

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

1. NATURE OF OPERATIONS

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

2. 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 subsidiaries.

Cash and cash equivalents

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.

Short-term investments

Short-term investments include Canadian dollar bankers' acceptances and commercial paper with remaining maturities greater than 90 days at acquisition. The average effective interest rate of the short-term investments is approximately 4.3% (2005 - 3.3%).

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.

Inventories

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

Property, plant and equipment

Property, plant and equipment purchased prior to January 31, 2002 is recorded at its estimated fair value on January 31, 2002 pursuant to a financial reorganization implemented by the Company on that date. Property, plant and equipment purchased after January 31, 2002 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 the asset is ready for its intended use.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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

Buildings	25 years
Machinery and equipment	5 to 20 years
Computer hardware and software	5 years
Mill rolls	1 to 15 years

Major new facilities are amortized using a unit of production basis until a commercial level of production is reasonably sustained and using the straight-line method thereafter. Capital costs related to extending the useful life of the blast furnace are amortized over its estimated life on a unit of production basis.

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.

Financing costs

Financing costs associated with the Revolving Facility (note 6) are deferred and amortized on a straight-line basis over the term of the facility as a component of interest expense. Financing costs related to equity issues are accounted for as a reduction of capital stock.

Translation of 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.

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. 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

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

members expected to receive the benefits under the plans and over the average remaining life expectancy of 16 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, 2006 was 9 to 10 years (2005 - 10 years). The expected average remaining service period of active members related to the other post-employment benefits at the measurement date of November 30, 2006 was 11 years (2005 - 11 years).

The Company also provides for other post-employment benefits upon retirement for employees and their dependants. The cost of these benefits is accrued over the service lives of the employees based on actuarial estimates.

Earnings per share

Basic earnings per share is determined by dividing net income attributable to common shareholders by the weighted average number of common shares outstanding during the year. Diluted earnings per share is determined by applying the treasury stock method to outstanding stock options and is based on the weighted average number of common shares and dilutive common share equivalents outstanding during the year.

Environmental costs

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

Fair value of financial instruments

The fair value of short-term investments, accounts receivable, accounts payable and accrued liabilities and income and other taxes payable approximates carrying value due to the short-term nature of these instruments.

Derivative financial instruments

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.

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 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.

The Company designates its natural gas swap contracts as hedges of the underlying expense. The related expense is adjusted to include the payments made or received under the swap contracts. Unrealized gains and losses on the swap contracts are

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

not recognized until realized. The Company's steel swap contracts are not accounted for as hedges and are recorded at fair value, which is included in Prepaid Expenses on the Consolidated Balance Sheet and Other Income on the Consolidated Statement of Income and Retained Earnings.

Stock-based compensation plans

At December 31, 2006, the Company has three stock-based compensation plans as described in note 11. The Company accounts for its grants under those plans in accordance with the fair value based method of accounting for stock-based compensation.

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.

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

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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

3. INVENTORIES

	2006	2005
Raw materials and supplies	\$ 202.9	\$ 156.8
Work in process	136.1	68.4
Finished products	<u>81.4</u>	<u>96.3</u>
	<u>\$ 420.4</u>	<u>\$ 321.5</u>

4. PROPERTY, PLANT AND EQUIPMENT

	2006			2005		
	Cost	Accumulated Amortization	Net book Value	Cost	Accumulated Amortization	Net book Value
Land	\$ 2.5	\$ -	\$ 2.5	\$ 2.6	\$ -	\$ 2.6
Buildings	15.5	3.5	12.0	14.9	2.8	12.1
Machinery and equipment	804.0	229.9	574.1	757.1	180.5	576.6
Computer hardware and software	6.4	1.3	5.1	2.4	0.4	2.0
Mill rolls	33.6	12.6	21.0	31.9	13.3	18.6
Equipment under capital leases	1.8	1.1	0.7	1.2	0.6	0.6
Construction in progress	<u>33.4</u>	<u>-</u>	<u>33.4</u>	<u>29.0</u>	<u>-</u>	<u>29.0</u>
	<u>\$ 897.2</u>	<u>\$ 248.4</u>	<u>\$ 648.8</u>	<u>\$ 839.1</u>	<u>\$ 197.6</u>	<u>\$ 641.5</u>

5. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

	2006	2005
Trade payables	\$ 55.6	\$ 57.0
Accrued liabilities	37.9	37.1
Wages and employee deductions payable	26.1	30.5
Accrued vacation pay	<u>28.9</u>	<u>29.0</u>
	<u>\$ 148.5</u>	<u>\$ 153.6</u>

6. BANKING FACILITIES

The Company has a Loan and Security Agreement ("Agreement") that expires on September 3, 2007 and provides the Company with a revolving credit facility ("Revolving Facility") with financing equal to the lesser of \$200 million and a borrowing base determined by the levels of the Company's accounts receivable and inventories less certain reserves.

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

6. BANKING FACILITIES *(continued)*

At December 31, 2006, there was \$186.3 million of unused availability under the Revolving Facility after taking into account \$13.7 million of outstanding letters of credit (December 31, 2005 - \$178.2 million of unused availability with \$21.8 million of outstanding letters of credit). The Company is required to maintain a minimum availability of \$25 million. The Revolving Facility is collateralized by a first charge on short-term investments, accounts receivable and inventories. Borrowings can be made in either Canadian or United States (U.S.) funds at rates fluctuating between 0.75% and 1.5% above either the Canadian prime bank rate or the U.S. base rate or, at the Company's option, at rates fluctuating between 1.75% and 2.5% over bankers' acceptance rate or London inter-bank offering rate.

Under the terms of the Agreement, the Company is required to be in compliance with various restrictive covenants.

7. 11% Notes payable

On November 2, 2005, the Company approved the irrevocable redemption of the 11% Notes. On January 3, 2006, the 11% Notes were redeemed at a premium of 105.5% of the principal balance for cash payments totaling \$153.3 million. The premium amount of \$7.9 million was charged to expense in January 2006.

8. PENSION BENEFITS**Defined contribution 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 2006 pension expense was \$0.2 million (2005 - \$0.1 million).

Defined benefit 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.

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

8. PENSION BENEFITS (continued)

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

	2006	2005
Current service cost	\$ 24.0	\$ 19.3
Interest cost	42.6	40.7
Actual return on plan assets	(69.0)	(74.3)
Actuarial loss on benefit obligation	28.2	92.8
Costs arising in the period	<u>25.8</u>	<u>78.5</u>
Differences between costs arising in the period and costs recognized in the period in respect of:		
Return on plan assets	30.2	44.8
Actuarial gain	(18.6)	(85.9)
Unamortized past service costs	15.6	15.6
Net periodic pension cost	<u>\$ 53.0</u>	<u>\$ 53.0</u>

Changes in accrued benefit obligation

	2006	2005
Accrued benefit obligation at beginning of measurement period	\$ 808.1	\$ 683.0
Current service cost	24.0	19.3
Interest cost	42.6	40.7
Actuarial loss	28.2	92.8
Benefits paid	(29.0)	(27.7)
Accrued benefit obligation at end of measurement period (November 30)	<u>\$ 873.9</u>	<u>\$ 808.1</u>

Change in defined benefit pension plan assets

	2006	2005
Market value at beginning of measurement period	\$ 521.3	\$ 429.0
Actual return on plan assets	69.0	74.3
Employer contributions	64.1	45.7
Benefits paid	(29.0)	(27.7)
Market value at end of measurement period (November 30)	<u>\$ 625.4</u>	<u>\$ 521.3</u>

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

8. PENSION BENEFITS (continued)

The assets of the pension plans are held by an independent trustee. Based on their fair value at November 30, 2006, the plan assets were comprised of 24.3% Canadian equity, 29.8% global equity, 44.9% bonds and 1.0% other.

Reconciliation of funded status

	2006	2005
Funded status at measurement date (November 30)	\$ (248.5)	\$ (286.8)
Unamortized actuarial loss	170.6	182.2
Employer contributions after measurement date:		
Regular funding	5.0	9.6
Prepayment	85.0	44.0
Unamortized past service costs	10.5	26.0
Accrued pension asset (liability)	<u>\$ 22.6</u>	<u>\$ (25.0)</u>

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

	2006	2005
Current portion	\$ -	\$ (10.5)
Accrued pension asset	91.7	-
Accrued pension liability	(69.1)	(14.5)
	<u>\$ 22.6</u>	<u>\$ (25.0)</u>

The significant weighted-average assumptions are as follows:

	2006	2005
Accrued benefit obligation:		
Discount rate	4.97%	5.21%
Rate of compensation increase	4.00%	4.00%
Net periodic pension costs:		
Discount rate	5.21%	5.91%
Expected long-term rate of return on plan assets	6.95%	6.75%
Rate of compensation increase	4.00%	4.00%

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

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

Total pension funding during the twelve months ended December 31, 2006 was \$100.6 million (2005 - \$96.7 million; 2004 - \$72.0 million), which included \$85 million of pre-funding (2005 - \$44.0 million of 2006) of the 2007 and future years pension contributions. As a result of the pre-funding there are no pension funding requirements in 2007.

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

2007	34.7
2008	36.0
2009	37.1
2010	38.5
2011	40.7
2012 - 2016	260.2

Contributions to the plans for 2006 were based on actuarial valuations at September 1, 2005. Actuarial valuations for funding purposes at September 1, 2006 are currently being completed for all plans.

9. 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

	2006	2005
Current service cost	\$ 3.8	\$ 2.8
Interest cost	19.4	19.0
Actuarial loss	<u>13.9</u>	<u>44.9</u>
Costs arising in the period	37.1	66.7
Differences between costs arising in the period and costs recognized in the period in respect of:		
Actuarial loss	(7.4)	(41.6)
Plan amendments	<u>2.0</u>	<u>2.0</u>
Net periodic post-employment benefit cost	<u>\$ 31.7</u>	<u>\$ 27.1</u>

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

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

	2006	2005
Benefit obligation at beginning of period	\$ 373.0	\$ 320.5
Current service cost	3.8	2.8
Interest cost	19.4	19.0
Actuarial loss	13.9	44.9
Benefits paid	<u>(15.6)</u>	<u>(14.2)</u>
Benefit obligation at end of period	<u>\$ 394.5</u>	<u>\$ 373.0</u>

Reconciliation of funded status

	2006	2005
Funded status at measurement date (November 30)	\$ (394.5)	\$ (373.0)
Unamortized actuarial loss	117.6	110.2
Unamortized past service costs	1.3	3.3
Benefits paid after measurement date	<u>1.1</u>	<u>1.2</u>
Accrued post-employment benefit obligation	<u>\$ (274.5)</u>	<u>\$ (258.3)</u>

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

	2006	2005
Current portion	\$ (16.5)	\$ (15.4)
Accrued post-employment benefit obligation	<u>(258.0)</u>	<u>(242.9)</u>
	<u>\$ (274.5)</u>	<u>\$ (258.3)</u>

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

9. OTHER POST-EMPLOYMENT BENEFITS (continued)

The significant weighted-average assumptions are as follows:

	2006	2005
Accrued benefit obligation:		
Discount rate	5.00%	5.25%
Rate of compensation increase	4.00%	4.00%
Initial health care rate	6.60%	6.90%
Ultimate health care rate	4.50%	4.50%
Year ultimate rate reached	2013	2013
Net periodic benefit costs:		
Discount rate	5.25%	6.00%
Rate of compensation increase	4.00%	4.00%
Initial health care rate	6.90%	7.20%
Ultimate health care rate	4.50%	4.50%
Year ultimate rate reached	2013	2013

Increasing the health care trend by 1% would change the accrued benefit obligation at December 31, 2006 by approximately \$50.4 million and the post-employment benefit cost for 2006 by approximately \$4.2 million. Decreasing the trend by 1% would change the accrued benefit obligation at December 31, 2006 by approximately \$62.0 million and the post-employment benefit cost for 2006 by approximately \$3.3 million.

Cash flow information

Payments made for other post-employment benefits were \$15.6 million for the year ended December 31, 2006 (2005 - \$14.2 million; 2004 - \$13.2 million), and are on a pay-as-you-go basis.

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

2007	16.5
2008	17.4
2009	18.3
2010	19.2
2011	20.0
2012 - 2016	111.2

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

10. CAPITAL STOCK**Common shares**

Authorized - unlimited number

The following table summarizes the share capital transactions since December, 31, 2004:

	Common shares			
	To be issued		Issued and outstanding	
	# shares	Stated capital	# shares	Stated capital
Balance at December 31, 2004	2,800	\$ 0.1	40,117,587	\$ 318.4
Shares purchased and cancelled under normal course issuer bid			(1,590,100)	(12.7)
Tax benefit of share issue costs				0.3
Stock options exercised (note 11)			30,336	0.1
Directors' Share Award Plan (note 11)				
Shares awarded	12,931	0.4		
Shares issued	(15,250)	(0.5)	15,250	0.5
Balance at December 31, 2005	481	-	38,573,073	306.6
Shares purchased and cancelled under normal course issuer bid			(1,242,400)	(9.9)
Shares purchased and cancelled under substantial issuer bid			(5,479,452)	(43.4)
Shares issued on exercise of restricted share units			35,116	0.2
Tax benefit of share issue costs				
Stock options exercised (note 11)			6,500	-
Directors' Share Award Plan (note 11):				
Shares awarded	7,781	0.2		
Shares issued	(3,521)	(0.1)	3,521	0.1
Balance at December 31, 2006	<u>4,741</u>	<u>\$ 0.1</u>	<u>31,896,358</u>	<u>\$ 253.6</u>

During the year, 1,242,400 common shares were purchased for \$40.1 million under a normal course issuer bid that expired on August 7, 2006. All shares acquired pursuant to the bid were cancelled. The excess of the purchase cost of these shares over the average paid-in amount was \$30.2 million, which was charged \$2.3 million to contributed surplus and \$27.9 million to retained earnings. On September 21, 2006 the Company also purchased 5,479,452 shares pursuant to a substantial issuer bid for \$200.0 million. The excess of the purchase cost of these shares over the average paid-in amount was \$156.6 million, which was charged \$10.0 million to contributed surplus and \$146.6 million to retained earnings.

During 2005, 1,590,100 common shares were purchased for \$38.0 million. The excess of the purchase cost of these shares over the average paid-in amount was \$25.3 million, of which \$2.8 million was charged to contributed surplus and \$22.5 million to retained earnings.

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

10. CAPITAL STOCK (continued)**Diluted earnings per share**

Diluted net income per common share assumes the dilutive effect of the stock-based compensation plans (note 11) as of the beginning of each period.

The following is expressed in millions of shares:

	<u>2006</u>	<u>2005</u>
Basic weighted average number of common shares outstanding	36.36	39.68
Common shares issued on the assumed exercising of stock options	<u>0.25</u>	<u>0.26</u>
Diluted weighted average number of common shares outstanding	<u><u>36.61</u></u>	<u><u>39.94</u></u>

The effect of 694,631 share options has not been included in the calculation of diluted net income per common share, because they are anti-dilutive.

11. STOCK-BASED COMPENSATION PLANS

At December 31, 2006, the Company has three stock-based compensation plans, which are described below. The Company accounts for its grants under these plans in accordance with the fair value based method of accounting for stock-based compensation. The compensation expense recognized for all awards granted under these plans for the year ended December 31, 2006 was \$3.8 million (2005 - \$3.6 million, 2004 - \$0.7 million).

Share Award Plan

The Company has a Share Award Plan for members of the Board of Directors which permits the Company, at its option, to award common shares to eligible directors as a portion of their compensation. Any shares granted under the Share Award Plan are issued monthly. The Company accounts for the related compensation expense based on the fair market value of the shares on the date granted. The maximum number of shares that may be issued pursuant to the terms of the plan shall not exceed 500,000 common shares. The cumulative number of shares issued under the plan to December 31, 2006 was 181,446. During the year ended December 31, 2006, 7,781 shares were awarded with an average fair market value of \$33.92 per share (2005 - 12,931 shares were awarded with an average fair market value of \$30.33 per share).

Share Option Plan

The Company has a Share Option Plan that permits the Company, at its option, to award common share options to senior management and directors. The Company has reserved two million common shares for issuance under the plan. The exercise price of a share option may not be less than the market value of the common shares on the date of the grant. The options have a term not exceeding ten years and may not be exercised until the third anniversary of the date granted.

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

11. STOCK-BASED COMPENSATION PLANS (continued)

During the year ended December 31, 2006, 413,360 (2005 - 281,480) options were granted with a weighted average exercise price of \$32.67 for 373,360 options and \$32.11 for the remaining 40,000 options (2005 - \$28.98) per share. The options vest as to one-third each on the first, second and third anniversary dates. The estimated weighted average fair value of the options of \$18.01 and \$17.66 respectively (2005 - \$15.69) per share was determined using the Black-Scholes options pricing model with the following assumptions:

	<u>2006</u>	<u>2005</u>
Expected time until exercise	5 years	5 years
Risk-free interest rate	4.2-4.3%	3.3%
Expected volatility in stock price	60%	60%
Expected dividend yield	0%	0%

The following table reflects the activity under the Share Option Plan, as at December 31, 2006 and 2005, and the weighted average exercise prices:

	2006		2005	
	Options	Weighted average exercise price	Options	Weighted average exercise price
Balance, beginning of year	531,716	\$ 17.98	280,572	\$ 5.19
Granted	413,360	32.62	281,480	28.98
Exercised	(6,500)	1.67	(30,336)	1.80
Forfeited/expired	(2,162)	24.98	-	-
Balance, end of year	<u>936,414</u>	<u>\$ 24.43</u>	<u>531,716</u>	<u>\$17.98</u>
Exercisable, end of year	<u>89,951</u>	<u>\$ 1.77</u>	<u>-</u>	<u>\$ -</u>

The weighted average remaining term of the outstanding share options is 8.3 years (2005 - 8.6 years).

The following table summarizes the share options outstanding at December 31, 2006.

Exercise price	Number outstanding	Remaining contractual life	Number exercisable
\$1.67	20,800	6.6 years	20,800
\$1.80	69,151	6.1 years	69,151
\$8.00	153,157	7.1 years	-
\$28.98	279,946	8.1 years	-
\$32.11	40,000	9.4 years	-
\$32.67	<u>373,360</u>	9.3 years	-
	<u>936,414</u>		<u>89,951</u>

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

11. STOCK-BASED COMPENSATION PLANS (continued)**Restricted Share Unit Plan**

The Company also has a Restricted Share Unit Plan that permits the Company, at its option, to award restricted share units (RSUs) to senior management and directors. A restricted share unit vests on the grant date and entitles the participant to one common share to be issued from treasury on the third anniversary of the grant date. The Company has reserved one million common shares for issuance under the plan. During the year ended December 31, 2006, the Company granted 2,500 (2005 - 92,294) restricted share units with a weighted average grant date fair value of \$32.11 (2004 - \$26.03) per unit.

A summary of the status of the Company's Restricted Share Unit Plan at December 31, 2006 is as follows:

	2006		2005	
	RSUs	Weighted average fair value	RSUs	Weighted average fair value
Balance, beginning of year	163,074	\$14.88	70,780	\$ 3.47
Granted	2,500	32.11	92,294	26.03
Exercised	<u>(35,116)</u>	<u>6.08</u>	<u>-</u>	<u>-</u>
Balance, end of year	<u>130,458</u>	<u>\$20.42</u>	<u>163,074</u>	<u>\$14.88</u>
Exercisable, end of year	<u>55,927</u>	<u>\$ 8.00</u>	<u>35,116</u>	<u>\$ 4.79</u>

The weighted average remaining term of the outstanding restricted share units is 6.6 years (2005 - 8.4 years).

12. 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 before the provision for profit sharing as follows:

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

During 2006, \$27.3 million (2005 - \$31.5 million) was expensed under the Company's profit sharing plan and charged to Cost of Sales. Under the terms of the collective bargaining agreements, \$15.5 million was advanced to employees within 30 days of the release of the third quarter financial results (2005 - \$16.8 million was advanced). Settlement of the remaining amount payable under the profit sharing plan will be made within 90 days of the close of the fiscal year.

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

13. CONTRIBUTED SURPLUS

	2006	2005
Balance, beginning of year	\$ 240.9	\$ 226.7
Stock-based compensation	3.4	4.2
Purchase and cancellation of shares	(12.3)	(2.8)
Recognition of income tax assets not recognized on implementation of fresh start accounting	6.2	12.8
Balance, end of year	<u>\$ 238.2</u>	<u>\$ 240.9</u>

14. INCOME TAXES

The provision for income taxes is summarized as follows:

	2006	2005
Current	\$ 102.7	\$ 60.6
Future	4.2	64.0
	<u>\$ 106.9</u>	<u>\$ 124.6</u>

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

	2006	2005
Initiating and reversing temporary differences:		
Accounting reserves	\$ 1.0	\$ 0.4
Pension and post-employment benefit expense	8.9	(0.1)
Tax depreciation less than book amortization	(1.4)	(0.5)
Unrealized (realized) foreign exchange gain on \$U.S. debt	(3.5)	0.8
Tax loss carry-forwards	-	57.2
Minimum tax credits	8.0	(8.0)
Other	(1.0)	0.8
Realization of fresh start income tax assets not previously recognized:		
Pension and post-employment benefit expense	5.3	10.6
Other	0.9	2.2
Effect of future tax rate reductions	(11.6)	-
Other	-	0.3
	<u>6.6</u>	<u>63.7</u>
Increase (decrease) in valuation allowance in respect of tax assets arising after implementing fresh start accounting	(2.4)	0.3
	<u>\$ 4.2</u>	<u>\$ 64.0</u>

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

14. 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:

	2006	2005
Income tax provision at the statutory manufacturing and processing rate of 34.1% (2005 - 34.1%)	\$ 112.1	\$ 124.2
Add (deduct):		
Impact of future Federal tax rate reductions	(11.6)	-
Provision for reassessment of prior tax years	3.5	-
Change in future tax asset valuation allowance:		
Impact of pension expense	12.8	18.1
Impact of pension funding	(21.3)	(27.2)
Impact of post-employment expenses	10.9	9.2
Other	0.5	0.3
Provision for income taxes	<u>\$ 106.9</u>	<u>\$ 124.6</u>

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

	2006	2005
Future income tax assets - current		
Canadian taxes		
Accounting reserves not currently deductible for tax purposes	\$ 1.0	\$ 2.0
Provincial minimum tax credits	-	8.0
Other	0.7	-
Total current assets	<u>\$ 1.7</u>	<u>\$ 10.0</u>
Future income tax liabilities - current		
Canadian taxes		
Unrealized foreign exchange gain on \$U.S. debt	\$ -	\$ (9.5)
Capital loss carry-forwards	-	6.0
Other	(1.0)	(1.2)
Total current liabilities, net	<u>\$ (1.0)</u>	<u>\$ (4.7)</u>

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

14. INCOME TAXES (continued)

	2006	2005
Future income tax assets - non-current		
Canadian taxes		
Post-employment benefit obligation:		
Pre-fresh start	\$ 50.0	\$ 60.5
Post-fresh start	34.8	27.5
Pension benefit obligation	-	8.5
Other:		
Pre-fresh start	7.5	8.4
Post-fresh start	1.8	1.7
	<u>94.1</u>	<u>106.6</u>
Valuation allowances:		
Pre-fresh start	(57.5)	(68.9)
Post-fresh start	(35.3)	(37.7)
Canadian non-current assets, net	<u>1.3</u>	<u>-</u>
United States taxes		
Tax loss carry-forwards - pre-fresh start	46.9	50.6
Valuation allowance	(46.9)	(50.6)
United States non-current assets, net	<u>-</u>	<u>-</u>
Total non-current assets, net	<u>1.3</u>	<u>-</u>
Future income tax liabilities - non-current		
Canadian taxes		
Accrued pension asset	\$ (7.7)	\$ -
Tax depreciation deducted in excess of book amortization	<u>(123.8)</u>	<u>(136.8)</u>
Total non-current liabilities	<u>(131.5)</u>	<u>(136.8)</u>
Net non-current liabilities	<u>\$ (130.2)</u>	<u>\$ (136.8)</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. In accordance with GAAP, any benefit recognized in respect of the pre-fresh start tax assets is credited directly to contributed surplus (note 13).

During 2006, the valuation allowance in respect of the Canadian future income tax assets, decreased by \$13.8 million (2005 - decreased by \$12.5 million) primarily due to the recognition of \$6.2 million (2005 - \$12.8 million) of pre-fresh start future tax assets related to pensions and approximately \$8.0 million related to the future tax rate reductions.

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 15). Consequently, a full valuation allowance of \$46.9 million (2005 - \$50.6 million) has been recorded against its future income tax assets.

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

14. INCOME TAXES (continued)**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 (2005 - \$1.0 million was applied). A future income tax asset of \$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 \$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.

Cannelton has non-capital losses of approximately U.S. \$65.6 million, of which U.S. \$27.3 million expire between 2007 and 2010, U.S. \$1.9 million in 2021 and U.S. \$36.4 million in 2022. Cannelton also has a capital loss of approximately U.S. \$52.8 million that expires in 2007 and can be applied against future capital gains.

15. CONTINGENCIES AND COMMITMENTS

Under operating leases for premises and equipment, the Company is obligated to make aggregate payments of \$8.9 million, comprised of \$2.9 million in 2007, \$2.5 million in 2008 and \$3.5 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

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

15. CONTINGENCIES AND COMMITMENTS *(continued)*

as environmental costs, that are not reflected in Tilden's financial statements.

The Company has 10 years remaining with this agreement and the purchase commitment for 2007 is approximately U.S. \$243.0 million. Under the terms of the agreement, the Company pays for its annual purchases evenly throughout the year which, at any given time, can result in prepayments. At December 31, 2006, \$14.8 million (U.S. \$12.6 million) is included in prepaid expenses in this respect (December 31, 2005 - \$12.0 million (U.S. \$10.3 million)).

The Company has agreements to source coal requirements until March 31, 2008 at fixed prices. The purchase commitment for 2007 under these agreements is approximately \$152.0 million (U.S. \$130.4 million).

The Company has 8-1/2 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 2.0 million MMBtus of natural gas in 2007 for approximately \$18.5 million.

Contractual commitments at December 31, 2006 amounted to \$23.3 million relating to authorized capital projects.

The Company has ordered a one hundred megawatt steam turbine generator for the new co-generation project that will require payments over the next two years of \$4.7 and \$11.1 million respectively.

Pursuant to a Certificate of Approval issued by the Ontario Ministry of the Environment, the Company is required to install, by 2010, certain equipment in the No. 7 Blast Furnace to reduce casthouse emissions. The cost of this equipment and its installation is currently estimated at \$25-\$30 million. The actual cost of the equipment and its installation could vary significantly due to cost escalation, design changes, regulatory policies, or other factors.

Pursuant to a Certificate of Approval issued by the Ontario Ministry of the Environment, the Company is required to apply technology or process changes to mitigate noise level from identified sources within the Sault Ste. Marie operations. It is estimated that the capital cost associated with the noise abatement plan is in the order of \$3 million during the period of 2007 through to 2012.

16. 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:

	2006	2005
Sheet and strip	\$ 1,269.3	\$ 1,225.0
Plate	541.8	546.4
Freight	85.3	73.2
Non-steel sales	<u>43.3</u>	<u>73.0</u>
	<u>\$ 1,939.7</u>	<u>\$ 1,917.6</u>

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

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

16. SEGMENTED INFORMATION (continued)

Sales to customers in the United States were approximately \$634.8 million for the year ended December 31, 2006 (2005 - \$598.9 million). Export sales to other countries were approximately \$43.3 million for the year ended December 31, 2006 (2005 - \$37.3 million).

One customer represented 11% of total sales in the year ended December 31, 2006 (2005 - one customer represented 11% of total sales).

At December 31, 2006, one customer represented 11% of the accounts receivable balance (December 31, 2005 - one customer represented 19.1% of the accounts receivable balance).

17. CHANGES IN NON-CASH OPERATING WORKING CAPITAL

	2006	2005
Accounts receivable	\$ 40.2	\$ 1.7
Inventories	(98.9)	(79.6)
Prepaid expenses	(1.1)	(2.0)
Accounts payable and accrued liabilities	(5.1)	25.9
Income and other taxes payable	1.4	47.2
	<u>\$ (63.5)</u>	<u>\$ (6.8)</u>

18. OTHER LONG-TERM LIABILITIES

	2006	2005
Environmental remediation liabilities (a)	\$ 7.4	\$ 8.8
Long-term lease obligation	0.3	0.4
Other	-	-
	<u>\$ 7.7</u>	<u>\$ 9.2</u>

(a) This liability represents the Company's obligations associated with its former iron ore mine in Wawa, Ontario. At December 31, 2006, this liability has been determined based on the Company's best estimate of the costs to be incurred, discounted at a risk-free rate of 4.11% (December 31, 2005 - 4.04%). It is expected that the costs related to this remediation will be incurred between 2007 and 2027. Changes in future conditions could require a change in this liability.

19. DERIVATIVE INSTRUMENTS

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. The cost to close these agreements has

ALGOMA STEEL INC.

Notes to consolidated financial statements

Expressed in millions of Canadian dollars, except share and per share amounts and as noted

19. DERIVATIVE INSTRUMENTS *(continued)*

not been accrued in the accounts and totals \$1.1 million. Fair value has been estimated using quoted market rates for the same or similar instruments. At

December 31, 2006, the aggregate notional amount of the steel swaps outstanding was approximately 57,000 metric tonnes (December 31, 2005 - nil) expiring at various dates through to September 12, 2007. The fair value of the steel swap agreements at December 31, 2006 was \$0.2 million which has been included in Prepaid Expenses on the balance sheet and Other Income in the Consolidated Statement of Income and Retained Earnings.

The Company is exposed to financial risk arising from fluctuations in foreign exchange rates and the degree of volatility of these rates. Balances with exchange risk include U.S. dollar denominated cash, short-term investments, accounts receivable, and accounts payable. The Company does not use derivative instruments to reduce its exposure to foreign currency risk.

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



Dan Ardila
Vice President, Finance and
Chief Financial Officer

Sault Ste. Marie, Ontario
February 7, 2007