUS

	Successor December 31 2007	Predecessor December 31 2006
Balance, beginning of year	\$ -	\$ 240.9
Arising from sale of 49.9% interest in AELP (note 23)	45.6	-
Stock-based compensation	-	3.4
Purchase and cancellation of shares	-	(12.3)
Recognition of income tax assets not recognized on implementation of fresh start accounting	-	6.2
Balance, end of year	\$ 45.6	\$ 238.2

17. INCOME TAXES

The provision for (recovery of) income taxes is summarized as follows:

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Current	\$ (18.0)	\$ 29.1	\$ 102.7
Future	(56.6)	(6.6)	4.2
	\$ (74.6)	\$ 22.5	\$ 106.9

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

17. INCOME TAXES (continued)

The composition of the future income tax provision (recovery) is as follows:

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Initiating and reversing temporary differences:			
Accounting reserves	\$ 0.3	\$ 0.7	\$ 1.0
Pension and post-employment benefit expense	(9.2)	(7.2)	8.9
Tax depreciation less than book amortization	(25.7)	(2.3)	(1.4)
Unrealized (realized) foreign exchange gain on \$U.S. debt	11.2	-	(3.5)
Cash payment on stock options and restricted share units	11.2	-	-
Purchase accounting inventory adjustment	(7.8)	-	-
Financing expenses	1.7	-	-
Minimum tax credits	-	-	8.0
Other	(1.8)	-	(1.0)
Realization of fresh start income tax assets not previously recognized:			
Pension and post-employment benefit expense	-	2.2	5.3
Other	-	-	0.9
Benefit of future tax rate reductions enacted during the period	(36.5)	-	(11.6)
	(56.6)	(6.6)	6.6
Decrease in valuation allowance in respect of tax assets arising after implementing fresh start accounting	-	-	(2.4)
	\$ (56.6)	\$ (6.6)	\$ 4.2

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

17. INCOME TAXES (continued)

Effective income tax rate

The following table explains the variation between the Company's provision for income taxes and the statutory income tax rate:

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Income tax provision at the statutory manufacturing and processing rate of 34.1%	\$ (24.5)	\$ 12.7	\$ 112.1
Add (deduct):			
Non-taxable portion of unrealized exchange gains on \$US debt	(11.2)	-	-
Impact of future Federal tax rate reductions	(36.5)	-	(11.6)
Provision for reassessment of prior tax years	-	-	3.5
Change in future tax asset valuation allowance:			
Impact of pension expense	-	-	12.8
Impact of pension funding	-	-	(21.3)
Impact of post-employment expenses	-	5.1	10.9
Other	(2.4)	4.7	0.5
Provision for (recovery of) income taxes	\$ (74.6)	\$ 22.5	\$ 106.9

Components of future income tax assets and liabilities are summarized as follows:

	Successor December 31 2007	Predecessor December 31 2006
Future income tax assets – current Canadian taxes		
Accounting reserves not currently deductible for tax purposes	\$ 0.2	\$ 1.0
Other	0.6	0.7
Total current assets	0.8	1.7
Future income tax liabilities– current Canadian taxes		
Other	(1.2)	(1.0)
Total current liabilities	(1.2)	(1.0)
Net current (liabilities)/assets	\$ (0.4)	\$ 0.7

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

17. INCOME TAXES (continued)

	Successor December 31 2007	Predecessor December 31 2006
Future income tax assets – non-current		
Canadian taxes		
Post-employment benefit obligation	\$ 106.9	\$ 84.8
Pension benefit obligation	34.8	-
Other	8.4	9.3
	<u>150.1</u>	<u>94.1</u>
Valuation allowances	-	(92.8)
Canadian non-current assets, net	<u>150.1</u>	<u>1.3</u>
United States taxes		
Tax loss carry-forwards	18.3	46.9
Valuation allowance	(18.3)	(46.9)
United States non-current assets, net	<u>-</u>	<u>-</u>
Total non-current assets, net	<u>150.1</u>	<u>1.3</u>
Future income tax liabilities – non-current		
Canadian taxes		
Excess of carrying amount of tangible and intangible assets over their tax bases	\$ (458.6)	\$ (123.8)
Unrealized exchange gains on \$US debt	(9.0)	-
Accrued pension asset	-	(7.7)
Total non-current liabilities	<u>(467.6)</u>	<u>(131.5)</u>
Net non-current liabilities	<u>\$ (317.5)</u>	<u>\$ (130.2)</u>

Future income tax assets are recognized to the extent that it is determined to be more likely than not that sufficient taxable income will be available within the carry-forward periods to allow the asset to be realized. The determination is made at the balance sheet date by assessing all positive and negative evidence regarding the future sources of taxable income.

The Company's U.S. subsidiary, Cannelton Iron Ore Company ("Cannelton"), has not engaged in any business activity since the disposition of its joint venture interest (note 18) in 2002. Consequently, a full valuation allowance of \$18.3 million (Predecessor - 2006 - \$46.9 million) has been recorded against its future income tax assets.

Loss carry-forwards

The Company's non-capital losses were reduced by approximately \$179.4 million as a result of debts being discharged under the 2002 financial reorganization for less than their principal amount. The Company utilized the remainder of its non-capital losses in 2005. The foreign exchange effect of the settlement of the \$U.S. First Mortgage Notes under the reorganization resulted in a capital loss of \$42.1 million, of which the remaining \$33.2 million was applied against capital gains realized in 2006.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

17. INCOME TAXES (continued)

The Company's 2002 and 2003 taxation years are presently under audit by the Canada Revenue Agency ("CRA"). An adjustment relating to the discharging of debts under the 2002 financial reorganization has been proposed by the CRA that would reduce the available non-capital losses by \$21.8 million with a corresponding increase in available capital losses. Consequently, the Company has recorded a charge of \$3.5 million to the 2006 tax provision representing the full tax effect of the adjustment. The CRA has completed its review of the Company's assignment of \$160 million as the fair market value of the 16 million common shares issued as consideration in discharging debts under the financial reorganization. The CRA has proposed that the \$160 million be reduced to \$83.2 million and is awaiting the Company's response to their proposal. The Company intends to strongly defend its position with respect to the valuation, however if a reassessment is issued and the Company does not prevail through the objection process, the Company's available non-capital losses upon emergence from CCAA would be reduced by \$76.8 million. This would result in an income tax reassessment and cash taxes payable of approximately \$26.0 million plus applicable interest. The Company believes its valuation is supportable and consequently, no liability has been recorded in the financial statements.

Cannelton has non-capital losses of approximately U.S. \$54.4 million, of which U.S. \$16.1 million expire between 2008 and 2010, U.S. \$1.9 million in 2021 and U.S. \$36.4 million in 2022.

Scientific research and experimental development claims

For the years 2002 to 2007, the Company has filed scientific research and experimental development claims with Canada Revenue Agency (CRA) as follows:

2002	\$53.0 million
2003	\$43.4 million
2004	\$62.8 million
2005	\$68.9 million
2006	\$63.0 million
2007	\$34.5 million

The 2002 claim is currently under audit by CRA and prior to the 2002 claim, the Company had no history of filing claims of comparable size. The potential tax benefit of these claims is 20% of the claims or \$65.1 million. In order to recognize the tax benefit for accounting purposes, there must be reasonable assurance that the benefit will be realized. The claims have not had final audit assessment and CRA has given a preliminary assessment for 2002 that they may reject a significant portion of the amount claimed. The Company has recognized the portion of the related tax benefit that management believes meets the threshold of "reasonable assurance" of realization. The total tax benefit recognized to date is \$21.9 million, of which \$4.6 million recognized by the Predecessor in the period from January 1, 2007 to June 19, 2007 as a reduction of cost of sales, and \$6.2 million was recognized by the successor in the period from June 20, 2007 to December 31, 2007. The determination of the amount of tax benefit to recognize requires judgement, and is subject to change based on CRA's audit of the claims which would result in adjustments to earnings.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

18. CONTINGENCIES AND COMMITMENTS

Under operating leases for premises and equipment, the Company is obligated to make aggregate payments of \$9.8 million, comprised of \$4.2 million in 2008, \$2.6 million in 2009 and \$3.0 million in subsequent years.

In January 2002, the Company's wholly-owned U.S. subsidiary, Cannelton, completed an agreement with Cleveland-Cliffs Inc. ("Cliffs") to transfer Cannelton's 45% interest in the Tilden Mining Company L.C. ("Tilden") in exchange for the assumption by Cliffs of Cannelton's share of Tilden's liabilities and no cash consideration. As part of this arrangement, the Company entered into an exclusive 15-year supply agreement with Cliffs for a minimum annual supply of 2.5 million tons of iron ore at market prices. If the Company defaults under the supply agreement prior to December 31, 2008, then 50% of the liabilities assumed by Cliffs will revert back to Cannelton and the Company. These assumed liabilities could include contingent obligations, such as environmental costs, that are not reflected in Tilden's financial statements.

The Company has 9 years remaining with this agreement and the purchase commitment for 2008 is approximately U.S. \$243.0 million. Under the terms of the agreement, until December 31, 2007 the Company paid for its annual purchases evenly throughout the year which, at any given time, could result in prepayments. At December 31, 2007, \$15.8 million (U.S. \$15.7 million) is included in prepaid expenses in this respect (December 31, 2006 - \$14.8 million (U.S. \$12.6 million)). Effective January 1, 2008, the contract requires that the Company make bi-weekly payments based on iron ore deliveries in the previous week and an estimate of iron ore deliveries in the following week.

The Company has agreements to source coal requirements until March 31, 2009 at fixed prices. The purchase commitment for 2008 under these agreements is approximately \$150.7 million (U.S. \$152.0 million).

The Company has 7-1/2 years remaining in a contract with a single supplier for the purchase of oxygen, argon and nitrogen. The annual purchases under this contract approximate \$10.8 million.

The Company is committed to purchase approximately 7.5 million MMBtus of natural gas at fixed prices in 2008 for approximately \$57.3 million (U.S. \$57.8 million).

Contractual commitments at December 31, 2007 amounted to \$29.2 million relating to authorized capital projects.

AELP contractual commitments at December 31, 2007 amount to \$42.9 million comprised of \$41.2 million in 2008 and \$1.7 million in 2009.

The Company has committed to make environmental expenditures during the period 2008 to 2015 in the amount of \$42.5 million. The actual cost of the equipment and its installation could vary significantly due to cost escalation, design changes, regulatory policies, or other factors.

From time to time, in the ordinary course of business, the Company is a defendant or party to a number of pending or threatened legal actions and proceedings. In addition, the Company is involved in and potentially subject to regular audits from federal and provincial tax authorities relating to income, capital and commodity taxes and as a result of these audits, may receive assessments and reassessments. Although such matters cannot be predicted with certainty, management currently considers the Company's exposure to such claims and litigation, to the extent not covered by the Company's insurance policies or otherwise provided for, not to have a material adverse effect on these consolidated financial statements.

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

19. SEGMENTED INFORMATION

The Company is viewed as a single business segment involving basic steel production for purposes of internal performance measurement and resource allocation. The revenue by product group is as follows:

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Sheet and strip	\$ 543.3	\$ 586.5	\$ 1,269.3
Plate	275.0	260.0	541.8
Freight	52.4	49.4	85.3
Non-steel sales	63.0	15.5	43.3
	<u>\$ 933.7</u>	<u>\$ 911.4</u>	<u>\$ 1,939.7</u>

Sales to customers in the United States were \$735.7 million for the year 2007 and \$634.8 million for the year 2006. Export sales to other countries for the year 2007 were \$54.0 million and for the year 2006 were \$43.3 million.

For the year 2007, no single customer represented greater than 10% of total sales. For the year 2006, one customer represented 11% of total sales.

At December 31, 2007, one customer represented 11% of the accounts receivable balance and at December 31, 2006, one customer represented 11% of the accounts receivable balance.

20. CHANGES IN NON-CASH OPERATING WORKING CAPITAL

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Accounts receivable	\$ (8.3)	\$ (11.4)	\$ 40.2
Inventories	113.9	11.5	(98.9)
Prepaid expenses	33.3	(31.1)	(1.1)
Accounts payable and accrued liabilities	(45.1)	59.2	(5.1)
Income and other taxes payable / receivable	(30.9)	(60.9)	1.4
	<u>\$ 62.9</u>	<u>\$ (32.7)</u>	<u>\$ (63.5)</u>

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

21. OTHER LONG-TERM LIABILITIES

	Successor December 31 2007	Predecessor December 31 2006
Environmental remediation liabilities (a)	\$ 7.4	\$ 7.4
Long-term lease obligation	1.2	0.3
	\$ 8.6	\$ 7.7

(a) This liability represents the Company's obligations associated with the Predecessor's former iron ore mine in Wawa, Ontario. At December 31, 2007, this liability has been determined based on the Company's best estimate of the costs to be incurred, discounted at risk-free rates. It is expected that the costs related to this remediation will be incurred between 2008 and 2028. Changes in future conditions could require a change in this liability.

22. TRANSACTION RELATED EXPENSES

Transaction related expenses were incurred as follows:

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Professional and advisory fees of Predecessor	\$ -	\$ 9.1	\$ -
Employment contract severance expense	-	6.7	-
Recognition of outstanding stock-based compensation expense	-	5.4	-
Bridge loan fees	2.4	-	-
	\$ 2.4	\$ 21.2	\$ -

The Predecessor incurred \$9.1 million in Transaction fees, including legal, accounting, advisory fees and other costs related to the Transaction, which were not eligible to be capitalized and are included in Transaction related expenses for the Predecessor period January 1, 2007 to June 19, 2007. In addition, the Predecessor incurred \$6.7 million in severance costs related to the termination of employment contracts that existed with the Predecessor.

Included in Transaction related expenses for the Predecessor period January 1, 2007 to June 19, 2007 was \$5.4 million in costs related to settlement of stock-based compensation plans. As a result of the Transaction, the vesting of these stock-based instruments was accelerated, and previously unrecognized compensation expense related to these instruments was recorded at the closing of the Transaction.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

23. RELATED PARTY TRANSACTIONS

The Company's major shareholder, Essar, and its commonly controlled affiliates are related parties.

Prior to the Acquisition, the Successor entered into foreign exchange forward and option contracts to purchase Canadian dollars with U.S. dollars as disclosed in note 4. The cost of these contracts was paid by Essar, resulting in a payable to Essar by the Company of \$8.2 million at December 31, 2007. This balance was reduced throughout the year by \$0.2 million for services provided by the Company on behalf of Essar and expenses incurred by the Company on behalf of Essar which are recorded at the exchange amounts. This liability is unsecured and non-interest bearing with no specific repayment terms.

On December 28, 2007, one of Essar's affiliates purchased 49.9% of the Company's interest in AELP for consideration of \$82.8 million. The affiliate also provided the Company an irrevocable deposit of \$44.1 million for the potential future purchase of the remaining 50.1% of AELP.

Net assets of AELP at the date of the transaction (in \$ millions):

Proceeds of the sale	\$ 82.8
Net assets of AELP at the date of the transaction:	
Other receivables	0.4
Construction in progress, including capitalized interest of \$0.7	32.4
Intangible asset – customer contract	56.6
Accounts payable and accrued liabilities	(8.5)
Future tax	(4.2)
	<u>\$ 76.7</u>
Portion sold	<u>49.9%</u>
Non-controlling interest	<u>\$ 38.3</u>
Excess of proceeds over carrying amount	<u>\$ 44.5</u>
Current and future tax effects of the transaction	1.1
Amount recorded in contributed surplus	<u><u>\$ 45.6</u></u>

The related party transaction has been accounted for at the carrying amount and the excess of the \$82.8 million consideration paid over the 49.9% share of net assets of AELP has been recorded as contributed surplus. The income tax effects arising from the transaction have also been recorded as a capital transaction consisting of \$9.9 million on the taxable capital gain, offset by future income tax reductions of \$11.0 million.

In addition, the affiliate has paid the Company an irrevocable cash deposit of \$44.1 million for the potential purchase of the remaining 50.1% of AELP, which is conditional on the approval of AELP's customer and the Company's lenders.

The assets and liabilities of AELP are shown as held for sale in the consolidated balance sheet and the 49.9% interest is shown as non-controlling interest of \$38.3 million.

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

SIGNIFICANT DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

The Company's consolidated financial statements are prepared in accordance with Canadian GAAP which differs in certain respects from United States GAAP ("U.S. GAAP"). Following is a summary of the effect of significant differences in GAAP on the Company's consolidated financial statements.

	Successor April 12 to December 31 2007	Predecessor January 1 to June 19 2007	Predecessor January 1 to December 31 2006
Net income in accordance with Canadian and U.S. GAAP	\$ 2.7	\$ 14.8	\$ 221.8
Change in fair value of swap contracts	-	-	(1.1)
Change in minimum pension liability	-	-	4.7
FAS 158 adjustment	(47.4)	-	-
Comprehensive income (loss) in accordance with U.S. GAAP	\$ (44.7)	\$ 14.8	\$ 225.4

As a result of the reconciliation between Canadian and U.S. GAAP and additional disclosure requirements under U.S. GAAP, the changes to the consolidated balance sheets are as follows:

	Successor December 31 2007	Predecessor December 31 2006
Accrued pension asset		
Balance under Canadian GAAP	\$ -	\$ 22.6
FAS 158 adjustment	-	(22.6)
Balance under U.S. GAAP	\$ -	\$ -
Deferred pension costs		
Balance under Canadian GAAP	\$ -	\$ -
Deferred past service cost	-	10.5
FAS 158 adjustment	-	(10.5)
Balance under U.S. GAAP	\$ -	\$ -
Accrued pension liability, long-term portion		
Balance under Canadian GAAP	\$ 111.2	\$ -
Additional minimum pension liability	-	109.0
FAS 158 adjustment	64.4	49.5
Balance under U.S. GAAP	175.6	\$ 158.5

ALGOMA STEEL INC.**Notes to consolidated financial statements**

Expressed in millions of Canadian dollars, except as noted

24. SIGNIFICANT DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) (continued)

Accrued post-employment benefit obligation, long-term portion		
Balance under Canadian GAAP	\$ 379.8	\$ 258.0
FAS 158 adjustment	0.6	118.8
Balance under U.S. GAAP	<u>\$ 380.4</u>	<u>\$ 376.8</u>
Future income tax liability, long-term		
Balance under Canadian GAAP	\$ 317.5	\$ 130.2
Tax effect of additional minimum pension liability	-	(39.4)
Tax effect of FAS 158 adjustment	(17.6)	(58.1)
Balance under U.S. GAAP	<u>\$ 299.9</u>	<u>\$ 32.7</u>
Accumulated other comprehensive loss		
Balance under Canadian GAAP	\$ -	\$ -
Minimum pension liability adjustment, net of tax	-	(81.7)
FAS 158 adjustment, net of tax of \$17.6	(47.4)	(120.7)
Balance under U.S. GAAP	<u>(47.4)</u>	<u>\$(202.4)</u>

a) Pension and other post employment benefit plans:

Prior to December 15, 2006, an additional minimum pension liability (AML) was reported under U. S. GAAP when the accrued benefit liability in the consolidated balance sheet was less than the deficit represented by the excess of the accumulated benefit obligation over the market value of the assets. An intangible asset was recorded up to the amount of any unrecognized past service costs with any remaining amount being charged to comprehensive income.

Effective December 15, 2006, the Company adopted SFAS No. 158, "Employers' Accounting for Defined Benefit and Other Postretirement Plans" (FAS 158). Under FAS 158, the Company is required to recognize the funded status of the defined benefit pension plans and other post-employment plans on the balance sheet with changes recorded in other comprehensive income.

The following additional disclosure is required under U.S. GAAP:

- The Accumulated Benefit Obligation at December 31, 2007 was \$850.8 million (December 31, 2006 – \$824.4 million)
- The expected return on assets represents management's best estimate of the long-term rate of return on plan assets applied to the fair value of the plan assets. The Company establishes its estimate of the expected rate of return on plan assets based on the fund's target asset allocation and estimated rate of return for each asset class.
- The Company's investment strategy provides that 45-55% of assets are to be invested in long-term bonds and 45-55% are to be invested in equities, of which 15-25% are to be invested in Canadian equities and 25-35% in Global equities.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

24. SIGNIFICANT DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) (continued)

- The discount rate is selected based on the returns of AA corporate bonds that are similar in duration to the plan liabilities.

b) Derivative instruments:

U.S. Accounting Standards SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities – An Amendment of SFAS 133" require that all derivative instruments be reported on the balance sheet at fair value and establishes criteria for designation and effectiveness of hedging relationships.

The Company periodically utilizes commodity price swap contracts to hedge the cost of natural gas and beginning in 2006, started to use steel swaps to hedge a portion of future spot steel sales. At December 31, 2006, the aggregate notional amount of the natural gas swaps outstanding was approximately 1.2 million MMBtus (December 31, 2005 – nil) expiring at various dates through to July 31, 2007. The Company pays a fixed average price of approximately \$7.44 per MMBtu and receives a floating average price per MMBtu based on the settlement price per MMBtu for the NYMEX Henry Hub Natural Gas futures contract. The fair value of the natural gas swap agreements is a cost to the Company. Fair value has been estimated using quoted market rates for the same or similar instruments. Under Canadian GAAP, in 2006, these instruments were accounted for as off balance sheet hedges and the fair value liability of \$1.1 million was not accrued in the accounts. Under U.S. GAAP the fair value of these agreements would be recorded on the balance sheet and the change in fair value related to the effective portion of the hedge relationship would be recorded in comprehensive income.

On January 1, 2007, the Predecessor retroactively adopted, without restatement of prior periods, CICA Handbook Section 1530, "Comprehensive Income", Section 3251, "Equity", Section 3861, "Financial Instruments – Disclosure and Presentation", "Section 3855, "Financial Instruments – Recognition and Measurement", and Section 3865, "Hedges". The adoption of these accounting standards eliminated this difference with U.S. GAAP for the 2007 year.

c) Accounts receivable:

The accounts receivable balance at December 31, 2007 includes a \$2.8 million allowance for doubtful accounts (December 31, 2006 - \$2.0 million).

d) Consolidated statements of cash flows:

Canadian GAAP permits the presentation of a subtotal of the amount of funds provided by operating activities before changes in non-cash operating working capital in the consolidated statements of cash flows. U.S. GAAP does not permit this subtotal to be reported on the statement of cash flows.

e) Collective bargaining agreements:

Approximately 96% of the Company's employees are covered by collective bargaining agreements. The August 1, 2007 collective bargaining agreements expire on July 31, 2010.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

24. SIGNIFICANT DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) (continued)

Recent United States accounting pronouncements:

FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes"

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes". FIN 48 also prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of tax positions taken or expected to be taken on a tax return and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Upon adopting the provisions of FIN 48 on January 1, 2007 the total amount of unrecognized tax benefits was \$11.1 million. As of the date of adoption, the amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$8.1 million. At December 31, 2007 the amount of unrecognized tax benefits and the amount that would affect the effective tax rate if recognized had increased to \$46.2 million and \$43.2 million, respectively, due to additional investment tax credits ("ITC's") on qualified scientific research and experimental development ("SR&ED") expenditures.

For the years 2002 to 2007 the Company has filed, or intends to file, SR&ED claims of \$325.6 million which have potential tax benefits of \$65.1 million. The Company has only reflected a benefit of \$21.9 million in its financial statements resulting in an unrecognized tax benefit of \$43.2 million. The claim made for 2002 is presently under review by the Canadian tax authorities and the final outcome of the CRA audit process is uncertain at this time. It is reasonably possible that the final assessments for 2002 and from audits of subsequent years will differ significantly from the Company's tax position taken with respect to ITC's in respect of qualified SR&ED expenditures.

The Company's non-capital losses were reduced by approximately \$179.4 million as a result of debts being discharged under the 2002 financial reorganization for less than their principal amount. The Company utilized the remainder of its non-capital losses in 2005. The foreign exchange effect of the settlement of the U.S. First Mortgage Notes under the reorganization resulted in a capital loss of \$42.1 million, of which the remaining \$33.2 million was applied against capital gains realized in 2006 (2005 - CDN \$1.0 million was applied, 2004 - CDN \$7.8 million was applied). A future income tax asset of \$5.2 (CDN \$6.0) million was recognized at December 31, 2005 in respect of these capital losses.

The Company's 2002 and 2003 taxation years are presently under audit by the Canada Revenue Agency ("CRA"). An adjustment relating to the discharging of debts under the 2002 financial reorganization has been proposed by the CRA that would reduce the available non-capital losses by \$21.8 million with a corresponding increase in available capital losses. Consequently, the Company has recorded a charge of \$3.5 million to the 2006 tax provision representing the full tax effect of the adjustment. The CRA is also reviewing the Company's assignment of CDN \$160 million as the fair market value of the 16 million common shares issued as consideration in discharging debts under the financial reorganization.

The Company is defending its position with respect to the valuation, however if a reassessment is issued and the Company does not prevail through the objection process, the Company's available non-capital losses upon emergence from CCAA would be reduced by the amount of any downward adjustment to the valuation. Each \$10 million reduction in the valuation of the common shares would result in an income tax reassessment and cash taxes payable of approximately \$3.4 million plus any applicable interest. The Company believes its valuation is supportable and it is too early to assess the outcome of this issue. Consequently, no liability has been recorded in the financial statements.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except as noted

24. SIGNIFICANT DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) (continued)

The Company's accounting policy under FIN 48 is to recognize interest and penalties accrued related to uncertain tax positions as a component of the income tax provision. A liability has not been recorded for tax penalties.

The Company is subject to taxation by Canada and the provinces of Ontario and Alberta. Tax returns for the year 2002 and forward are open for examination by tax authorities.

EITF 06-03 "How Taxes Collected from Customers and Remitted to Government Authorities should be Presented in the Income Statement"

Effective January 1, 2007, the company adopted EITF 06-03 "How Taxes Collected from Customers and Remitted to Government Authorities should be Presented in the Income Statement". The Company's policy is to record revenues net of such taxes. Adoption of EITF 06-03 had no effect on the consolidated financial statements.

Management's Responsibility for Financial Reporting

The consolidated financial statements of Algoma Steel Inc. ("Algoma") have been prepared in accordance with Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. These statements include certain amounts based on management's estimates and judgements. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. Management has prepared the financial information presented elsewhere in this annual report and has ensured that it is consistent with that in the financial statements.

The integrity and reliability of Algoma's reporting systems are achieved through the use of formal policies and procedures, the careful selection of employees and an appropriate division of responsibilities. These systems are designed to provide reasonable assurance that the financial information is reliable and accurate.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility principally through its Audit Committee. The Audit Committee is appointed by the Board and meets periodically with management and the shareholders' auditors to review significant accounting, reporting and internal control matters. Following its review of the financial statements and discussions with the auditors, the Audit Committee reports to the Board of Directors prior to its approval of the financial statements. The Committee also considers, for review by the Board and approval by the shareholders, the engagement or re-appointment of the external auditors.

The consolidated financial statements have been audited on behalf of the shareholders by KPMG LLP, in accordance with Canadian generally accepted auditing standards.

Denis Turcotte
President and Chief Executive Officer

Daniel Ardila
Vice President, Finance and Chief Financial Officer

Sault Ste. Marie, Ontario
February 28, 2008