

KAPSTONE PAPER & PACKAGING CORP  
Form 10-K/A  
March 19, 2008

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10 K/A**  
**(Amendment No. 1)**

(Mark One)

✓ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2007**

**Commission File No. 000-51444**

**Kapstone Paper and Packaging Corporation**

(Name of issuer as specified in its charter)

KapStone Paper and Packaging Corporation  
1101 Skokie Boulevard, Suite 300  
Northbrook, Illinois 60062

(Address of principal executive offices) (Zip Code)

**Delaware**  
(State or other jurisdiction of  
Incorporation or organization))

**20-2699372**  
(I.R.S. Employer Identification No.)

Registrant's telephone number, including area code: (847) 239-8800

**Securities registered pursuant to Section 12(B) of the Act: NONE**

<b>Title of Title Of Class</b>	<b>Name Of Each Exchange On Which Registered</b>
Common Stock (Par Value \$.0001)	Nasdaq Stock Market, LLC
Warrants to purchase Common Stock	Nasdaq Stock Market, LLC

**Securities registered pursuant to Section 12(g) of the Act: None**

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

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

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

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

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

Large accelerated filer o

Accelerated filer y

Non-accelerated filer o  
(Do not check if a smaller reporting company)

Smaller reporting company o

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

The aggregate market value of the 18,715,300 shares of Common Stock held by non-affiliates of the Registrant on June 29, 2007 was \$142,049,127. This calculation was made using a price per share of Common Stock of \$7.59, the closing price of the Common Stock on the NASDAQ on June 29, 2007, the last day of the registrant's most recently completed second fiscal quarter of 2007. Solely for purposes of this calculation, all shares held by directors and executive officers of the registrant have been excluded. This exclusion should not be deemed an admission that these individuals are affiliates of the registrant.

On February 29, 2008, the number of shares of Common Stock outstanding, excluding 40,000 treasury shares, was 25,283,897.

**DOCUMENTS INCORPORATED BY REFERENCE**

The registrant's Definitive Proxy Statement for its 2008 Annual Meeting of Stockholders will be filed with the Securities and Exchange Commission no later than 120 days after the end of the fiscal year covered by this Form 10-K pursuant to General Instruction G(3) of the Form 10-K. Information from such Definitive Proxy Statement will be incorporated by reference into Part III, Items 10, 11, 12, 13 and 14 hereof.

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**EXPLANATORY NOTE**

We are filing Amendment No. 1 (this "Amendment") to the KapStone Paper and Packaging Corporation (the "Company") Annual Report on Form 10-K for the year ended December 31, 2007, which was originally filed on March 14, 2008 (the "Original Filing").

The Company inadvertently included in the Original Filing a report by, and consent of, Eisner LLP ("Eisner"), our predecessor auditor, which were not approved for release by Eisner. The report of Eisner on page F-6 and the consent of Eisner on Exhibit 23.3 of the amended Form 10-K replace and supersede in their entirety the report and consent of Eisner included in the Original Filing. The audited financial statement and schedules included in the Amendment are otherwise unchanged from the audited financial statements and schedules included in the Original Filing. In addition, this Amendment corrects a typographical error on the facing page of the Form 10-K in the number of shares of Common Stock outstanding as of February 29, 2008.

This Amendment does not otherwise amend or update any exhibit to or disclosure set forth in the Original Filing. Pursuant to Rule 12b-15 under the Securities Exchange Act of 1934, as amended, this Amendment contains new certifications pursuant to the Sarbanes-Oxley Act of 2002.

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**Part IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a)(1) *Financial Statements.*

An index to Consolidated Financial Statements appears on page F-1.

(a)(2) *Financial Statement Schedules.*

Financial Statement Schedules have been omitted because they are not applicable, or the required information is shown in the financial statements or the notes thereto.

(b) *Exhibits.*

The following Exhibits are filed as part of this report:

Exhibit No.	Description
2.1	Purchase Agreement, dated June 23, 2006, by and among International Paper Company, the Registrant, and KapStone Kraft Paper Corporation.(1)
2.2	Letter Amendment to Purchase Agreement, dated June 23, 2006, by and among International Paper Company, the Registrant, and KapStone Kraft Paper Corporation, dated December 15, 2006.(2)
3.1	Amended and Restated Certificate of Incorporation.(3)
3.2	Certificate of Amendment of the Amended and Restated Certificate of Incorporation(2)
3.3	By-laws.(3)
4.1	Specimen Unit Certificate.(3)
4.2	Specimen Common Stock Certificate.(3)
4.3	Specimen Warrant Certificate.(3)
4.4	Form of Unit Purchase Option to be granted to Representative.(2)
4.5	Form of Warrant Agreement between Continental Stock Transfer & Trust Company and the Registrant.(3)
4.6	Amended and Restated Warrant Clarification Agreement.(4)
4.7	Amended and Restated Unit Purchase Clarification Agreement(5)
10.1	Form of Letter Agreement among the Registrant, Morgan Joseph & Co. Inc. and each of the Initial Stockholders.(3)
10.2	Form of Promissory Note issued to each of Roger Stone, Matthew Kaplan, John Chapman, Jonathan Furer and Muhit Rahman.(3)
10.3	Form of Investment Management Trust Agreement between Continental Stock Transfer & Trust Company and the Registrant.(3)
10.4	Form of Stock Escrow Agreement between the Registrant, Continental Stock Transfer & Trust Company and the Initial Stockholders.(3)
10.5	Form of Letter Agreement between Stone-Kaplan Investments LLC and Registrant regarding administrative support.(3)
10.6	Form of Registration Rights Agreement among the Registrant and the Initial Stockholders.(3)

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Exhibit No.	Description
10.7	Form of Warrant Purchase Agreement among each of the Initial Stockholders and Morgan Joseph & Co. Inc.(3)

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- 10.8 2006 Equity Incentive Plan.(2)
  - 10.9 Credit Agreement among KapStone Kraft, LaSalle Bank National Association, and various lenders thereto.(2)
  - 10.10 Form of Agreement for the Provision of Transition Services between KapStone Kraft and IP.(2)
  - 10.11 Lease Agreement between City of Fordyce, Arkansas and IP.(2)
  - 14 Code of Ethics.(7)
  - 16.1 Letter Regarding Change in Certifying Accountant.(6)
  - 21 Subsidiary.(7)
  - 23.1 Consent of Ernst & Young, LLP.(8)
  - 23.2 Consent of Deloitte & Touche LLP.(8)
  - 23.3 Consent of Eisner LLP.
  - 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.
  - 31.2 Certification of the Principal Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.
  - 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.2 Certification of the Principal Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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- (1) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 23, 2006.
  - (2) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on January 4, 2007.
  - (3) Incorporated by reference to the Registrant's Registration Statement on Form S-1 (File No. 333-124601).
  - (4) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q/A for the period ended June 30, 2006 filed on December 12, 2006.
  - (5) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q/A for the period ended September 30, 2006 filed on December 12, 2006.
  - (6) Incorporated by reference to the Registrant's Current Report on Form 8-K/A filed on April 19, 2006.
  - (7) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2006 filed on March 13, 2007.
  - (8) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2007 filed on March 14, 2008.
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**SIGNATURES**

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

KAPSTONE PAPER AND  
PACKAGING CORPORATION

March 18, 2008

By: /s/ ROGER STONE

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Roger Stone,  
Chairman of the Board and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

March 18, 2008

By: /s/ ROGER STONE

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Roger Stone,  
Chairman of the Board and Chief Executive Officer

March 18, 2008

By: /s/ ANDREA K. TARBOX

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Andrea K. Tarbox  
Chief Financial Officer and Vice President

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**KapStone Paper and Packaging Corporation**

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**MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2007. Management based this assessment on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "*Internal Control Integrated Framework*."

Our management has excluded KPB from its assessment of internal control over financial reporting as of December 31, 2007 as it was acquired by us in a purchase business combination on January 2, 2007. KPB is a wholly-owned subsidiary whose total assets and total net sales represent 71% and 100%, respectively, of our consolidated financial statement amounts as of, and for the year ended December 31, 2007. Under guidelines established by the Securities and Exchange Commission, companies are allowed to exclude acquisitions from their assessment of internal control over financial reporting during the first year of an acquisition.

Based on this assessment, management concluded that, as of December 31, 2007, our internal control over financial reporting is effective.

Ernst & Young LLP, independent registered accounting firm, has audited the consolidated financial statements of the Company and the Company's internal control over financial reporting and has included their reports herein.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders  
KapStone Paper and Packaging Corporation

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

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

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

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

As indicated in the accompanying Management's Annual Report on Internal Control over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of the acquired Kraft Papers Business, which is included in the 2007 consolidated financial statements of KapStone Paper and Packaging Corporation and constituted \$159.7 million and \$141.8 million of total and net assets, respectively, as of December 31, 2007 and \$256.8 million and \$37.3 million of revenues and net income, respectively, for the year then ended. Our audit of internal control over financial reporting of KapStone Paper and Packaging Corporation also did not include an evaluation of the internal control over financial reporting of the acquired Kraft Papers Business.

In our opinion, KapStone Paper and Packaging Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of KapStone Paper and Packaging Corporation as of December 31, 2007 and 2006 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2007, and our report dated March 12, 2008, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

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Ernst & Young LLP

Chicago, IL

March 12, 2008

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders  
KapStone Paper and Packaging Corporation

We have audited the accompanying consolidated balance sheets of KapStone Paper and Packaging Corporation (the "Company") as of December 31, 2007 and 2006 and the related consolidated statements of income, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of KapStone Paper and Packaging Corporation as of December 31, 2007 and 2006 and the consolidated results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Oversight Board (United States), the effectiveness of KapStone Paper and Packaging Corporation's internal controls over financial reporting as of December 31, 2007, based on criteria establish in *Internal Control Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 12, 2008 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

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Ernst & Young LLP

Chicago, IL  
March 12, 2008

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders  
KapStone Paper and Packaging Corporation

We have audited the accompanying statements of income, changes in stockholders' equity and cash flows for the period from April 15, 2005 (date of inception) through December 31, 2005 of KapStone Paper and Packaging Corporation (formerly Stone Arcade Acquisition Corporation) (a development stage company) (the "Company"). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly in all material respects, the results of operations and cash flows of KapStone Paper and Packaging Corporation for the period from April 15, 2005 (date of inception) through December 31, 2005 in conformity with U.S. generally accepted accounting principles.

/s/ Eisner LLP

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Eisner LLP  
New York, New York  
March 9, 2006

Except for the second paragraph under the heading 'Underwriter's Purchase Option' of Note 11, as to which the date is January 4, 2007.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors of  
International Paper Company:

We have audited the accompanying combined balance sheet of the Kraft Papers Business A Division (the "Division" or "Kraft Papers Business") of International Paper Company as of December 31, 2006, and the related combined statements of operations and cash flows for each of the two years in the period ended December 31, 2006. These financial statements are the responsibility of the Division's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Division is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Division's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Notes 1, 10, 11, and 18 to the financial statements, the accompanying combined financial statements have been prepared from the separate records maintained by the Division and International Paper Company and may not necessarily be indicative of the conditions that would have existed or the results of operations if the Kraft Papers Business had been operated as an unaffiliated company. Portions of certain expenses represent allocations made from corporate-office items applicable to International Paper Company as a whole.

In our opinion, such combined financial statements present fairly, in all material respects, the financial position of the Kraft Papers Business as of December 31, 2006, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 to the financial statements, in March 2006, International Paper Company committed to a plan to sell the Kraft Papers Business and during 2006 recorded a pretax impairment charge of approximately \$112 million to write down the Division's assets to their estimated net realizable value.

As described in Note 1 to the financial statements, on January 2, 2007, International Paper Company completed the sale of the Division.

As described in Note 3 to the financial statements, certain selling, general and administrative expenses related to administrative salaries of manufacturing personnel have been reclassified to cost of sales to conform to the KapStone Paper and Packaging Corporation presentation.

/s/ Deloitte & Touche LLP

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Deloitte & Touche LLP  
Memphis, Tennessee  
March 19, 2007 (March 14, 2008 as to the effects of the reclass discussed in Note 3)

**KapStone Paper and Packaging Corporation**  
**Consolidated Balance Sheets**  
(In thousands, except share and per share amounts)

	December 31,		Predecessor KPB December 31,
	2007	2006	2006
<b>Assets</b>			
Current assets:			
Cash and cash equivalents	\$ 56,635	\$	\$ 1
Restricted cash held in trust		115,239	
Trade accounts receivable	30,208		25,824
Accounts receivable International Paper Company, net			336
Inventories	16,358		24,087
Inventories consigned to third parties	3,488		
Deferred income taxes	1,263		
Prepaid expenses and other current assets	735	120	1,089
<b>Total current assets</b>	<b>108,687</b>	<b>115,359</b>	<b>51,337</b>
Plant, property and equipment, net	104,858		201,593
Deferred income taxes		689	
Other assets	3,735	3,209	4,452
Intangible assets, net	5,875		
Goodwill	2,295		
<b>Total assets</b>	<b>\$ 225,450</b>	<b>\$ 119,257</b>	<b>\$ 257,382</b>
<b>Liabilities and Stockholders' Equity</b>			
Current liabilities:			
Current portion of long-term debt	\$ 19,578	\$	\$
Accounts payable	11,050	196	7,931
Accrued expenses	4,867	2,786	2,636
Accrued compensation costs	6,625		4,508
Accrued income taxes	1,477		
<b>Total current liabilities</b>	<b>43,597</b>	<b>2,982</b>	<b>15,075</b>
Other liabilities:			
Long-term debt	32,922		22,357
Pension and post-retirement benefits	3,420		
Deferred income taxes	1,047		
Other liabilities	279		265
<b>Total other liabilities</b>	<b>37,668</b>		<b>22,622</b>
Commitments and contingencies			
Common stock, subject to redemption 40,000 shares at December 31, 2006		230	
Stockholders' equity:			
Preferred stock \$.0001 par value; 1,000,000 shares authorized; no shares issued and outstanding			
Common stock \$.0001 par value, 175,000,000 shares authorized; 25,280,197 shares issued and outstanding (40,000 treasury shares outstanding) at December 31, 2007 and 25,000,000 issued and outstanding at December 31, 2006 (including 40,000 shares subject to possible redemption at December 31, 2006)	3	3	
Additional paid-in capital	115,002	113,904	

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Retained earnings	29,101	2,138	
Accumulated other comprehensive income	79		
Divisional control			219,685
	<u>          </u>	<u>          </u>	<u>          </u>
Total stockholders' equity	144,185	116,045	219,685
	<u>          </u>	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 225,450	\$ 119,257	\$ 257,382
	<u>          </u>	<u>          </u>	<u>          </u>

See notes to consolidated financial statements.

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**KapStone Paper and Packaging Corporation**  
**Consolidated Statements of Income**  
(In thousands, except share and per share amounts)

	Years Ended December 31,		Inception (April 15, 2005) through December 31, 2005	Predecessor KPB Years Ended December 31,	
	2007	2006		2006	2005
Net sales (Including Predecessor related-party net sales of \$16.0 million, and \$3.8 million for the years ended December 31, 2006 and 2005, respectively)	\$ 256,795	\$	\$	\$ 246,161	\$ 221,972
Cost of sales, excluding depreciation (Including Predecessor related-party purchases of \$48.8 million, and \$44.2 million for the years ended December 31, 2006 and 2005, respectively)	162,429			160,444	161,197
Freight and distribution	23,581			22,274	19,996
Selling, general and administrative expenses (Including Predecessor costs allocated to IP of \$10.8 million, and \$9.1 million for the years ended December 31, 2006 and 2005, respectively)	16,482	1,976	221	11,282	10,016
Depreciation and amortization	11,327			18,210	21,285
Other operating income	1,324				
<b>Operating income / (loss)</b>	<b>44,300</b>	<b>(1,976)</b>	<b>(221)</b>	<b>33,951</b>	<b>9,478</b>
Interest income	2,096	5,291	1,460		
Interest expense	4,295			1,411	1,439
<b>Income before provision for income taxes</b>	<b>42,101</b>	<b>3,315</b>	<b>1,239</b>	<b>32,540</b>	<b>8,039</b>
Provision for income taxes	15,138	1,119	421	12,573	3,106
<b>Net income</b>	<b>\$ 26,963</b>	<b>\$ 2,196</b>	<b>\$ 818</b>	<b>\$ 19,967</b>	<b>\$ 4,933</b>
Interest income, net of taxes, attributable to common stock subject to possible redemption		(686)	(189)		
<b>Net income allocable to holders of nonredeemable common stock</b>	<b>\$ 26,963</b>	<b>\$ 1,510</b>	<b>\$ 629</b>		
<b>Weighted-average number of shares outstanding:</b>					
Basic	25,010,057	25,000,000	15,307,692		
Diluted	36,134,488	29,601,770	16,547,715		
<b>Net income per share:</b>					
Basic	\$ 1.08	\$ 0.09	\$ 0.05		
Diluted	\$ 0.75	\$ 0.07	\$ 0.05		
<b>Weighted-average shares outstanding exclusive of shares subject to possible redemption:</b>					
Basic	25,006,724	21,023,688	13,247,185		
Diluted	36,064,206	25,625,458	14,487,208		

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Net income per share exclusive of shares and  
deferred interest subject to possible redemption:

Basic	\$	1.08	\$	0.07	\$	0.05
Diluted	\$	0.75	\$	0.06	\$	0.04

See notes to consolidated financial statements.

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**KapStone Paper and Packaging Corporation**  
**Consolidated Statements of Changes in Stockholders' Equity**  
(In thousands, except share amounts)

	Common Stock, net of Treasury Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
	Shares	Amount				
<b>Balance April 15, 2005 (date of inception)</b>		\$	\$	\$	\$	\$
Initial capital from founding stockholders	5,000,000		1	24		25
Sale of 20,000,000 units and underwriter's option (including 3,998,000 shares of common stock subject to possible redemption), net of underwriter's discount and offering expenses	20,000,000	2	113,234			113,236
Reclassification as a result of 3,998,000 shares of common stock being subject to possible redemption			(22,159)			(22,159)
Accretion of trust fund relating to common stock subject to possible redemption				(190)		(190)
Net income				818		818
<b>Balance December 31, 2005</b>	25,000,000	\$ 3	\$ 91,099	\$ 628	\$	\$ 91,730
Reclassification as a result of 3,958,000 shares of common stock no longer subject to possible redemption			22,805			22,805
Accretion of trust fund relating to common stock no longer subject to possible redemption				(686)		(686)
Net income				2,196		2,196
<b>Balance December 31, 2006</b>	25,000,000	\$ 3	\$ 113,904	\$ 2,138	\$	\$ 116,045
Purchase of redeemed common stock	(40,000)					
Exercises of warrants into common stock	320,197		1,601			1,601
Stock compensation cost			697			697
Underwriter fee			(1,200)			(1,200)
Comprehensive Income:						
Net income				26,963		26,963
Actuarial gain on pension and postretirement plans (net of tax of \$44)					79	79
<b>Total Comprehensive Income</b>						27,042
<b>Balance December 31, 2007</b>	25,280,197	\$ 3	\$ 115,002	\$ 29,101	\$ 79	\$ 144,185

See notes to consolidated financial statements.

**KapStone Paper and Packaging Corporation**  
**Consolidated Statements of Cash Flows**  
(In thousands)

	Years Ended December 31,		Inception (April 15, 2005) through December 31, 2005	Predecessor KPB Years Ended December 31,	
	2007	2006		2006	2005
<b>Operating activities</b>					
Net income	\$ 26,963	\$ 2,196	\$ 818	\$ 19,967	\$ 4,933
Depreciation and amortization	11,327			18,210	21,285
Stock based compensation expense	697				
Amortization of debt issuance costs	254				
Loss on disposal of fixed assets	463			700	566
Deferred income taxes	(244)	(725)	36		
Other, net				(2,076)	876
Changes in operating assets and liabilities	12,775	960	(258)	(596)	(2,676)
<b>Net cash provided by operating activities</b>	<b>52,235</b>	<b>2,431</b>	<b>596</b>	<b>36,205</b>	<b>24,984</b>
<b>Investing activities</b>					
Acquisition costs paid	(1,191)	(149)			
KPB acquisition	(149,603)	(900)			
Capital expenditures	(11,861)			(7,419)	(8,116)
Purchase of short-term investments	(35,000)				
Proceeds from of short-term investments	35,000				
Restricted cash held in trust	115,239	(115,239)		53	(845)
Purchase of U.S. government securities held in trust		(1,482,963)	(556,765)		
Maturities of U.S. government securities held in trust		1,594,662	445,066		
<b>Net cash used in investing activities</b>	<b>(47,416)</b>	<b>(4,589)</b>	<b>(111,699)</b>	<b>(7,366)</b>	<b>(8,961)</b>
<b>Financing activities</b>					
Proceeds from long-term debt	60,000				
Debt issuance costs paid	(855)				
Repayments of long-term debt	(7,500)				
Redemption of shares	(230)				
Investment banking fee paid	(1,200)				
Proceeds from public offering, net of expenses			113,236		
Proceeds from sale of common stock			25		
Proceeds from notes payable to stockholders			200		
Repayment of notes payable to stockholders			(200)		
Proceeds from exercise of common stock warrants	1,601				
Distributed to International Paper Company				(28,839)	(16,024)
<b>Net cash provided (used in) by financing activities</b>	<b>51,816</b>		<b>113,261</b>	<b>(28,839)</b>	<b>(16,024)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>56,635</b>	<b>(2,158)</b>	<b>2,158</b>		<b>(1)</b>

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Cash and cash equivalents-beginning of period		2,158	Inception (April 15, 2005) through December 31, 2005	2,158	1	2
Cash and cash equivalents-end of period	\$	56,635	\$	\$	1	\$ 1

See notes to consolidated financial statements.

**KAPSTONE PAPER AND PACKAGING CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except share and per share amounts)**

**1. Formation, Basis of Presentation and Description of Business**

***Formation***

On April 15, 2005, KapStone Paper and Packaging Corporation (formerly Stone Arcade Acquisition Corporation) or the "Company" was incorporated in Delaware. The Company was formed to serve as a vehicle for acquisition through a merger, capital stock exchange, asset acquisition, or other similar business combination of an operating business in the paper, packaging, forest products and related industries.

In connection with the Company's initial public offering, on August 19, 2005, the Company sold 20,000,000 units ("Units") for a gross price of \$6.00 per Unit. Each Unit consists of one share of the company's common stock, \$0.0001 par value, and two warrants ("Warrants"); the proceeds of which were earmarked for a business acquisition.

***Description of Business***

On January 2, 2007, the Company acquired substantially all of the assets and assumed certain liabilities of the Kraft Papers Business ("KPB") from International Paper Company ("IP"). The accompanying consolidated financial statements include the results of KPB since the date of acquisition. Prior to the acquisition of KPB, the Company had no operations and was considered a development stage enterprise. For periods prior to the acquisition, KPB is deemed to be the "Predecessor" to the Company. As a result, certain financial information of KPB is presented for comparative purposes including the financial position as of December 31, 2006, and for the years ended December 31, 2006 and 2005, the statements of income and statements of cash flows. The accompanying consolidated statements of income and cash flows present the results of operations and cash flows for i) the period preceding the acquisition of KPB, exclusive of KPB results of operations and cash flows and ii) for the periods succeeding the acquisition our consolidated results of operations including KPB. The results of operations and cash flows on a consolidated basis subsequent to the acquisition of KPB is not comparative to the Predecessor KPB results of operations and cash flows as i) the basis of the acquired assets and liabilities from KPB have been adjusted to fair value pursuant to Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* and ii) KPB was a division of IP and not a stand alone business.

***Predecessor's Basis of Presentation***

The Predecessor's accompanying combined financial statements for the years ended December 31, 2006 and 2005 were prepared from separate records maintained by the Kraft Papers Business and IP and include all allocations of certain IP corporate costs and expenses. The liabilities associated with the IP corporate costs and expenses were not allocated to KPB in the accompanying combined financial statements. These costs and obligations are those of IP, not KPB. These liabilities primarily include workers' compensation and general liability insurance reserves, payroll taxes and pension and post retirement and post employment liabilities. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 57, *Related Party Disclosures*, related-party transactions cannot be presumed to be carried out on an arms-length basis as the requisite conditions of competitive, free-market dealing may not exist. These combined financial statements may not necessarily be indicative of the conditions that would have existed, or the results of operations that would have resulted, had KPB been operated as an unaffiliated company.

KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**1. Formation, Basis of Presentation and Description of Business (Continued)**

On July 19, 2005, IP announced a plan to transform its business portfolio to concentrate on two key platform businesses: Uncoated Papers and Packaging. In connection with this plan, IP announced it would evaluate strategic options for other businesses, including the possible sale or spin-off of KPB. In March 2006, IP's management committed to a plan to sell KPB. As a result, the net assets of KPB met the criteria of held for sale for IP as described in SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Accordingly, IP performed the impairment test required by SFAS No. 144 using a held-for-sale classification for its investment in KPB. An aggregate impairment charge of approximately \$112 million was recognized by IP in its 2006 operating results.

At March 31, 2006, in conjunction with the actions of IP, discussed above, KPB considered whether an impairment of the carrying value of its assets should be recorded pursuant to SFAS No. 144. The financial statements of KPB reflect KPB as an entity and as an entity KPB's assets are held and used and not held for sale. KPB as an entity had no plans to sell any of its separate assets at March 31, 2006.

KPB determined that, with respect to its assets on a held and used basis, an indicator of impairment existed pursuant to SFAS No. 144. KPB recognized that IP's intent to sell its investment in the assets indicated that the fair market price of an asset group of KPB may have significantly decreased as discussed in SFAS No. 144. KPB performed a recoverability test of carrying values of its asset groups on a held and used basis. Specifically, the carrying values of its long-lived asset group within KPB were compared to the future cash flows expected to result from the operations of such asset groups on an undiscounted basis as of December 31, 2005, March 31, 2006 and December 31, 2006. KPB's assets were grouped for this purpose with other assets and liabilities at the lowest level of independent identifiable cash flows, which was the Roanoke Rapids, North Carolina and Fordyce, Arkansas facilities. KPB estimated those cash flows expected to be derived from using the assets under a held and used basis to determine whether there was an impairment, without consideration of any sale of such asset groups. The results of those tests indicated that the undiscounted future cash flows of each asset group on a held and used basis exceeded the carrying amount of the respective long-lived assets in the accompanying financial statements.

On January 2, 2007, IP completed the sale of its unbleached kraft papers business to KapStone Paper and Packaging Corporation for approximately \$155 million in cash (subject to certain closing adjustments) and two contingent earn-out payments totaling up to \$60 million, payable five years from the close of the transaction, based upon future business performance.

**2. Summary of Significant Accounting Policies**

The consolidated statements have been prepared on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The significant accounting policies are summarized below:

**Principles of Consolidation** The consolidated financial statements include the accounts of the Company and subsidiaries. All significant intercompany accounts and transactions have been eliminated.

**Use of Estimates** The preparation of financial statements and related disclosures requires management to make estimates and assumptions that affect the amounts reported in the consolidated

KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

2. Summary of Significant Accounting Policies (Continued)

financial statements and accompanying notes. Although these estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future, actual results may be different from the estimates.

**Revenue Recognition** Revenue is recognized when the customer takes title and assumes the risks and rewards of ownership. Sales with terms designated f.o.b. (free on board) shipping point are recognized at the time of shipment. For sales transactions designated f.o.b. destination, revenue is recorded when the product is delivered to the customer's site and when title and risk of loss are transferred. Sales on consignment are recognized in revenue at the earlier of the month that the goods are consumed or after a period of time subsequent to receipt by the customer as specified by contract terms, provided all other revenue recognition criteria is met. Incentive rebates are typically paid in cash and are netted against revenue on an accrual basis as qualifying purchases are made by the customer to earn and thereby retain the rebate. Prepaid rebates are recorded in prepaid expenses until earned.

Freight charged to customers is recognized in net sales.

**Cost of Sales** Cost of sales is determined on a first-in first-out basis and includes the following: the cost of inventory sold during the period, maintenance and property taxes related to manufacturing facilities and excludes depreciation and amortization. Proceeds received from the sale of by-products generated from the paper manufacturing process are reflected as a reduction to cost of sales. By-product revenue is derived primarily from the sale of tall oil and turpentine to a third party and is netted in cost of sales. During 2007, 2006, and 2005, cost of sales was reduced by \$5.9 million, \$5.4 million, and \$3.6 million for by-products.

**Annual Maintenance Cost** The Company recognizes the cost of major maintenance activities in the period in which they occur under the direct expense method of FSP No. AUG AIR-1, *Accounting for Planned Major Maintenance Activities*. Other maintenance costs are expensed as incurred.

The Company completed its annual planned maintenance shutdown during the quarter ended June 30, 2007. Costs of \$4.6 million related to the shutdown are included in cost of sales for the years ended December 31, 2007 and 2006 (Predecessor).

**Net Income per Common Share** Basic net income per share is based on the weighted average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution assuming common shares were issued for the exercise of outstanding in-the-money warrants and stock options and restricted stock awards and assuming the proceeds thereof were used to purchase common shares at the average market price during the period such awards were outstanding.

**Concentrations of Risk** Financial instruments that potentially expose the Company to concentrations of credit and market risk consist primarily of cash and cash equivalents and trade accounts receivable from sales of product to third parties. Cash and cash equivalents are placed in high credit quality securities.



## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**2. Summary of Significant Accounting Policies (Continued)**

A summary of net sales to major customers who exceeded 10% of consolidated net sales is as follows (\$000's):

	Year ended December 31, 2007	Predecessor KPB Years ended December 31,	
		2006	2005
Net sales to largest customer	\$ 43,963	\$ 50,000	\$ 53,500
Net sales to second largest customer	26,669	27,322	24,600
Net sales to third largest customer		23,100	22,700

Sales to the above customers are reflected in the unbleached kraft operating segment.

Receivables from these customers that potentially expose the Company to concentrations of credit risk totaled \$5.1 million, \$10.1 million (Predecessor) and \$12.9 million (Predecessor) at December 31, 2007, 2006 (Predecessor) and 2005 (Predecessor), respectively.

The Company establishes its allowance for doubtful accounts based upon factors surrounding the credit risks of specific customers, historical trends, and other information. No allowance for doubtful accounts was deemed necessary at December 31, 2007. At December 31, 2006, Predecessor's allowance for doubtful accounts was \$0.7 million. For the years ended December 31, 2006 and 2005, Predecessor's bad debt expense was approximately \$0.2 million and \$0.1 million, respectively.

**Cash and Cash Equivalents** Cash equivalents include all highly liquid investments with maturities of three months or less when purchased. Such investments are stated at cost which approximates fair value. The Company has no restricted cash as of December 31, 2007, (see note 4).

**Restricted Cash** At December 31, 2006, Predecessor restricted cash held by trustees related to certain bonds payable is included in other assets in the amount of \$1.4 million.

**Fair value of Financial Instruments** Due to the short maturities of receivables and payables, the carrying values of these financial instruments approximates their fair values. The fair value of Predecessor's debt is estimated based on current rates offered for debt of the same maturity. The fair value of Predecessor's debt was approximately \$27.3 million at December 31, 2006.

**Inventories** Inventories are valued at the lower of cost or market; whereby, cost includes all direct and indirect materials, labor, and manufacturing overhead, less by-product recoveries. Costs of raw materials, work-in-process, and finished goods are determined using the first-in, first-out method. Replacement parts and other supplies are stated using the average cost method.

**Plant, Property, and Equipment, net** Plant and equipment is stated at cost less accumulated depreciation. Property, plant and equipment acquired in the KPB acquisition was recorded at fair value

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**2. Summary of Significant Accounting Policies (Continued)**

on the date of acquisition (see Note 4). Depreciation is computed using the straight-line method over the assets' estimated useful lives. The range of estimated useful lives is as follows:

	Years
Machinery and equipment	1-30
Buildings	20-40
Computer hardware and software	3-6
Furniture and office equipment	3-10
Leasehold improvements	Lesser of life of leasehold improvements or term of the lease

The Company accounts for costs incurred for the development of software for internal use in accordance with the American Institute of Certified Public Accountants Statement of Position No. 98-1 ("SOP 98-1"), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. SOP-98-1 requires the capitalization of certain costs incurred in connection with developing or obtaining internal use software.

**Impairment of Long-Lived Assets** Long-lived assets, excluding goodwill and indefinite-lived intangibles, are reviewed for impairment upon the occurrence of events or changes in circumstances that indicate that the carrying value of the assets or group of assets may not be recoverable, as measured by comparing their net book value to the undiscounted estimated future cash flows generated by their use. In the event undiscounted estimated future cash flows are less than the net book value, an impairment charge is recorded to reflect the estimated fair value of the assets, determined principally using discounted cash flows.

**Income Taxes** The Company accounts for income taxes under the liability method in accordance with SFAS No. 109, *Accounting for Income Taxes*. Accordingly, deferred income taxes are provided for the future tax consequences attributable to differences between the carrying amounts of assets and liabilities for financial reporting and income tax purposes. Deferred tax assets and liabilities are measured using tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. A valuation allowance is established when necessary to reduce deferred tax assets to the amount expected to be realized.

**Deferred Acquisition Costs** The Company capitalizes direct external costs incurred relating to planned acquisitions which include legal fees, due diligence and other costs.

**Stock Based Compensation Costs** The Company accounts for stock awards in accordance with SFAS No. 123 (R), *Share Based Payment*. Accordingly, compensation expense for the fair value of stock options, as determined on the date of grant, is recorded on an accelerated basis over the awards' vesting periods. The compensation expense for the fair value of restricted stock, as determined on the date of grant, is recorded on a straight-line basis over the awards' vesting periods. For the year ended December 31, 2007, \$0.7 million in stock compensation expense has been recognized.

**Recent Accounting Pronouncements.**

In December 2007, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141 (R), *Business Combinations* ("FAS 141(R)") and SFAS No. 160, *Accounting and Reporting of Noncontrolling*

KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**2. Summary of Significant Accounting Policies (Continued)**

*Interest in Consolidated Financial Statements, an amendment of ARB 51* ("FAS 160"). These Statements improves reporting by creating greater consistency in the accounting and financial reporting of business combinations and non-controlling interests, resulting in more complete, comparable, and relevant information for investors and other users of financial statements. To achieve this goal, FAS 141(R) requires the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction; with limited exceptions, establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. FAS 160 requires: non-controlling interest (previously referred to as minority interest) be presented as a component of equity separate from parent's equity; the amount of income attributable to parent and non-controlling interest be clearly identified on the face of the income statement; and changes in ownership of a controlling subsidiary; whereby, control is not lost, is treated as equity transactions. FAS 141(R) and FAS 160 are effective for fiscal years beginning after December 15, 2008, required to be adopted simultaneously and early adoption is not permitted. The Company is currently evaluating the potential impact of the adoption of FAS 141(R) and FAS 160 on the Company's consolidated financial statements. The guidance will be effective for any acquisitions closed by the Company beginning on or after January 1, 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company is currently evaluating the potential impact, if any, of SFAS No. 159 on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, ("SFAS No. 157"). SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value and the expanded disclosures about fair value measurements. The Statement is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company does not believe that the adoption of the provisions of SFAS No. 157 will materially impact the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, ("SFAS No. 158"). SFAS No. 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through other comprehensive income. SFAS No. 158 also requires an employer to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end. The provisions of this Statement are effective for an employer with publicly traded equity securities and are required to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006; the measurement

KAPSTONE PAPER AND PACKAGING CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**2. Summary of Significant Accounting Policies (Continued)**

requirements are effective for fiscal years ending after December 15, 2008. The Company adopted the recognition and disclosure requirements of SFAS No. 158 as of January 1, 2007 and the adoption did not have a material significant effect on the Company's consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes*. FIN 48 prescribes detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. The Company adopted the recognition and disclosure requirements of FIN No. 48 on January 1, 2007. There was no impact on the Company's financial statements upon adoption.

**3. Reclassifications**

Certain selling, general and administrative expenses related to administrative salaries of manufacturing personnel of prior period Predecessor balances have been reclassified to cost of sales to conform to the current period presentation. The reclassification had no effect on operating income or net income.

**4. KPB Acquisition**

On January 2, 2007, the Company purchased substantially all of the assets and assumed certain liabilities of the Kraft Papers Business, or KPB, a division of IP, consisting of an unbleached kraft paper manufacturing facility in Roanoke Rapids, North Carolina and Ride Rite® Converting, an inflatable dunnage bag manufacturer located in Fordyce, Arkansas, trade accounts receivables, and inventories for a cash purchase price of \$155.0 million less certain post-closing adjustments of \$7.8 million plus two contingent earn-out payments of up to \$60.0 million (in aggregate), based on KPB's annual earnings before interest, income taxes and depreciation and amortization, or EBITDA, during the five years immediately following the acquisition. Any contingent earn-out payments will be accounted for as additional purchase price consideration and be recorded as goodwill if such performance targets are achieved. KPB was deemed an attractive acquisition candidate based on meeting the objectives of being a North American based profitable operating company in the paper and packaging industry.

The KPB acquisition was accounted for in accordance with the provisions of SFAS No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**4. KPB Acquisition (Continued)**

The Company used a portion of restricted cash held in trust at December 31, 2006 of \$115.2 million, combined with the net long-term loan proceeds of \$59.1 million (\$60.0 million less \$0.9 million of financing costs) to fund the acquisition.

The final purchase price allocation includes cash of \$155.0 million less post-closing adjustments of \$7.8 million plus transaction costs of \$3.3 million. The following table summarizes the fair value of the assets acquired and the liabilities assumed at the date of the acquisition. The allocation of the acquisition consideration is final (\$000's):

Trade accounts receivable	\$	26,498
Inventories		25,613
Prepaid expenses and other current assets		1,089
Plant, property and equipment		104,820
Other assets		1,103
Goodwill		2,295
Intangible assets		6,058
Accounts payable		(7,931)
Accrued expenses		(5,843)
Pension and post-retirement benefits		(2,258)
Deferred income taxes, net		(676)
Other liabilities		(265)
		<hr/>
Allocated acquisition consideration	\$	150,503
		<hr/>

The intangible assets represent the value of a long term lease with favorable terms compared to market rates, \$3.1 million, the Ride Rite Converting trademark, \$2.8 million and customer lists, \$0.2 million. The favorable building lease asset is being amortized over 19 years, the remaining lease term. Customer lists are amortized over 8 years. For the year ended December 31, 2007, amortization expense totaled \$0.2 million. Trademarks were appraised with an indefinite life and as a result are not being amortized, but are subject to an annual impairment review.

The expected amortization expense for intangible assets is \$0.2 million for each of the next five fiscal years ending December 31, and \$2.1 million thereafter.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized, but instead is tested annually for impairment, or more frequently, if circumstances indicate a possible impairment may exist. The impairment test was conducted in the fourth quarter of 2007. Goodwill is allocated amongst reporting units in proportion to the fair value of their net assets acquired at January 2, 2007. Goodwill allocated to the unbleached kraft and dunnage bag reporting units was \$1.1 million and \$1.2 million, respectively, at December 31, 2007.

The appraisal process for determining the fair value of the acquired KPB assets, in accordance with SFAS No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*, included a valuation of the acquired assets with a consideration of the three traditional valuation approaches to fair value: cost, market and income. The appraisal was based on management's estimates and assumptions.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**4. KPB Acquisition (Continued)**

As part of the KPB acquisition, the Company assumed liabilities for retiree medical/life obligation for employees not eligible to retire at December 31, 2006, of \$0.9 million. In addition, obligations for an increase in the hourly pension benefit level totaling \$1.4 million were assumed by the Company. Pursuant to the purchase agreement with IP, in May 2007, the Company established a defined benefit pension plan for its union employees providing benefits beginning January 1, 2007. See Note 9.

The following unaudited pro forma financial information combines certain accounts of KapStone and KPB for the year ended December 31, 2006, giving effect to the transaction as if it had occurred on January 1, 2006.

The historical financial information has been adjusted to give effect to pro forma events that are directly attributable to the transaction, are factually supportable and have a recurring impact.

	<u>Unaudited</u>
Net sales	\$ 246,161
Operating income	\$ 38,858
Net income	\$ 21,490
Net income per share basic	\$ 0.86
Net income per share diluted	\$ 0.73

**5. Inventories**

Inventories consist of the following at December 31, 2007 and 2006, respectively (\$000's):

	<u>December 31,</u>		<u>Predecessor KPB</u>
	<u>2007</u>	<u>2006</u>	<u>December 31, 2006</u>
Raw materials	\$ 5,351	\$ 6,466	\$ 6,466
Work in process	655	321	321
Finished goods	6,363	13,352	13,352
Replacement parts and supplies	3,989	3,948	3,948
Inventories	<u>\$ 16,358</u>	<u>\$ 24,087</u>	<u>\$ 24,087</u>

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**6. Plant, Property and equipment**

Plant, property and equipment consist of the following at December 31, 2007 and 2006, respectively (\$000's):

	December 31,		Predecessor KPB
	2007	2006	December 31, 2006
Land	\$ 4,170	\$	\$ 4,919
Buildings	3,769		22,756
Machinery and equipment	101,966		425,846
Leasehold improvements	269		
Construction-in-progress	5,828		1,880
	<u>116,002</u>		<u>455,401</u>
Less accumulated depreciation	11,144		253,808
	<u>\$ 104,858</u>	\$	<u>\$ 201,593</u>

Depreciation expense for the years ended December 31, 2007 and 2006 was \$11.1 million and \$18.2 million (Predecessor), respectively.

At December 31, 2007, included in construction in progress is \$3.9 million of software development costs for the Company's new Enterprise Resource Planning system. The new ERP system had not been placed into service as of December 31, 2007.

The Company leases a 155,000 square foot production facility in Fordyce, Arkansas, under a 19 year lease with annual rentals of \$0.1 million through 2012 reducing to less than \$0.1 million in 2013 through the end of the lease term.

**7. Accrued expenses**

Accrued expenses consist of the following at December 31, 2007 and 2006, respectively (\$000):

	As of December 31,		Predecessor KPB
	2007	2006	December 31, 2006
Accrued acquisition costs	\$ 520	\$ 2,073	\$
Accrued audit and accounting	284	161	
Accrued capital spending	700		
Accrued taxes other than income tax	1,835	224	64
Other miscellaneous accruals	1,528	328	2,572
	<u>\$ 4,867</u>	<u>\$ 2,786</u>	<u>\$ 2,636</u>

**8. Long-term Debt and Credit Facility**

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On January 2, 2007 in connection with the KPB acquisition, the Company obtained a senior secured credit facility, which provided the Company the ability to borrow up to \$95.0 million pursuant to a five year \$35.0 million revolving line of credit and a five year \$60.0 million term loan, due

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## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**8. Long-term Debt and Credit Facility (Continued)**

December 31, 2011. Advances under the revolving line of credit are primarily based upon percentages of eligible accounts receivable and inventories. At December 31, 2007, the only advance under the revolving line of credit was a letter of credit for \$0.3 million. The credit facility is secured by all of the Company's tangible and intangible assets and all of the tangible and intangible assets of the Company and its subsidiary and a pledge of the capital stock of the Company.

Long-term debt as of December 31, 2007 is summarized as follows (\$000's):

	As of December 31,		Predecessor KPB
	2007	2006	December 31, 2006
Term loan	\$ 52,500	\$	\$
Less current portion of long-term debt		19,578	
Halifax County 2001A 5.9%			6,583
Northampton County 2001A 6.20%			2,100
Halifax County 1999 6.45%			3,823
Northampton County 1999 6.45%			3,332
Halifax County 1998 5.45%			6,519
<b>Total Long-term debt</b>	<b>\$ 32,922</b>	<b>\$</b>	<b>\$ 22,357</b>

Borrowings under the term loan accrue interest, at our option, at either: LIBOR plus 1.25% to 2.00% depending on the Company's total debt to EBITDA ratio (as defined in the agreement); or the Base Rate (prime rate) plus 0% to .50% depending on the Company's total debt to EBITDA ratio. At December 31, 2007, the LIBOR loan rate, which adjusts quarterly, was 6.3% for the balance of the term loan (\$52.5 million).

The Company is required to make prepayments on the term loan under certain circumstances from the net cash proceeds of certain asset dispositions, issuances of securities or debt, and 50% of the excess cash flow generated in fiscal years ending December 31, 2007 and 2008. At December 31, 2007, this prepayment requirement totaled \$11.6 million. In addition, \$1.6 million of funds received from the exercise of common stock warrants has been classified as current portion of long-term debt as it is required to be prepaid. These prepayments, presented as current portion of long-term debt on the accompanying Consolidated Balance Sheets, are due within 100 days after the fiscal year ended December 31, 2007 and are prorated against the original future quarterly loan payment schedule.

The aggregate maturities of our term loan for each of the next five years are as follows: \$19.6 million in 2008 (including \$13.2 million of prepayments due), \$6.3 million in 2009, \$6.3 million in 2010, \$20.3 million in 2011, and no payments thereafter.

**Debt Covenants**

The term loan and revolving line of credit governing KapStone's senior secured credit facility contain, among other provisions, covenants with which KapStone must comply while they are in force. The covenants limit KapStone's ability to, among other things, incur indebtedness, create additional liens on its assets, make investments, engage in mergers and acquisitions, pay dividends and sell any assets outside the normal course of business.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**8. Long-term Debt and Credit Facility (Continued)**

KapStone's senior secured credit facility includes requirements to maintain minimum earnings before interest expense, income taxes, depreciation and amortization amount, a maximum leverage ratio and a minimum fixed charge coverage ratio. The secured credit facility also defines a permitted level of annual capital spending. The leverage ratio is calculated by dividing KapStone's debt by its rolling twelve month total earnings before interest expense, taxes, depreciation and amortization. The coverage ratio is calculated by dividing KapStone's earnings before interest expense, taxes, depreciation and amortization less cash payments for income taxes and capital expenditures by its consolidated cash financing expense.

The minimum earnings before interest expense, income taxes, depreciation and amortization amount at December 31, 2007 is \$29.4 million. The maximum leverage ratio is 3.50 as of December 31, 2007. The minimum fixed charge coverage ratio is 1.10:1 as of December 31, 2007. The maximum permitted capital spending for the year ended December 31, 2007, is \$15 million.

As of December 31, 2007, KapStone was in compliance with all applicable covenants.

**9. Retirement Plans****Defined Benefit Plan**

As part of the KPB acquisition, the Company established the KapStone Paper and Packaging Corporation Defined Benefit Plan ("Plan") to provide benefits for approximately 560 union represented employees. This plan is part of the collective bargaining agreement between Kapstone and the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied-Industrial, Chemical and Service Workers Union, AFL-CIO, CLC. The assumed liability for the retroactive benefits provided for prior service was \$1.4 million at January 2, 2007, and employees accrue benefits under the Plan as of January 1, 2007. The measurement date for the plan is December 31, 2007.

Net pension cost recognized for the year ended December 31, 2007 for the Company's pension plan, as well as the amount of allocated pension costs from IP to the Predecessor for the years ending December 31, 2006 and 2005, is as follows (\$000's):

	Year Ended December 31, 2007	Predecessor KPB Years Ended December 31,	
		2006	2005
Service cost for benefits earned during the year	\$ 1,154	\$	\$
Interest cost on projected benefit obligations	84		
Return on plan assets	(1)		
Allocation of pension cost from IP		1,233	757
Net pension cost	\$ 1,237	\$ 1,233	\$ 757
Weighted Average discount rate assumption used to measure net periodic cost	6.00%		

The Company annually evaluates and updates as necessary the assumptions used in the determination of net pension cost, including the discount rate and the expected return on plan assets. The discount rate and the long-term rate of return on plan assets as of December 31, 2007 were 6.0% and 7.5% respectively. The discount rate reflects long-term high quality bond rates.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**9. Retirement Plans (Continued)**

As of December 31, 2007 the plan is under funded by \$2.6 million which has been recorded in the accompanying Consolidated Balance Sheets. The Company will fund its pension plan according to IRS funding limitations. Based on those limitations, KapStone expects to contribute \$1.1 million to its pension plan in 2008.

The following reconciles beginning and ending projected benefit obligation for the Company. No obligation was recognized for the years ended December 31, 2006 and 2005 as the Company's plan was initiated on January 2, 2007 (\$000's).

	<u>December 31, 2007</u>
Projected benefit obligation assumed at acquisition	\$ 1,398
Service cost for benefits earned during the year	1,154
Interest cost on projected benefit obligations	84
Actuarial loss	3
	<u>2,639</u>
Projected benefit obligation at end of year	\$ 2,639
Weighted Average discount rate assumption used to measure projected benefit obligation	6.00%

The accumulated benefit obligation at December 31, 2007, was \$2.6 million.

The following reconciles beginning and ending fair value of the Company's plan assets (\$000's):

	<u>December 31, 2007</u>
Fair value of plan assets at beginning of year	\$
Actual return on plan assets	(46)
Employer contributions	50
	<u>4</u>
Fair value of plan assets at end of year	\$ 4

The following benefit payments are expected to be paid over the next 10 fiscal years ending December 31 (\$000's):

2008	\$ 25
2009	44
2010	73
2011	100
2012	140
Years 2013 and thereafter	1,450

For the years ended December 31, 2006 and 2005, IP allocated \$0.8 million and \$0.5 million, respectively, to KPB for salaried pension expense.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**9. Retirement Plans (Continued)***Other Post-retirement Benefits*

As part of the KPB acquisition, the Company assumed liabilities for retiree medical/life obligation for the prior service of hourly employees not eligible to retire at December 31, 2006, of \$0.9 million. The measurement date for the plan is December 31, 2007.

Included in accumulated other comprehensive income at December 31, 2007 is an unrecognized actuarial gain of \$0.1 million, net of tax. The estimated actuarial gain that will be amortized into 2008 periodic post-retirement cost is less than \$0.1 million.

Net post-retirement cost recognized for the year ended December 31, 2007, for the Company's retiree medical and life insurance benefits as well as the amount of allocated retiree medical and life insurance benefit costs from IP to the Predecessor for the years ending December 31, 2006 and 2005, is as follows (\$000's):

	Year Ended December 31, 2007	Predecessor KPB Years Ended December 31,	
		2006	2005
Service cost for benefits earned during the year	\$ 27	\$	\$
Interest cost on projected benefit obligations	48		
Expected return on plan assets			
Allocation of post-retirement cost from IP		221	366
Net postretirement cost	\$ 75	\$ 221	\$ 366

Weighted Average discount rate assumption used to measure net periodic cost 5.50%

The Company annually evaluates and updates as necessary the assumptions used in the determination of post-retirement benefit cost, including the discount rate and health care trend rates. The discount rate as of December 31, 2007 was 5.50%. The discount rate reflects long-term high quality bond rates.

As of December 31, 2007 the plan is under funded by \$0.8 million which has been recorded in the accompanying Consolidated Balance Sheets. The plan is only funded in an amount equal to benefits paid. The Company does not fund these benefits prior to payment of claims.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**9. Retirement Plans (Continued)**

The following reconciles beginning and ending projected benefit obligations (\$000's):

	<u>2007</u>
Projected benefit obligation assumed at acquisition	\$ 860
Service cost for benefits earned during the year	27
Interest cost on projected benefit obligations	48
Actuarial (gain)/loss	(174)
Benefits paid	
	<u>761</u>
Projected benefit obligation at end of year	\$ 761
Weighted Average discount rate assumption used to measure projected benefit obligation	5.50%

The following benefit payments are expected to be paid over the next 10 fiscal years ending December 31 (\$000's):

2008	\$ 19
2009	98
2010	165
2011	174
2012	133
Years 2013-2017	337

For the years ended December 31, 2006 and 2005, IP allocated \$0.2 million each year to KPB for post-retirement costs for salaried employees.

**Defined Contribution Plans**

In January 2007 the Company established a defined contribution plan covering all eligible employees. Company contributions to the 401(k) plan are based on matching of employee contributions, vest immediately for salaried employees and vest after three years for union employees. For the year ended December 31, 2007, the Company recognized expense of \$1.0 million for matching contributions.

The Company's Retirement Savings Plan, which covers all eligible salaried employees, provides for contributions based on an employee's salary and age. The Company contributions vest 100% after three years. For the year ended December 31, 2007, the expense recognized by the Company for contributions to the Retirement Savings Plan was \$0.6 million. Retirement Savings Plan contributions were made to employees' 401(k) accounts in January 2008.

**10. Income taxes**

The Company's U.S. federal statutory tax rate is 35% for 2007 and 34% for 2006 and 2005. The Company's effective tax rate for the years ended December 31, 2007, 2006 and 2005 was 36.0%, 33.8% and 34.0%, respectively. All income is earned in the United States.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**10. Income taxes (Continued)**

The Company's provision for income taxes for the years ended December 31, 2007, 2006 and 2005 consists of the following (\$000's):

	Years Ended December 31,		
	2007	2006	2005
<b>Current:</b>			
Federal	\$ 13,298	\$ 1,818	\$ 385
State	2,084	6	
Total current	15,382	1,824	385
<b>Deferred:</b>			
Federal	\$ (152)	\$ (705)	\$ 36
State	(92)		
Total deferred	(244)	(705)	36
Total provision for income taxes	\$ 15,138	\$ 1,119	\$ 421

The Company's income tax provision differs from the amount computed using the statutory federal income tax rate as follows:

	Years Ended December 31,		
	2007	2006	2005
Statutory tax rate	35.0%	34.0%	34.0%
State income taxes, net of federal income tax benefit	3.2		
Manufacturing deduction & other permanent differences	(2.0)		
Other	(0.2)	(0.2)	
	36.0%	33.8%	34.0%

The effective tax rate for the year ended December 31, 2007, includes a 2.0% benefit provided to U.S. manufacturers under the American Jobs Creation Act of 2004.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**10. Income taxes (Continued)**

The tax effects of the temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 31, 2007 and 2006 for the Company are as follows (\$000's):

	Years Ended December 31,	
	2007	2006
Deferred tax assets and liabilities resulting from:		
Reserve accounts	\$ 116	\$
Inventories	394	
Accrued compensation costs	789	
Start up costs	621	689
Pension and post retirement benefits	928	
Stock based compensation	268	
	<u>3,116</u>	<u>689</u>
Total deferred tax assets	3,116	689
Prepaid expenses	(36)	
Tax depreciation in excess of book depreciation	(1,312)	
Intangible assets and other	(1,552)	
	<u>(2,900)</u>	
Total deferred tax liabilities	(2,900)	
	<u>\$ 216</u>	<u>\$ 689</u>
Net deferred tax assets	\$ 216	\$ 689

At December 31, 2007 and 2006 the Company had the following deferred tax balances on the Consolidated Balance Sheets (\$000's):

	Years Ended December 31,	
	2007	2006
Current deferred tax assets, net	\$ 1,263	\$
Non current deferred tax assets		689
Non current deferred tax liabilities, net	(1,047)	
	<u>\$ 216</u>	<u>\$ 689</u>
Total deferred tax assets, net	\$ 216	\$ 689

The Company believes that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the deferred tax assets.

In July 2006, the Financial Accounting Standards Board issued Financial Interpretation Number ("FIN") 48, which clarifies the application of SFAS No. 109. FIN 48 establishes a threshold condition that a tax position must meet for any part of the benefit of such a position to be recognized in the financial statements. In addition, FIN 48 provides guidance regarding measurement, de-recognition, classification, and disclosure of tax positions. The Company adopted FIN 48 effective January 1, 2007. The Company to date has no unrecognized tax benefit. The Company classifies interest and penalties as a component of the provision for income taxes. We do not have any significant uncertain income tax positions included in the accompanying consolidated financial statements at December 31, 2007.

In the normal course of business, we are subject to examination by taxing authorities. The Company's open tax years are 2005 and 2006.





**KAPSTONE PAPER AND PACKAGING CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(In thousands, except share and per share amounts)**

**10. Income taxes (Continued)**

The results of operations of the Predecessor were included in the income tax returns of IP. In the accompanying consolidated financial statements, the Predecessor reflected U.S. federal and state income tax expense on its pretax income based on an allocated rate of 38.64%. The Predecessor settled the current amount due to/from IP through the divisional control account.

**11. Stockholder's equity and Predecessor Divisional Control**

*Common Stock Warrants*

In connection with the Company's initial public offering, on August 19, 2005, the Company sold 20,000,000 units ("Units") for a gross price of \$6.00 per Unit. Each Unit consists of one share of the company's common stock, \$0.0001 par value, and two warrants ("Warrants"). Each Warrant entitles the holder to purchase from the Company one share of common stock at an exercise price of \$5.00 and expires on August 15, 2009. The Warrants are redeemable by the Company at a price of \$0.01 per Warrant upon 30 days notice after the Warrants become exercisable, only in the event that the last sale price of the common stock is at least \$8.50 per share for any 20 trading days within a 30 day trading period ending on the third day prior to the date on which notice of redemption is given.

*Common Stock Reserved for Issuance*

At December 31, 2007, approximately 39.7 million shares of common stock were reserved for issuance upon exercise of warrants, 3.0 million shares for stock awards and 3.0 million shares for the underwriter's option.

*Underwriter's Fee*

In connection with the Company's initial public offering on August 19, 2005, the Company agreed to pay the underwriter \$1.2 million relating to the Company's initial public offering payable upon a successful business combination. Upon the closing of KPB in January 2007, the fee was paid and charged against additional paid in capital.

*Underwriter's Purchase Option*

In connection with the Company's initial public offering, the Company paid the underwriters an underwriting discount of five percent of the gross proceeds of the Offering. The Company also issued for \$100 an option to the representative of the underwriters to purchase up to a total of 1,000,000 units at a price of \$7.50 per unit. The units issuable upon the exercise of this option are identical to those offered in the public offering, except that the exercise price of the warrants included in the underwriters' purchase option is \$6.25. This option is exercisable commencing on the later of the consummation of a Business Combination or one year from the date of the public offering, expires five years from the date of the public offering, and may be exercised on a cashless basis. However, the option may be transferred to any underwriter or selected dealer participating in the public offering and their bona fide officers or partners.

The underwriters' purchase option and the Warrants (including the warrants underlying the underwriters' option) will be exercisable only if at the time of exercise a current registration statement covering the underlying securities is effective or, in the opinion of counsel, not required, and if the

**KAPSTONE PAPER AND PACKAGING CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(In thousands, except share and per share amounts)**

**11. Stockholder's equity and Predecessor Divisional Control (Continued)**

securities are qualified for sale or exempt from qualification under the applicable state securities laws of the exercising holder. The Company is obligated to use its best efforts to maintain an effective registration statement during the term of the option and the Warrants; however, it may be unable to do so. Holders of the option and the Warrants are not entitled to receive a net cash settlement or other settlement in lieu of physical settlement if the common stock underlying the Warrants, or securities underlying the option, as applicable, are not covered by an effective registration statement. Accordingly, the Warrants, which do not have a cashless exercise provision, may expire unexercised and worthless if a current registration statement covering the common stock is not effective.

The holders of the option have demand and piggy-back registration rights under the Securities Act for periods of five and seven years, respectively, from the date of the prospectus with respect to registration of the securities directly and indirectly issuable upon exercise of the option. The exercise price and number of units issuable upon exercise of the option may be adjusted in certain circumstances, including issuances of a stock dividend, recapitalization, reorganization, merger or consolidation. However, the option will not be adjusted for issuances at a price below its exercise price.

The Company has estimated, based upon a Black Scholes model, that the fair value of the purchase option on the date of sale was approximately \$980,000, using an expected life of four years, volatility of 23.9 percent, and a risk-free interest rate of 3.93 percent. However, because the Units did not have a trading history, the volatility assumption was based on information available to management. The volatility estimate was derived using five-year historical stock prices for the nine companies in the Standard and Poor's Supercomposite Paper Packaging Index. The Company believes the volatility estimate calculated from this index is a reasonable benchmark to use in estimating the expected volatility of the Units; however, the use of an index to estimate volatility may not necessarily be representative of the volatility of the underlying securities.

The Company accounted for this purchase option, inclusive of the receipt of the \$100 cash payment, as an expense of the public offering resulting in a charge directly to stockholders' equity. Accordingly there was no impact in the Company's financial position or results of operations except for the recording of the \$100 proceeds from the sale.

***Redemption Status of Common Stock***

The registration statement for the Company's initial public offering indicated that, after signing a definitive agreement for the acquisition of a target business, the Company would submit such transaction for stockholder approval. Based on the votes submitted on December 29, 2006, 40,000 shares voted against the proposed KPB business combination and sought to be redeemed for cash. As a result, \$0.2 million of the net proceeds from the initial offering plus interest was classified as common stock subject to redemption at December 31, 2006. The stock redemption occurred in February 2007 and the redeemed shares were held in treasury at December 31, 2007.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**11. Stockholder's equity and Predecessor Divisional Control (Continued)***Predecessor Division Control*

KPB operated in 2005 and 2006 as a division of IP. Accordingly, certain operating, financing, and investing activities of KPB were funded through interdivisional transactions with IP and its other operating divisions and subsidiaries. The accompanying combined balance sheets reflect these amounts on the divisional control account.

Intercompany sales and purchases with wholly owned entities of IP may result in payables or receivables that have not been settled through the divisional control account at December 31, 2006 and 2005. Such amounts are reported separately from the divisional control account. Trade and non-trade transactions that involve U.S. locations were allowed to accumulate in the intercompany accounts. Trade transactions involving non-U.S. locations were settled with cash according to the terms of the sale. Non-trade transactions involving non-U.S. locations were settled with cash by the end of each calendar quarter.

There has been no direct interest income or interest expense (other than capitalized interest) allocated to KPB by IP with respect to the divisional control account or other net receivables or payables due to/from IP.

The changes in the divisional control account for the years ended December 31, 2006 and 2005 are as follows (in thousands of U.S. dollars):

	<u>2006</u>	<u>2005</u>
Balance January 1	\$ 228,557	\$ 239,648
Net income	19,967	4,933
Funding (distributed to)/provided by IP	(28,839)	(16,024)
	<u>          </u>	<u>          </u>
Balance December 31	\$ 219,685	\$ 228,557
	<u>          </u>	<u>          </u>

**12. Stock-Based Compensation**

On December 29, 2006, stockholders approved the 2006 Incentive Plan ("Plan"). A maximum of 3.0 million shares of our common stock, available for issuance pursuant to stock options, restricted stock awards or stock appreciation rights (collectively called "Awards"), may be granted under the Plan. If any Award is forfeited or expires without being exercised, or if restricted stock is repurchased by the Company, the shares of stock subject to the Award shall be available for additional grants under the Plan. The number of shares available under the Plan is subject to adjustment in the event of any stock split, stock dividend, recapitalization, spin-off or other similar action. Awards may be granted to employees, officers and directors of, and consultants or advisors to, the Company and any subsidiary corporations. Options intended to qualify, under the standards set forth in certain federal tax rules, as incentive stock options ("ISOs") may be granted only to employees while actually employed the Company. Non-employee directors, consultants and advisors are not entitled to receive ISOs. Option Awards granted under the Plan are exercisable for a period fixed by the Administrator, but no longer than 10 years from the date of grant, at an exercise price which is not less than the fair market value of the shares on the date of the grant.

During 2007, the Company's Compensation Committee approved the stock awards of 174,000 shares of restricted stock and 631,050 stock options to directors, executive officers and employees of

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**12. Stock-Based Compensation (Continued)**

the Company. The Company accounts for these awards in accordance with SFAS No. 123R, *Share-Based Payment*, which requires that the cost resulting from all share-based payment transactions be recognized as compensation cost over the vesting period based on the fair value of the instrument on the date of grant. As a result, the Company recognized \$0.7 million compensation cost for the year ended December 31, 2007.

At December 31, 2007, common stock reserved for future stock awards totaled 3.0 million shares.

SFAS No. 123R requires that cash flows relating to the benefits of tax deductions in excess of recognized compensation cost be reported as financing cash flow, rather than as an operating cash flow, as previously required. The Company did not recognize any excess tax benefits for the year ended December 31, 2007.

**Stock options**

The stock options vest as follows: 50% after two years and the remaining 50% after three years. The stock options have a contractual term of seven years. The stock options are subject to forfeiture should these employees terminate their employment with the Company for certain reasons prior to vesting in their awards, or the occurrence of certain other events such as termination with cause. The exercise price of these stock options is based on closing market price of our common stock on the date of grant and compensation expense is recorded on an accelerated basis over the awards' vesting periods.

A summary of information related to stock options is as follows:

KapStone Stock Options	Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Intrinsic Value (dollars in Thousands)
Outstanding at January 1, 2007		\$		
Granted	631,050	6.77	6.3	147
Exercised				
Lapsed (forfeited or cancelled)				
Outstanding at December 31, 2007	631,050	\$ 6.77	6.3	\$ 147
Exercisable at December 31, 2007		\$		

Total stock-based compensation recorded in the Consolidated Statements of Income related to the stock option grants was \$0.4 million for the year ended December 31, 2007.

As of December 31, 2007, there was \$1.0 million of total unrecognized compensation cost related to non-vested stock options. That cost is expected to be recognized over a weighted average period of 2.3 years. No stock options were vested as of December 31, 2007.

The weighted average fair value for the KapStone stock options granted in 2007 was \$2.30 per option. The fair value was estimated using the Black-Scholes option-pricing model based on the average market price at the grant date and the weighted average assumptions specific to the underlying options. Expected volatility assumptions are based on volatility of related peer companies. The expected term is based on management's estimate of employees' expected exercise behavior. The risk-free

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

## 12. Stock-Based Compensation (Continued)

interest rate was selected based upon yields of U.S. Treasury issues with a term equal to the expected life of the stock option being valued. The assumptions utilized for stock options during the period are as follows:

	<b>Year Ended December 31, 2007</b>
KapStone Stock Options Black-Scholes assumptions (weighted average):	
Expected volatility	28.6%
Expected term (years)	5.0
Risk-free interest rate	4.6%
Expected dividend yield	0.0%
Expected forfeitures	2.0%
<b>Restricted Stock</b>	

In April 2007, the Company's Compensation Committee granted 174,000 restricted shares of common stock to executive officers and employees as compensation for service. These common stock shares are restricted as to transferability until they vest three years from the grant date. These restricted shares are subject to forfeiture should these employees terminate their employment with the Company for certain reasons prior to vesting in their awards, or the occurrence of certain other events. The value of these restricted shares is based on the closing market price of our common stock on the date of grant and compensation expense is recorded on a straight-line basis over the awards' vesting periods.

The following table summarizes restricted stock amounts and activity:

	<b>Shares</b>	<b>Weighted Average Grant Price</b>
Outstanding at January 1, 2007		\$
Granted	174,000	6.76
Vested		
Forfeited		
Outstanding at December 31, 2007	174,000	\$ 6.76

Total stock-based compensation recorded in the Consolidated Statements of Income related to the restricted stock awards was \$0.3 million for the year ended December 31, 2007. As of December 31, 2007, there was \$0.8 million of total unrecognized compensation cost related to the restricted stock which will be recognized over the remaining vesting period.

## 13. Commitments and Contingencies

*Legal claims*

From time to time, the Company has various lawsuits, claims, and contingent liabilities arising from the conduct of its business; however, in the opinion of management, they are not expected to

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**13. Commitments and Contingencies (Continued)**

have a material adverse effect on the combined results of operations, cash flows, or financial position of the Company.

**Operating Leases**

The following represents the Company's future minimum rental payments due under non cancellable operating leases that have initial or remaining lease terms in excess of one year as of the following years (\$000's):

Years Ending December 31,	
2008	506
2009	446
2010	396
2011	343
2012	254
Thereafter	639
Total	\$ 2,584

The Company's rental expense under operating leases amounted to \$1.1 million for the year ended December 31, 2007 and \$0.9 million for each of the years ended December 31, 2006 and 2005, respectively.

**14. Net income per share**

The Company's basic and diluted net income per share is calculated as follows (\$000's except for share and per share data):

	Years Ended December 31,		
	2007	2006	2005
Net income as reported	\$ 26,963	\$ 2,196	\$ 818
Weighted-average number of common shares for basic net income per share	25,010,057	25,000,000	15,307,692
Incremental effect of dilutive common stock equivalents:			
Common stock warrants	10,994,018	4,601,770	1,240,023
Underwriter's option	111,536		
Unvested restricted stock awards	18,877		
Weighted-average number of shares for diluted	36,134,488	29,601,770	16,547,715
Net income per share basic	\$ 1.08	\$ 0.09	\$ 0.05
Net income per share diluted	\$ 0.75	\$ 0.07	\$ 0.05

Stock option grants of 631,050 were outstanding at December 31, 2007, but were not included in the computation of diluted net income per share because the effect of including the stock option grants would be anti-dilutive.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

## 15. Segment Information

The Company operates in one geographic segment, the United States. The Company operates in two operating segments: unbleached kraft and dunnage bags. The unbleached kraft segment produces a variety of unbleached kraft paper and linerboard products. These products are sold to customers who convert the paper into end-market finished products. The dunnage bags segment converts unbleached Kraft paper and film into inflatable dunnage products, which are used to secure freight to minimize movement and potential damage of goods and products during transport. The products are sold to distributors and on a direct basis for use by manufacturers, less-than-trailer-load carriers and retail regional distribution centers. Corporate expenses that benefit the entire organization are not charged to the operating segments. Corporate assets represent mainly cash and cash equivalents, capitalized software for a new ERP system and deferred acquisition costs.

	Year Ended December 31,	Predecessor KPB	
		Years Ended December 31,	
Operating Segment (\$000's):	2007	2006	2005
Net sales:			
Unbleached kraft	\$ 227,921	214,175	\$ 191,007
Dunnage bags	32,801	35,753	35,381
Elimination of intersegment sales	(3,927)	(3,767)	(4,416)
Total	\$ 256,795	\$ 246,161	\$ 221,972
Net sales to external customers:			
Unbleached kraft	\$ 223,994	\$ 210,408	\$ 186,591
Dunnage bags	32,801	35,753	35,381
Total	\$ 256,795	\$ 246,161	\$ 221,972
Operating income/(loss):			
Unbleached kraft	\$ 51,901	34,280	8,112
Dunnage bags	6,350	7,514	7,490
Corporate	(13,951)	(7,843)	(6,124)
Total	\$ 44,300	\$ 33,951	\$ 9,478
Depreciation and amortization:			
Unbleached kraft	\$ 10,966	\$ 17,895	\$ 20,984
Dunnage bags	349	315	301
Corporate	12		
Total	\$ 11,327	\$ 18,210	\$ 21,285

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

## 15. Segment Information (Continued)

	Year Ended December 31,	Predecessor KPB	
		Years Ended December 31,	
Operating Segment (\$000's):	2007	2006	2005
Capital spending:			
Unbleached kraft	\$ 6,095	\$ 7,336	\$ 7,045
Dunnage bags	359		653
Corporate	5,407		
Total	\$ 11,861	\$ 7,336	\$ 7,698

Operating Segment (\$000's):	December 31, 2007	Predecessor KPB
		December 31, 2006
Total assets (at December 31, 2007 and 2006):		
Unbleached kraft	\$ 144,798	\$ 245,412
Dunnage bags	17,079	11,970
Corporate	63,573	
Total	\$ 225,450	\$ 257,382

## 16. Quarterly Financial Information (Unaudited)

The following tables set forth the historical unaudited quarterly financial data for fiscal 2007 and 2006. The information for each of these periods has been prepared on the same basis as the audited consolidated financial statements and, in our opinion, reflects all adjustments consisting only of normal recurring adjustments necessary to present fairly our financial results. Operating results for previous periods do not necessarily indicate results that may be achieved in any future period. Amounts are in thousands, except earnings per share information.



## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

## 16. Quarterly Financial Information (Unaudited) (Continued)

## Fiscal 2007

	Quarters Ended,			
	March 31, 2007	June 30, 2007 (1)	September 30, 2007	December 31, 2007
Net sales	\$ 65,427	\$ 60,242	\$ 66,188	\$ 64,938
Gross profit	\$ 15,132	\$ 10,289	\$ 16,984	\$ 17,053
Operating income	\$ 11,865	\$ 6,121	\$ 12,854	\$ 13,460
Net income	\$ 7,078	\$ 3,449	\$ 7,802	\$ 8,634
Net income per share:				
Basic	\$ 0.28	\$ 0.14	\$ 0.31	\$ 0.34
Diluted	\$ 0.21	\$ 0.09	\$ 0.21	\$ 0.23

(1) Operating income in the quarter ended June 30, 2007, includes annual planned maintenance outage costs of \$4.6 million.

## Fiscal 2006

	Quarters Ended,			
	March 31, 2006	June 30, 2006	September 30, 2006	December 31, 2006
Net sales	\$	\$	\$	\$
Gross profit				
Operating income/(loss)	\$ (155)	\$ (364)	\$ (373)	\$ (1,084)
Net income	\$ 691	\$ 640	\$ 672	\$ 193
Net income per share:				
Basic	\$ 0.03	\$ 0.03	\$ 0.03	\$ 0.01
Diluted	\$ 0.02	\$ 0.02	\$ 0.02	\$ 0.01

## Predecessor KPBB

## Fiscal 2006

	Quarters Ended,			
	March 31, 2006	June 30, 2006	September 30, 2006	December 31, 2006
Net sales	\$ 64,012	\$ 61,010	\$ 64,318	\$ 56,997
Gross profit	10,985	9,194	12,873	12,357
Operating income/(loss)	\$ 7,891	\$ 6,003	\$ 10,234	\$ 9,999
Net income	\$ 4,637	\$ 3,467	\$ 6,064	\$ 5,919

Quarters Ended,

Net income per share:

Basic	\$	N/A	\$	N/A	\$	N/A	\$	N/A
Diluted	\$	N/A	\$	N/A	\$	N/A	\$	N/A

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## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**16. Quarterly Financial Information (Unaudited) (Continued)**

The Predecessor results for the quarter ended March 31, 2006 have been restated within the results for the six-month period ended June 30, 2006 from those previously reported within the Company's Form 10-Q for the three month period ending March 31, 2007. The restatement corrects errors related to cash discounts and the book to fair value adjustments for Industrial Development Bonds, related to the acquisition of one of KP B's facilities, was incorrectly recorded as a premium rather than a discount. The impact of this correction was a decrease to net sales and net income of \$0.2 million and \$0.1 million, respectively.

Predecessor results have been restated in accordance with FSP No. AUG AIR-1, *Accounting for Planned Major Maintenance Activities*, to account for major maintenance activities under the direct expense method. Accordingly, cost of sales has been increased by \$1.1 million for the three months ended March 31, September 30 and December 31, 2006 and decreased by \$3.3 million for the three months ended June 30, 2006. In addition, net income has been decreased by \$0.7 million for the three months ended March 31, September 30 and December 31, 2006 and increased by \$2.1 million for the three months ended June 30, 2006. For the year ended December 31, 2006, there was no effect on cost of sales, operating income and net income.

**17. Cash flows**

Changes in operating assets and liabilities are as follows (\$000's):

	Years Ended December 31,			Predecessor KP B	
	Years Ended December 31,			Years Ended December 31,	
	2007	2006	2005	2006	2005
<b>Changes in operating assets and liabilities:</b>					
Trade accounts receivable, net	(3,710)			1,315	(5,697)
Interest receivable on investments		266	(266)		
Inventories	5,767			(930)	2,213
Prepaid expenses and other current assets	474	9	(128)	567	(1,817)
Accounts payable	2,923	196		(608)	2,037
Accrued expenses	6,039	489	136	(940)	588
Accrued pension and postretirement benefits	1,282				
<b>Total change in operating assets and liabilities</b>	<b>12,775</b>	<b>960</b>	<b>(258)</b>	<b>(596)</b>	<b>(2,676)</b>
<b>Cash paid during the period:</b>					
Income taxes	13,812	1,990	325		
Interest	3,976				
<b>Supplemental disclosures of non-cash activities:</b>					
Reclassification of common stock subject to redemption		(22,805)	22,160		
Accretion of trust fund relating to common stock subject to possible redemption		686	189		

**KAPSTONE PAPER AND PACKAGING CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(In thousands, except share and per share amounts)

**18. KPB Transactions With IP and Affiliates**

Beginning January 1, 2006, KPB entered into an agreement with IP to market certain bleached product produced by IP and sold to KPB customers in exchange for a commission of 2.5% of gross sales. Commissions earned during 2006 totaled \$0.9 million and is included as a reduction to cost of sales. Prior to this date, KPB had provided these services without a formal agreement and allocated a portion of the costs of its sales function to IP for these services. The allocation totaled \$2.3 million for the year ended December 31, 2005.

Certain services were provided to KPB by IP, including corporate management, legal, accounting and tax, treasury, payroll, and benefits administration, public warehouse space, risk management, information technology, and centralized transaction processing. Expenses for such corporate services were allocated to KPB totaled \$10.6 million and \$9.1 million for the years ended December 31, 2006 and 2005, respectively. These expenses, other than allocated warehouse rent which was included in cost of sales, were included in selling, general and administrative expenses in the accompanying combined statements of income. These costs were allocated based on various allocation methods, which management believed to be reasonable. These methods included direct consumption, percent of capital employed, and number of employees. The allocation method was consistent from year to year; however, as factors change, the allocation amounts increased or decreased.

Substantially, all domestic employees hired prior to July 2004, and retirees of KPB, participated in IP's pension plans and were eligible to receive retirement benefits. IP allocated service cost to KPB based upon a percent-of-pay for salaried employees and a calculated flat amount for hourly employees. During the years ended December 31, 2006 and 2005, IP allocated periodic pension costs to KPB of approximately \$2.0 million and \$1.3 million, respectively.

IP provided certain retiree healthcare and life insurance benefits to a majority of KPB salaried employees and certain of its hourly employees. IP allocated postretirement benefit costs to KPB based on a percent-of-pay for salaried employees and a calculated flat amount for hourly employees. During the years ended December 31, 2006 and 2005, IP allocated postretirement benefit costs to KPB of \$0.4 million and \$0.6 million, respectively.

KPB had net sales to IP of approximately \$16.0 million and \$3.8 million for the years ended December 31, 2006 and 2005, respectively. KPB had purchases principally for pulpwood from IP of approximately \$48.8 million and \$44.2 million for the years ended December 31, 2006 and 2005, respectively.

**19. Other Predecessor Information**

***Revenue Recognition Cash Discounts and Incentives***

Accrued discounts are netted against trade accounts receivable net. Revenue is presented net of cash discounts of \$7.4 million and \$11.3 million and cash incentive payments of \$1.6 million and \$1.3 million for the years ended December 31, 2006 and 2005, respectively.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**19. Other Predecessor Information (Continued)***Inventories*

Slow-moving replacement parts and other supplies of \$2.8 million are included in other assets in the accompanying consolidated balance sheets net of obsolete replacement part reserves of \$1.0 million at December 31, 2006.

*Capitalized Software*

KPB capitalized software and amortized over its anticipated useful life of approximately three years. Software amortization was less than \$0.1 million for the years ended December 31, 2006 and 2005. The unamortized portion of software, included in plant, property and equipment in the accompanying consolidated financial statements at December 31, 2006 is less than \$0.1 million.

*Plant, Property and Equipment*

KPB plant, property and equipment at December 31, 2006 and 2005, is stated at cost, net of accumulated depreciation. Interest was capitalized on projects meeting certain criteria and is included in the cost of the assets. The capitalized interest was depreciated over the same useful lives as the related assets. Expenditures for major repairs and improvements were capitalized, whereas normal repairs and maintenance were expensed as incurred.

Depreciation and amortization were computed using the units-of-production method for all machinery and equipment and supporting assets and the straight-line method for all other assets over the assets' estimated useful lives. The useful life of machinery and equipment was not expected differ significantly between the units-of-production method and the straight-line method. KPB used the following estimated useful lives for calculating depreciation expense:

	<u>Years</u>
Machinery and equipment	12-20
Buildings	20-40
Computer hardware and software	3-6
Furniture and office equipment	3-20
Leasehold improvements	Over terms of the lease

Interest costs related to the development of certain long-term assets are capitalized and amortized over the related assets' estimated useful lives. Capitalized net interest costs were \$0.2 million in 2006 and \$0.1 million in 2005. Capitalized interest was allocated to KPB using International Paper Company's incremental borrowing rate. In 2005, KPB accelerated approximately \$3.0 million of depreciation expense for a recover boiler whose useful life was determined to be shorter than originally estimated.

At December 31, 2006 and 2005, KPB had purchased plant, property, and equipment which was included in trade accounts payable in amounts of \$0.9 million and \$1.0 million, respectively. Such amounts were paid soon after year-end.

## KAPSTONE PAPER AND PACKAGING CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share amounts)

**19. Other Predecessor Information (Continued)**

In 2006, KPB transferred special purpose structures with a cost basis of \$11.0 million from machinery and equipment to buildings.

**Asset Retirement Obligations**

In accordance with SFAS No. 143, *Accounting for Asset Retirement Obligations*, KPB recorded a liability equal to the present value of the estimated costs associated with the retirement of long-lived assets where a legal or contractual obligation existed. The liability was accreted over time and a related asset was depreciated over its useful life. KPB's asset retirement obligation under this standard related to closure costs for landfills. KPB determined in 2006 that certain recycling and recovery efforts had reduced the amount of waste materials going to the landfill which extended the estimated landfill closure date by approximately 40 years to the year 2060. The obligation was re-measured using the revised closure date. As a result of this change, the obligation was reduced by \$1.6 million. The related deferred cost in fixed assets was reduced by \$0.3 million and selling, general and administrative expenses were reduced by \$1.3 million. Future revisions to the liability could occur due to changes in the estimated costs or timing of closure, or possible new federal or state regulations affecting the closure.

The following table presents an analysis of the activity related to asset retirement obligations since January 1, 2005 through December 31, 2006 (in thousands of U.S. dollars):

	<u>2006</u>	<u>2005</u>
Asset retirement obligations January 1	\$ 1,752	\$ 1,667
Accretion expense	90	85
Change in estimate	(1,577)	
	<u>          </u>	<u>          </u>
Asset retirement obligations December 31	\$ 265	\$ 1,752
	<u>          </u>	<u>          </u>

Asset retirement obligations are included in the accompanying consolidated balance sheets in other liabilities.

**Environmental Costs and Obligations**

KPB accrued the costs associated with environmental obligations, such as remediation or closure costs, when probable and reasonably estimable. Such accruals were adjusted as further information developed or circumstances changed. Costs of future expenditures for environmental obligations were discounted to their present value when the expected cash flows were reliably determinable. At December 31, 2006 and 2005 there were no accruals for environmental obligations other than asset retirement obligations.

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