

LINCOLN ELECTRIC HOLDINGS INC

Form 10-K

February 22, 2013

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2012

Commission file number 0-1402

LINCOLN ELECTRIC HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Ohio

34-1860551

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

22801 St. Clair Avenue, Cleveland, Ohio

44117

(Address of principal executive offices)

(Zip Code)

(216) 481-8100

(Registrant's telephone number, including area code)

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

Common Shares, without par value

The NASDAQ Stock Market LLC

(Title of each class)

(Name of each exchange on which registered)

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  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  No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

(§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) 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

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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

<input checked="" type="checkbox"/> Large accelerated filer	<input type="checkbox"/> Accelerated filer	<input type="checkbox"/> Non-accelerated filer (Do not check if a smaller reporting company)	<input type="checkbox"/> Smaller reporting company
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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The aggregate market value of the common shares held by non-affiliates as of June 30, 2012 was \$3,558,724,932 (affiliates, for this purpose, have been deemed to be Directors and Executive Officers of the Company and certain

significant shareholders).

The number of shares outstanding of the registrant's common shares as of December 31, 2012 was 82,944,817.

**DOCUMENTS INCORPORATED BY REFERENCE**

Part III of this Annual Report on Form 10-K incorporates by reference certain information from the registrant's definitive proxy statement to be filed on or about March 22, 2013 with respect to the registrant's 2013 Annual Meeting of Shareholders.

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## PART I

### ITEM 1. BUSINESS

#### General

As used in this Annual Report on Form 10-K, the term "Company," except as otherwise indicated by the context, means Lincoln Electric Holdings, Inc. and its wholly-owned and majority-owned subsidiaries for which it has a controlling interest. The Lincoln Electric Company began operations in 1895 and was incorporated under the laws of the State of Ohio in 1906. During 1998, The Lincoln Electric Company reorganized into a holding company structure, and Lincoln Electric Holdings, Inc. became the publicly-held parent of Lincoln Electric subsidiaries worldwide, including The Lincoln Electric Company.

The Company is one of only a few worldwide broad-line manufacturers of welding, cutting and brazing products. Welding products include arc welding power sources, wire feeding systems, robotic welding packages, fume extraction equipment, consumable electrodes and fluxes. The Company's product offering also includes computer numeric controlled ("CNC") plasma and oxy-fuel cutting systems and regulators and torches used in oxy-fuel welding, cutting and brazing. In addition, the Company has a leading global position in the brazing and soldering alloys market. The arc welding power sources and wire feeding systems manufactured by the Company range in technology from basic units used for light manufacturing and maintenance to highly sophisticated robotic applications for high volume production welding and fabrication. Three primary types of arc welding electrodes are produced: (1) coated manual or stick electrodes; (2) solid electrodes produced in coil, reel or drum forms for continuous feeding in mechanized welding; and (3) cored electrodes produced in coil form for continuous feeding in mechanized welding.

The Company has, through wholly-owned subsidiaries or joint ventures, manufacturing facilities located in the United States, Brazil, Canada, China, Colombia, France, Germany, India, Indonesia, Italy, Mexico, the Netherlands, Poland, Portugal, Russia, Turkey, the United Kingdom and Venezuela, of which 34 are ISO 9001 certified.

The Company has aligned its business units into five operating segments to enhance the utilization of the Company's worldwide resources and global end user and sourcing initiatives. The operating segments consist of North America Welding, Europe Welding, Asia Pacific Welding, South America Welding and The Harris Products Group. The North America Welding segment includes welding operations in the United States, Canada and Mexico. The Europe Welding segment includes welding operations in Europe, Russia and Africa. The other two welding segments include welding operations in Asia Pacific and South America, respectively. The fifth segment, The Harris Products Group, includes the Company's global cutting, soldering and brazing businesses as well as the retail business in the United States. See Note 5 to the Company's consolidated financial statements for segment and geographic area information, which is incorporated herein by reference.

#### Customers

The Company's products are sold in both domestic and international markets. In North America, products are sold principally through industrial distributors, retailers and also directly to users of welding products. Outside of North America, the Company has an international sales organization comprised of Company employees and agents who sell products from the Company's various manufacturing sites to distributors and product users.

The Company's major end-user markets include:

- general metal fabrication,
- power generation and process industry,
- structural steel construction (buildings and bridges),
- heavy equipment fabrication (farming, mining and rail),
- shipbuilding,
- automotive,
- pipe mills and pipelines, and
- offshore oil and gas exploration and extraction.

The Company is not dependent on a single customer or a few customers and no individual customer currently accounts for more than ten percent of total Net sales. However, the loss of a large customer could have an adverse effect on the Company's business. The Company's operating results are sensitive to changes in general economic

conditions. The arc welding and cutting industry is generally a mature industry in developed markets such as North America and Western Europe, and is cyclical in nature. Overall demand for arc welding and cutting products is largely determined by economic cycles and the level of capital spending in manufacturing and other industrial sectors. The Company experiences some variability in reported period-to-period results as demand for the Company's products are mildly seasonal with generally higher demand in the second and

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third quarters. See "Item 1A. Risk Factors" for further discussion regarding risks associated with customers, general economic conditions and demand.

#### Competition

Conditions in the arc welding and cutting industry are highly competitive. The Company believes it is the world's largest manufacturer of consumables and equipment with relatively few major broad-line competitors worldwide, but numerous smaller competitors in specific geographic markets. The Company continues to pursue strategies to heighten its competitiveness in domestic and international markets, which includes positioning low cost manufacturing facilities in most geographical markets. Competition in the arc welding and cutting industry is based on brand preference, product quality, price, performance, warranty, delivery, service and technical support. The Company believes its performance against these factors has contributed to the Company's position as the leader in the industry. Most of the Company's products may be classified as standard commercial articles and are manufactured for stock. The Company believes it has a competitive advantage in the marketplace because of its highly trained technical sales force and the support of its welding research and development staff to assist customers in optimizing their welding applications. This allows the Company to introduce its products to new users and to establish and maintain close relationships with its customers. This close relationship between the technical sales force and the direct customers, together with its supportive relationship with its distributors, who are particularly interested in handling the broad range of the Company's products, is an important element of the Company's market success and a valuable asset of the Company.

#### Raw Materials

The principal raw materials essential to the Company's business are steel, electronic components, engines, brass, copper, silver, aluminum alloys and various chemicals, all of which are normally available for purchase in the open market.

#### Patents and Trademarks

The Company holds many valuable patents, primarily in arc welding, and has increased the application process as research and development has progressed in both the United States and major international jurisdictions. The Company believes its trademarks are an important asset and aggressively pursues brand management.

#### Environmental Regulations

The Company's facilities are subject to environmental regulations. To date, compliance with these environmental regulations has not had a material adverse effect on the Company's earnings. The Company is ISO 14001 certified at most significant manufacturing facilities in North America and Europe and is progressing towards certification at its remaining facilities worldwide. In addition, the Company is ISO 9001 certified at nearly all facilities worldwide.

#### International Operations

The Company conducts a significant amount of its business and has a number of operating facilities in countries outside the United States. As a result, the Company is subject to business risks inherent to non-U.S. activities, including political uncertainty, import and export limitations, exchange controls and currency fluctuations.

#### Research and Development

Research activities, which the Company believes provide a competitive advantage, relate to the development of new products and the improvement of existing products. Research activities are Company-sponsored. Refer to Note 1 to the Company's consolidated financial statements with respect to total costs of research and development, which is incorporated herein by reference.

#### Employees

The number of persons employed by the Company worldwide at December 31, 2012 was approximately 10,000. See "Part I, Item 1C" for information regarding the Company's executive officers, which is incorporated herein by reference.

#### Website Access

The Company's website, [www.lincolnelectric.com](http://www.lincolnelectric.com), is used as a channel for routine distribution of important information, including news releases and financial information. The Company posts its filings as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC, including annual, quarterly, and current reports on Forms 10-K, 10-Q, and 8-K; proxy statements; and any amendments to those reports or statements. The

Company also posts its Code of Corporate Conduct and Ethics on its website. All such postings and filings are available on the Company's website free of charge. In addition, this website allows investors and other interested persons to sign up to automatically receive e-mail alerts when news releases and financial information is posted on the website. The SEC also maintains a website, [www.sec.gov](http://www.sec.gov), that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC. The

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content on any website referred to in this Annual Report on Form 10-K is not incorporated by reference into this Annual Report unless expressly noted.

#### ITEM 1A. RISK FACTORS

From time to time, information we provide, statements by our employees or information included in our filings with the SEC may contain forward-looking statements that are not historical facts. Those statements are "forward-looking" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally can be identified by the use of words such as "may," "will," "expect," "intend," "estimate," "anticipate," "believe," "forecast," "guidance" or words of similar meaning. Actual results may differ materially from such statements due to a variety of factors that could adversely affect the Company's operating results. Forward-looking statements, and our future performance, operating results, financial position and liquidity, are subject to a variety of factors that could materially affect results, including those risks described below. Any forward-looking statements made in this report or otherwise speak only as of the date of the statement, and, except as required by law, we undertake no obligation to update those statements. Comparisons of results for current and any prior periods are not intended to express any future trends or indications of future performance, unless expressed as such, and should only be viewed as historical data.

In the ordinary course of our business, we face various strategic, operating, compliance and financial risks. These risks could have a material impact on our business, financial condition, operating results and cash flows.

Our Enterprise Risk Management ("ERM") process seeks to identify and address significant risks. Our ERM process is a company-wide initiative that is designed with the intent of prioritizing risks and assigning appropriate consideration for such risks. We use the integrated risk framework of the Committee of Sponsoring Organizations to assess, manage and monitor risks.

Management has identified and prioritized critical risks based on the severity and likelihood of each risk and assigned an executive to address each major identified risk area and lead action plans to monitor and mitigate risks, where possible. Our Board of Directors provides oversight of the ERM process and systematically reviews identified critical risks. The Audit Committee also reviews major financial risk exposures and the steps management has taken to monitor and control them.

Our goal is to pro-actively manage risks in a structured approach and in conjunction with the strategic planning process, with the intent to preserve and enhance shareholder value. However, these and other risks and uncertainties could cause our results to vary materially from recent results or from our anticipated future results. The risk factors and uncertainties described below, together with information incorporated by reference or otherwise included elsewhere in this Annual Report on Form 10-K, should be carefully considered. Additional risks and uncertainties of which we are currently unaware or that we currently believe to be immaterial may also adversely affect our business. General economic and market conditions may adversely affect the Company's financial condition, results of operations and access to capital markets.

The Company's operating results are sensitive to changes in general economic conditions. Further recessionary economic cycles, higher interest rates, inflation, higher labor costs, trade barriers in the world markets, financial turmoil related to sovereign debt and changes in tax laws or other economic factors affecting the countries and industries in which we do business could adversely affect demand for the Company's products, thereby impacting our results of operations, collection of accounts receivable and our expected cash flow generation from current and acquired businesses, which may adversely impact our financial condition and access to capital markets.

Economic and supply disruptions associated with events beyond our control, such as war, acts of terror, political unrest, public health concerns, labor disputes or natural disasters could adversely affect our supply chain and distribution channels or result in loss of sales and customers.

Our facilities and operations, and the facilities and operations of our suppliers and customers, could be disrupted by events beyond our control, such as war, political unrest, public health concerns, labor disputes or natural disasters. Any such disruption could cause delays in the production and distribution of our products and the loss of sales and customers. Insurance proceeds may not adequately compensate the Company for the losses.





Availability of and volatility in energy costs or raw material prices may adversely affect our performance.

In the normal course of business, we are exposed to market risks related to the availability of and price fluctuations in the purchase of energy and commodities used in the manufacture of our products (primarily steel, brass, copper, silver, aluminum alloys, electronic components, electricity and natural gas). The availability and prices for raw materials are subject to volatility and are influenced by worldwide economic conditions, speculative action, world supply and demand balances, inventory levels, availability of substitute materials, currency exchange rates, our competitors' production costs, anticipated or perceived shortages and other factors. The price of steel used to manufacture our products has experienced periods of significant price volatility and has been subject to periodic shortages due to global economic factors. We have also experienced substantial volatility in prices for other raw materials, including nonferrous metals, chemicals and energy costs.

Increases in the cost of raw materials and components may adversely affect our profitability if we are unable to pass along to our customers these cost increases in the form of price increases or otherwise reduce our cost of goods sold. Although most of the raw materials and components used in our products are commercially available from a number of sources and in adequate supply, any disruption in the availability of such raw materials and components, our inability to timely or otherwise obtain substitutes for such items, or any deterioration in our relationships with or the financial viability of our suppliers could adversely affect our business.

We are a co-defendant in litigation alleging asbestos induced illness. Liabilities relating to such litigation could reduce our profitability and impair our financial condition.

At December 31, 2012, we were a co-defendant in cases alleging asbestos induced illness involving claims by approximately 15,050 plaintiffs. In each instance, we are one of a large number of defendants. The asbestos claimants allege that exposure to asbestos contained in welding consumables caused the plaintiffs to develop adverse pulmonary diseases, including mesothelioma and other lung cancers.

Since January 1, 1995, we have been a co-defendant in asbestos cases that have been resolved as follows: 41,161 of those claims were dismissed, 20 were tried to defense verdicts, seven were tried to plaintiff verdicts (two of which are being appealed), one was resolved by agreement for an immaterial amount and 612 were decided in favor of the Company following summary judgment motions.

The long-term impact of the asbestos loss contingency, in the aggregate, on operating results, operating cash flows and access to capital markets is difficult to assess, particularly since claims are in many different stages of development and we benefit significantly from cost-sharing with co-defendants and insurance carriers. While we intend to contest these lawsuits vigorously, and believe we have applicable insurance relating to these claims, there are several risks and uncertainties that may affect our liability for personal injury claims relating to exposure to asbestos, including the future impact of changing cost sharing arrangements or a change in our overall trial experience.

Asbestos use in welding consumables in the U.S. ceased in 1981.

We may incur material losses and costs as a result of product liability claims that may be brought against us.

Our business exposes us to potential product liability risks that are inherent in the design, manufacture, sale and application of our products and the products of third-party suppliers that we utilize or resell. Our products are used in a variety of applications, including infrastructure projects such as oil and gas pipelines and platforms, buildings, bridges and power generation facilities, the manufacture of transportation and heavy equipment and machinery, and various other construction projects. We face risk of exposure to product liability claims in the event that accidents or failures on these projects result, or are alleged to result, in bodily injury or property damage. Further, our products are designed for use in specific applications, and if a product is used inappropriately, personal injury or property damage may result.

The occurrence of defects in or failures of our products, or the misuse of our products in specific applications, could cause termination of customer contracts, increased costs and losses to us, our customers and other end users. We cannot be assured that we will not experience any material product liability losses in the future or that we will not incur significant costs to defend those claims. Further, we cannot be assured that our product liability insurance coverage will be adequate for any liabilities that we may ultimately incur or that product liability insurance will continue to be available on terms acceptable to us.

The cyclical nature and maturity of the arc welding and cutting industry in developed markets may adversely affect our performance.

The arc welding and cutting industry is generally a mature industry in developed markets such as North America and Western Europe and is cyclical in nature. Overall demand for arc welding and cutting products is largely determined by the level of capital spending in manufacturing and other industrial sectors, and the welding industry has historically experienced contraction during periods of slowing industrial activity. If economic, business and industry conditions deteriorate, capital spending in those sectors may be substantially decreased, which could reduce demand for our products, our revenues and our results of operations.

We may not be able to complete our acquisition strategy or successfully integrate acquired businesses. Part of our business strategy is to pursue targeted business acquisition opportunities, including foreign investment opportunities. For example, we have completed and continue to pursue acquisitions in emerging markets including, but not limited to, Brazil, Russia, India and China in order to strategically position resources to increase our presence in growing markets. We cannot be certain that we will be successful in pursuing potential acquisition candidates or that the consequences of any acquisition would be beneficial to us. Future acquisitions may expose us to unexpected liabilities and involve the expenditure of significant funds and management time. Further, we may not be able to successfully integrate any acquired business with our existing businesses or recognize the expected benefits from any completed acquisition.

Depending on the nature, size and timing of future acquisitions, we may be required to raise additional financing, which may not be available to us on acceptable terms. Our current operational cash flow is sufficient to fund our current acquisition plans, but a significant acquisition could require access to the capital markets.

If we cannot continue to develop, manufacture and market products that meet customer demands, our revenues and gross margins may suffer.

Our continued success depends, in part, on our ability to continue to meet our customers' needs for welding and cutting products through the introduction of innovative new products and the enhancement of existing product design and performance characteristics. We must remain committed to product research and development and customer service in order to remain competitive. We cannot be assured that new products or product improvements, once developed, will meet with customer acceptance and contribute positively to our operating results, or that we will be able to continue our product development efforts at a pace to sustain future growth. Further, we may lose customers to our competitors if they demonstrate product design, development or manufacturing capabilities superior to ours.

The competitive pressures we face could harm our revenue, gross margins and prospects.

We operate in a highly competitive global environment and compete in each of our businesses with other broad-line manufacturers and numerous smaller competitors specializing in particular products. We compete primarily on the basis of brand, product quality, price, performance, warranty, delivery, service and technical support. We have previously initiated, and may in the future initiate significant rationalization activities to align our business to market conditions. Such rationalization activities could fail to deliver the desired competitive cost structure and could result in disruptions in customer service. If our products, services, support and cost structure do not enable us to compete successfully based on any of the criteria listed above, our operations, results and prospects could suffer.

Further, in the past decade, the arc welding industry in the United States and other developed countries has been subject to increased levels of foreign competition as low cost imports have become more readily available. Our competitive position could also be harmed if new or emerging competitors become more active in the arc welding business. For example, while steel manufacturers traditionally have not been significant competitors in the domestic arc welding industry, some foreign integrated steel producers manufacture selected consumable arc welding products. Our sales and results of operations, as well as our plans to expand in some foreign countries, could be adversely affected by this practice.

The loss of any of our largest customers could adversely affect our revenue, gross margins and profit.

We have a large and varied customer base due, in part, to our extensive distribution channels in the industries and regions that we serve. Although no individual customer currently accounts for more than ten percent of total Net sales, there are customers to which we sell a large amount of product. The loss of any of these customers could have an adverse effect on our revenue, gross margins and profit.

We conduct our sales and distribution operations on a worldwide basis and maintain manufacturing facilities in a number of foreign countries, which subjects us to risks associated with doing business outside the United States.

Our long-term strategy is to continue to increase our market share in growing international markets, particularly Asia (with emphasis in China and India), Latin America, Eastern Europe, Russia and other developing markets.

The share of sales and profits we derive from our international operations and exports from the United States is significant and growing. This trend increases our exposure to the performance of many developing economies in addition to the developed economies outside of the United States. For example, during 2012, approximately 8% of our net sales were generated from China and approximately 19% of our property, plant and equipment were located there.

If the Chinese economy were to experience a significant slowdown, it could adversely affect our financial condition, results of operations and cash flows.

There are a number of risks in doing business internationally, which may impede our ability to achieve our strategic objectives relating to our foreign operations. Many developing countries have a significant degree of political and economic uncertainty and social turmoil that may impede our ability to implement and achieve our international growth objectives. Conducting business internationally subjects us to corporate governance and management challenges in consideration of the numerous U.S.

and foreign laws and regulations, including regulations relating to import-export control, technology transfer restrictions, repatriation of earnings and funds, exchange controls, labor regulations, nationalization, anti-boycott provisions and anti-bribery laws (such as the Foreign Corrupt Practices Act and the Organization for Economic Cooperation and Development Convention). Failure by the Company or its sales representatives, agents or distributors to comply with these laws and regulations could result in administrative, civil or criminal liabilities, all or any of which could negatively impact our business and reputation. Our foreign operations also subject us to the risks of international terrorism and hostilities.

Our operations depend on maintaining a skilled workforce, and any interruption in our workforce could negatively impact our results of operations and financial condition.

Our success depends in part on the efforts and abilities of our management team and key employees. Their skills, experience and industry knowledge significantly benefit our operations and performance. Our future success will also depend on our ability to identify, attract, and retain highly qualified managerial, technical (including research and development), sales and marketing, and customer service personnel. Competition for these individuals is intense, and we may not succeed in identifying, attracting, or retaining qualified personnel. With our strategy to expand internationally into developing markets, we may incur additional risks as some developing economies lack a sufficiently trained labor pool.

Any interruption of our workforce, including interruptions due to unionization efforts, changes in labor relations or shortages of appropriately skilled individuals could impact our results of operations and financial condition.

Our revenues and results of operations may suffer if we cannot continue to enforce the intellectual property rights on which our business depends or if third parties assert that we violate their intellectual property rights.

We rely upon patent, trademark, copyright and trade secret laws in the United States and similar laws in foreign countries, as well as agreements with our employees, customers, suppliers and other third parties, to establish and maintain our intellectual property rights. However, any of our intellectual property rights could be challenged, invalidated or circumvented, or our intellectual property rights may not be sufficient to provide a competitive advantage. Further, the laws and their application in certain foreign countries do not protect our proprietary rights to the same extent as U.S. laws. Accordingly, in certain countries, we may be unable to protect our proprietary rights against unauthorized third-party copying or use, which could impact our competitive position.

Further, third parties may claim that we or our customers are infringing upon their intellectual property rights. Even if we believe that those claims are without merit, defending those claims and contesting the validity of patents can be time-consuming and costly. Claims of intellectual property infringement also might require us to redesign affected products, enter into costly settlement or license agreements or pay costly damage awards, or face a temporary or permanent injunction prohibiting us from manufacturing, marketing or selling certain of our products.

Our defined benefit pension plans are subject to financial market trends, such as changes in discount rates and actual investment return on pension assets, which could adversely affect our results of operations and cash flows.

The performance of the financial markets and interest rates impact our funding obligations under our defined benefit pension plans. Significant changes in discount rates, decreases in the fair value of plan assets and investment losses on plan assets may increase our benefit obligations and adversely impact our results of operations, shareholders' equity and cash flows through our annual measurement of plan assets and liabilities. For a discussion regarding how the financial statements have been affected by significant changes in 2012, refer to the pension related disclosure under "Part II, Item 7 – Critical Accounting Policies" and Note 11 to the Company's consolidated financial statements.

We are subject to changes in the U.S. regulatory environment, which could adversely affect our results of operations, cash flows and financial condition.

Our businesses, results of operations or financial condition could be adversely affected if laws, regulations or standards relating to us, our products or the markets in which we operate are newly implemented or changed. In March 2010, the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, "the Acts") were signed into law. The Acts make broad-based changes to the U.S. health care system, which could significantly affect the U.S. economy and our financial results. While the provisions of the Acts are not expected to have any significant short-term impacts, the long-term potential impacts on our business and the consolidated financial statements are currently uncertain. We are currently assessing the potential

impact of the Acts.

A significant fluctuation between the U.S. dollar and other currencies could adversely impact our operating income. Although our financial results are reported in U.S. dollars, a significant portion of our sales and operating costs are realized in other currencies. Our profitability is affected by movements of the U.S. dollar against other foreign currencies in which we generate revenues and incur expenses. Significant long-term fluctuations in relative currency values, in particular an increase in the value of the U.S. dollar against foreign currencies, could have an adverse effect on our profitability and financial condition.

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Changes in tax rates or exposure to additional income tax liabilities could affect profitability.

Our business is subject to income taxes in the United States and various foreign jurisdictions. Domestic and international tax liabilities are subject to the allocation of income among various tax jurisdictions. Our effective tax rate could be adversely affected by changes in the mix among earnings in countries with differing statutory tax rates, changes in the valuation allowances of deferred tax assets or changes in tax laws.

The amount of income taxes paid is subject to ongoing audits by United States federal, state and local tax authorities and by foreign tax authorities. If these audits result in assessments different from amounts reserved, future financial results may include unfavorable adjustments which could have a material adverse effect on our results of operations. We are subject to risks relating to our information technology systems.

The conduct and management of our business relies extensively on information technology systems. If these systems are damaged, cease to function properly or are subject to a cyber security breach, we may suffer an interruption in our ability to manage and operate the business and our results of operations and financial condition could be adversely affected.

Our global operations are subject to increasingly complex environmental regulatory requirements.

We are subject to increasingly complex environmental regulations affecting international manufacturers, including those related to air and water emissions, waste management and climate change.

There is a growing political and scientific belief that emissions of greenhouse gases ("GHG") alter the composition of the global atmosphere in ways that are affecting the global climate. Various stakeholders, including legislators and regulators, shareholders and non-governmental organizations, as well as companies in many business sectors, are considering ways to reduce GHG emissions. These concerns may lead to international, national, regional or local legislative or regulatory responses in the future. Such regulation could result in new or additional regulatory or product standard requirements for the Company's global businesses. We are unable, at this time, to predict the significance of these requirements as the impact of any future GHG legislative, regulatory or product standards is dependent on the timing and design of the mandates or standards. Furthermore, the potential physical impacts of theorized climate change on the Company's customers, and therefore on the Company's operations, are speculative and highly uncertain, and would be particular to the circumstances developing in various geographical regions. These may include changes in weather patterns (including drought and rainfall levels), water availability, storm patterns and intensities, and temperature levels. These potential physical effects may adversely impact the cost, production, sales and financial performance of the Company's operations which we are unable, at this time, to predict.

It is our policy to apply strict standards for environmental protection to all of our operations inside and outside the United States, even when we are not subject to local government regulations. We may incur substantial costs, including cleanup costs, fines and civil or criminal sanctions, liabilities resulting from third-party property damage or personal injury claims, or our products could be enjoined from entering certain jurisdictions, if we were to violate or become liable under environmental laws or if our products become non-compliant with environmental laws.

We also face increasing complexity in our products design and procurement operations as we adjust to new and future requirements relating to the design, production and labeling of our products that are sold worldwide in multiple jurisdictions. The ultimate costs under environmental laws and the timing of these costs are difficult to predict, and liability under some environmental laws relating to contaminated locations can be imposed retroactively and on a joint and several basis.

#### ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 1C. EXECUTIVE OFFICERS OF THE REGISTRANT  
EXECUTIVE OFFICERS OF THE REGISTRANT

Name	Age	Position
John M. Stropki, Jr.	62	Executive Chairman of the Board effective December 31, 2012; Chairman of the Board since October 13, 2004 to December 31, 2012; Director since 1998; Chief Executive Officer and President since June 3, 2004 to December 31, 2012; Chief Operating Officer from May 1, 2003 to June 3, 2004; Executive Vice President from 1995 to June 3, 2004; and President, North America from 1996 to 2003.
Christopher L. Mapes	51	President and Chief Executive Officer effective December 31, 2012; Chief Operating Officer from September 1, 2011 to December 31, 2012; Director since February 2010. Prior to his service with the Company, Mr. Mapes was Executive Vice President of A.O. Smith Corporation (a global manufacturer with a water heating and water treatment technologies business and an electric motor and motor solutions business) a position he held from 2006 through August 2011, and the President of its Electrical Products unit, a position he held from September 2004 through August 2011.
Vincent K. Petrella	52	Senior Vice President, Chief Financial Officer and Treasurer since October 7, 2005; Vice President, Chief Financial Officer and Treasurer from February 4, 2004 to October 7, 2005; and Vice President, Corporate Controller from 2001 to 2003.
Frederick G. Stueber	59	Senior Vice President, General Counsel and Secretary since 1996.
George D. Blankenship	50	Senior Vice President; President, Lincoln Electric North America since July 30, 2009; Senior Vice President, Global Engineering from October 7, 2005 to July 30, 2009; Vice President, Global Engineering from May 5, 2005 to October 7, 2005; President, Lincoln Electric North America of The Lincoln Electric Company since July 30, 2009; Senior Vice President; President, Lincoln Cleveland of The Lincoln Electric Company from January 8, 2008 to July 30, 2009; Senior Vice President, U.S. Operations of The Lincoln Electric Company from October 7, 2005 to January 8, 2008; Vice President, Cleveland Operations of The Lincoln Electric Company from June 6, 2005 to October 7, 2005; and Vice President, Engineering and Quality Assurance of The Lincoln Electric Company from 2000 to June 6, 2005.
Gabriel Bruno	45	Vice President, Chief Information Officer since May 1, 2012; Vice President, Corporate Controller from 2005 to May 1, 2012.
Gretchen A. Farrell	50	Senior Vice President, Human Resources and Compliance since July 30, 2009; Vice President, Human Resources from May 5, 2005 to July 30, 2009; and Vice President, Human Resources of The Lincoln Electric Company since March 5, 2003.
Thomas A. Flohn	52	Vice President; President, Lincoln Electric Europe, Middle East & Africa (EMEA) since July 1, 2010; Vice President; President, Lincoln Asia Pacific from January 1, 2005 to June 30, 2010; and Vice President of Sales and Marketing, Lincoln Electric Asia Pacific from May 1, 1999 to December 31, 2004.
Steven B. Hedlund	46	Vice President, Strategy and Business Development since September 15, 2008. Prior to his service with the Company, Mr. Hedlund was the Vice President, Growth and Innovations with Master Lock, LLC (a security products company) from June 1, 2005 to July 1, 2008.
David M. LeBlanc	48	Senior Vice President; President, Lincoln Electric International since July 30, 2009; Vice President; President, Lincoln Electric Europe and Russia from March 10, 2008 to July 30, 2009; Vice President; President, Lincoln Electric Europe from September 1, 2005 to March 10, 2008; and Vice President; President, Lincoln Electric Latin America from January 1, 2002 to August 31, 2005.

The Company has been advised that there is no arrangement or understanding among any one of the officers listed and any other persons pursuant to which he or she was elected as an officer. The executive officers are elected by the



Board of Directors normally for a term of one year and/or until the election of their successors.

**ITEM 2. PROPERTIES**

The Company's corporate headquarters and principal United States manufacturing facilities are located in the Cleveland, Ohio area. Total Cleveland area property consists of 233 acres, of which present manufacturing facilities comprise an area of approximately 2,940,000 square feet.

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The Company has 45 manufacturing facilities, including operations and joint ventures in 19 countries, the locations (grouped by operating segment) of which are as follows:

North America Welding:

United States	Cleveland and Fort Loramie, Ohio; San Diego and Anaheim, California; Reno, Nevada; Baltimore, Maryland; Ladson, South Carolina; Chattanooga, Tennessee.
Canada	Toronto; Mississauga.
Mexico	Mexico City; Torreon.
United Kingdom	Port Talbot, Wales.

Europe Welding:

France	Grand-Quevilly.
Germany	Essen.
Italy	Genoa; Corsalone.
Netherlands	Nijmegen.
Poland	Bielawa; Dzierzoniow.
Portugal	Lisbon.
Russia	Mtsensk.
Turkey	Istanbul.
United Kingdom	Sheffield and Chertsey, England.

Asia Pacific Welding:

China	Shanghai; Jinzhou; Nanjing; Zhengzhou; Luan County.
India	Chennai.
Indonesia	Cikarang.

South America Welding:

Brazil	Sao Paulo.
Colombia	Bogota.
Venezuela	Maracay.

The Harris Products

Group:

United States	Mason, Ohio; Gainesville, Georgia; Santa Fe Springs, California.
Brazil	Guarulhos.
Mexico	Tijuana.
Poland	Dzierzoniow.

All properties relating to the Company's Cleveland, Ohio headquarters and manufacturing facilities are owned by the Company. Most of the Company's foreign subsidiaries own manufacturing facilities in the country where they are located. The Company believes that its existing properties are in good condition and are suitable for the conduct of its business. At December 31, 2012, \$0.2 million of indebtedness under capital leases was secured by property with a book value of \$0.4 million.

In addition, the Company maintains operating leases for many of its distribution centers and sales offices throughout the world. See Note 16 to the Company's consolidated financial statements for information regarding the Company's lease commitments.

### ITEM 3. LEGAL PROCEEDINGS

The Company is subject, from time to time, to a variety of civil and administrative proceedings arising out of its normal operations, including, without limitation, product liability claims, regulatory claims and health, safety and environmental claims. Among such proceedings are the cases described below.

At December 31, 2012, the Company was a co-defendant in cases alleging asbestos induced illness involving claims by approximately 15,050 plaintiffs, which is a net decrease of three claims from those previously reported. In each instance, the Company is one of a large number of defendants. The asbestos claimants seek compensatory and punitive damages, in most cases for unspecified sums. Since January 1, 1995, the Company has been a co-defendant in other similar cases that have been resolved as follows: 41,161 of those claims were dismissed, 20 were tried to

defense verdicts, seven were tried to plaintiff verdicts (two of which are being appealed), one was resolved by agreement for an immaterial amount and 612 were decided in favor of the Company following summary judgment motions.

In July 2012, the Company received a Notice of Reassessment from the Canada Revenue Agency (the "CRA") for 2004 to 2011, which would disallow the deductibility of inter-company dividends. These adjustments would increase Canadian federal

and provincial tax due. The Company disagrees with the position taken by the CRA and believes it is without merit. The Company will vigorously contest the assessment through the Tax Court of Canada. A trial date has not yet been scheduled. In connection with the litigation process, the Company is required to deposit no less than one-half of the tax and interest assessed by the CRA, of which a payment was made in September 2012 and the balance of the tax and interest assessment was made in the quarter ended December 31, 2012. Any Canadian tax ultimately due will be creditable in the parent company's U.S. federal tax return. The Company expects to be able to utilize the full amount of foreign tax credits generated in the statutorily allowed carry-back and carry-forward periods. Accordingly, should the Company not prevail in this dispute, the income statement charge will approximate the deficiency interest, net of tax. The Company believes it will prevail on the merits of the tax position. In accordance with prescribed recognition and measurement thresholds, no income tax accrual has been made for any uncertain tax positions related to the CRA reassessment. An unfavorable resolution of this matter could have a material effect on the Company's financial statements in the period in which a judgment is reached.

#### ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

#### PART II

#### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common shares are traded on The NASDAQ Global Select Market under the symbol "LECO." The number of record holders of common shares at December 31, 2012 was 1,699.

The total amount of dividends paid in 2012 was \$73.1 million. During 2012, dividends were paid quarterly on January 13, April 13, July 13 and October 15. The December dividend that the Company would normally pay in January 2013 was paid on December 28, 2012.

Quarterly high and low stock prices and dividends declared per share for the last two years were:

	2012			2011		
	Stock Price		Dividends	Stock Price		Dividends
	High	Low	Declared	High	Low	Declared
First quarter	\$47.87	\$38.96	\$0.170	\$38.50	\$32.69	\$0.155
Second quarter	50.36	41.42	0.170	39.62	32.30	0.155
Third quarter	46.11	37.83	0.170	39.18	27.47	0.155
Fourth quarter	49.00	37.63	0.200	40.10	26.84	0.170

Issuer purchases of equity securities for the fourth quarter 2012 were:

Period	Total Number of Shares Repurchased	Average Price Paid Per Share	Total Number of Shares Repurchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs <sup>(2)</sup>
October 1-31, 2012	—	\$—	—	3,779,773
November 1-30, 2012	271,518	<sup>(1)</sup> 44.74	253,400	3,526,373
December 1-31, 2012	184,000	47.36	184,000	3,342,373
Total	455,518	45.80	437,400	

The above share repurchases include the surrender of 18,118 shares of the Company's common stock to satisfy (1) minimum income tax withholding requirements related to the vesting of 45,460 restricted shares granted pursuant to the Company's 2006 Equity and Performance Incentive Plan.

The Company's Board of Directors authorized a share repurchase program for up to 30 million shares of the (2) Company's common stock. Total shares purchased through the share repurchase program were 26,657,627 shares at a cost of \$430.1 million for a weighted average cost of \$16.13 per share through December 31, 2012.

The following line graph compares the yearly percentage change in the cumulative total shareholder return on the Company's common stock against the cumulative total return of the S&P Composite 500 Stock Index ("S&P 500") and the S&P 400 MidCap Index ("S&P 400") for the five-year calendar period commencing January 1, 2008 and ending December 31, 2012. This graph assumes that \$100 was invested on December 31, 2007 in each of the Company's common stock, the S&P 500 and the S&P 400. A peer-group index for the welding industry, in general, was not readily available because the industry is comprised of a large number of privately held competitors and competitors that are smaller parts of large publicly traded companies.

	2007	2008	2009	2010	2011	2012
The Company	100	73	78	97	118	149
S&P 500	100	63	80	92	94	109
S&P 400	100	64	88	111	109	128

## ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share amounts)

	Year Ended December 31,				
	2012 <sup>(1)</sup>	2011 <sup>(2)</sup>	2010 <sup>(3)</sup>	2009 <sup>(4)</sup>	2008 <sup>(5)</sup>
Net sales	\$2,853,367	\$2,694,609	\$2,070,172	\$1,729,285	\$2,479,131
Net income	257,411	217,186	130,244	48,576	212,286
Basic earnings per share	3.10	2.60	1.54	0.57	2.49
Diluted earnings per share	3.06	2.56	1.53	0.57	2.47
Cash dividends declared per share	0.710	0.635	0.575	0.545	0.510
Total assets	2,089,863	1,976,776	1,783,788	1,705,292	1,718,805
Long-term debt	1,599	1,960	84,627	87,850	91,537

Results for 2012 include rationalization and asset impairment net charges of \$9,354 (\$7,442 after-tax) which include \$7,512 (\$6,153 after-tax) in rationalization charges and asset disposals, impairment charges of \$1,842 (\$1,289 after-tax). Results also include a charge of \$1,381 (\$906 after-tax) related to the change in Venezuelan labor law, which provides for increased employee severance obligations.

Results for 2011 include rationalization and asset impairment net charges of \$282 (\$237 after-tax) resulting from rationalization activities primarily initiated in 2009 and a gain of \$4,844 related to a favorable adjustment for tax audit settlements.

Results for 2010 include rationalization and asset impairment net gains of \$384 (\$894 after-tax) which include net gains of \$3,684 (\$3,725 after-tax) related to the sale of property and asset disposals, impairment charges of \$883 (\$801 after-tax) and \$2,417 (\$2,030 after-tax) in rationalization charges. Results also include a net charge of \$3,123 (\$3,560 after-tax) related to the change in functional currency and devaluation of the Venezuelan currency, income of \$5,092 was recognized due to an adjustment in tax liabilities for a change in applicable tax regulations, a gain of \$108 after-tax in non-controlling interests related to the impairment of assets for a majority-owned consolidated subsidiary and a charge of \$1,890 after-tax in non-controlling interests related to gains on the disposal of assets in a majority-owned consolidated subsidiary.

Results for 2009 include rationalization and asset impairment net charges of \$29,897 (\$23,789 after-tax). The net charges include rationalization charges of \$26,957 (\$21,529 after-tax) and impairment charges of \$2,940 (\$2,260 after-tax) for certain indefinite-lived intangible assets. Results also include a loss of \$7,943 (\$7,943 after-tax) associated with the acquisition of a business in China and the related disposal of an interest in Taiwan, a pension settlement gain of \$2,144 (\$2,144 after-tax), a charge of \$601 after-tax in non-controlling interests associated with the pension settlement gain for a majority-owned consolidated subsidiary and a gain on the sale of a property by the Company's joint venture in Turkey of \$5,667 (\$5,667 after-tax).

Results for 2008 include a charge of \$2,447 (\$1,698 after-tax) relating to the Company's rationalization programs that began in the fourth quarter 2008. Results for 2008 also include \$16,924 (\$16,615 after-tax) in asset impairment charges including \$13,194 of goodwill and \$2,388 of long-lived assets related to two businesses in China (with no tax benefit) as well as an impairment charge of \$1,342 (\$1,033 after-tax) for intangible assets.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollars in thousands, except per share amounts)

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read together with "Selected Financial Data," the Company's consolidated financial statements and other financial information included elsewhere in this Annual Report on Form 10-K. This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties. Actual results may differ materially from those indicated in the forward-looking statements. See "Item 1A. Risk Factors" for more information regarding forward-looking statements.

General

The Company is the world's largest designer and manufacturer of arc welding and cutting products, manufacturing a broad line of arc welding equipment, consumable welding products and other welding and cutting products.

The Company is one of only a few worldwide broad-line manufacturers of welding, cutting and brazing products. Welding products include arc welding power sources, wire feeding systems, robotic welding packages, fume extraction equipment, consumable electrodes and fluxes. The Company's product offering also includes CNC plasma and oxy-fuel cutting systems, regulators and torches used in oxy-fuel welding, cutting and brazing. In addition, the Company has a leading global position in the brazing and soldering alloys market.

The Company invests in the research and development of arc welding products in order to continue its market leading product offering. The Company continues to invest in technologies that improve the quality and productivity of welding products. In addition, the Company continues to actively increase its patent application process in order to secure its technology advantage in the United States and other major international jurisdictions. The Company believes its significant investment in research and development and its highly trained technical sales force coupled with its extensive distributor network provide a competitive advantage in the marketplace.

The Company's products are sold in both domestic and international markets. In North America, products are sold principally through industrial distributors, retailers and also directly to users of welding products. Outside of North America, the Company has an international sales organization comprised of Company employees and agents who sell products from the Company's various manufacturing sites to distributors and product users.

The Company's major end-user markets include:

- general metal fabrication,
- power generation and process industry,
- structural steel construction (buildings and bridges),
- heavy equipment fabrication (farming, mining and rail),
- shipbuilding,
- automotive,
- pipe mills and pipelines, and
- offshore oil and gas exploration and extraction.

The Company has, through wholly-owned subsidiaries or joint ventures, manufacturing facilities located in the United States, Brazil, Canada, China, Colombia, France, Germany, India, Indonesia, Italy, Mexico, the Netherlands, Poland, Portugal, Russia, Turkey, the United Kingdom and Venezuela.

The Company has aligned its business units into five operating segments to enhance the utilization of the Company's worldwide resources and global end user and sourcing initiatives. The operating segments consist of North America Welding, Europe Welding, Asia Pacific Welding, South America Welding and The Harris Products Group. The North America Welding segment includes welding operations in the United States, Canada and Mexico. The Europe Welding segment includes welding operations in Europe, Russia and Africa. The other two welding segments include welding operations in Asia Pacific and South America, respectively. The fifth segment, The Harris Products Group, includes the Company's global cutting, soldering and brazing businesses as well as the retail business in the United States. See Note 5 to the Company's consolidated financial statements for segment and geographic area information, which is incorporated herein by reference.

The principal raw materials essential to the Company's business are steel, electronic components, engines, brass, copper, silver, aluminum alloys and various chemicals, all of which are normally available for purchase in the open market.

The Company's facilities are subject to environmental regulations. To date, compliance with these environmental regulations has not had a material adverse effect on the Company's earnings. The Company is ISO 9001 certified at nearly all facilities worldwide. In addition, the Company is ISO 14001 certified at most significant manufacturing facilities in North America and Europe and is progressing towards certification at its remaining facilities worldwide.



## Key Indicators

Key economic measures relevant to the Company include industrial production trends, steel consumption, purchasing manager indices, capacity utilization within durable goods manufacturers and consumer confidence indicators. Key industries which provide a relative indication of demand drivers to the Company include steel, farm machinery and equipment, construction and transportation, fabricated metals, electrical equipment, ship and boat building, defense, truck manufacturing, energy and railroad equipment. Although these measures provide key information on trends relevant to the Company, the Company does not have available a more direct correlation of leading indicators which can provide a forward-looking view of demand levels in the markets which ultimately use the Company's welding products.

Key operating measures utilized by the operating units to manage the Company include orders, sales, inventory and fill-rates, all of which provide key indicators of business trends. These measures are reported on various cycles including daily, weekly and monthly depending on the needs established by operating management.

Key financial measures utilized by the Company's executive management and operating units in order to evaluate the results of its business and in understanding key variables impacting the current and future results of the Company include: sales; gross profit; selling, general and administrative expenses; operating income; earnings before interest and taxes; earnings before interest, taxes and bonus; net income; adjusted operating income; adjusted net income; adjusted diluted earnings per share; operating cash flows; and capital expenditures, including applicable ratios such as return on invested capital and average operating working capital to sales. These measures are reviewed at monthly, quarterly and annual intervals and compared with historical periods, as well as objectives established by the Board of Directors of the Company.

## Results of Operations

The following table shows the Company's results of operations:

	Year Ended December 31,							
	2012		2011		2010			
	Amount	% of Sales	Amount	% of Sales	Amount	% of Sales		
Net sales	\$2,853,367	100.0 %	\$2,694,609	100.0 %	\$2,070,172	100.0 %		
Cost of goods sold	1,986,711	69.6 %	1,957,872	72.7 %	1,506,353	72.8 %		
Gross profit	866,656	30.4 %	736,737	27.3 %	563,819	27.2 %		
Selling, general & administrative expenses	495,221	17.4 %	439,775	16.3 %	377,773	18.2 %		
Rationalization and asset impairment charges (gains)	9,354	0.3 %	282	—	(384)	—		
Operating income	362,081	12.7 %	296,680	11.0 %	186,430	9.0 %		
Interest income	3,988	0.1 %	3,121	0.1 %	2,381	0.1 %		
Equity earnings in affiliates	5,007	0.2 %	5,385	0.2 %	3,171	0.2 %		
Other income	2,685	0.1 %	2,849	0.1 %	1,817	0.1 %		
Interest expense	(4,191)	(0.1 %)	(6,704)	(0.2 %)	(6,691)	(0.3 %)		
Income before income taxes	369,570	13.0 %	301,331	11.2 %	187,108	9.0 %		
Income taxes	112,354	3.9 %	84,318	3.1 %	54,898	2.7 %		
Net income including non-controlling interests	257,216	9.0 %	217,013	8.1 %	132,210	6.4 %		
Non-controlling interests in subsidiaries' (loss) earnings	(195)	—	(173)	—	1,966	0.1 %		
Net income	\$257,411	9.0 %	\$217,186	8.1 %	\$130,244	6.3 %		

## 2012 Compared with 2011

**Net Sales:** Net sales for 2012 increased 5.9% from 2011. The sales increase reflects volume increases of 1.3%, price increases of 1.7%, increases from acquisitions of 4.9% and unfavorable impacts from foreign exchange of 2.0%. Sales volumes increased because of growth in the domestic markets offset by lower demand in the international markets. Product pricing increased from prior year levels due to the realization of price increases implemented in response to increases in raw material costs.

**Gross Profit:** Gross profit increased 17.6% to \$866,656 during 2012 compared with \$736,737 in 2011. As a percentage of Net sales, Gross profit increased to 30.4% in 2012 compared with 27.3% in 2011. The increase was the result of pricing increases and operating leverage partially offset by lower margins from the acquisitions of Kaliburn, Burny and Cleveland Motion Control businesses (collectively, "Kaliburn"), Wayne Trail Technologies, Inc. ("Wayne Trail"), Weartech International, Inc. ("Weartech"), Techalloy Company, Inc. and certain assets of its parent company, Central Wire Industries Ltd. (collectively, "Techalloy") and OOO Severstal-metiz: welding consumables ("Severstal"). In the current period, the Company recorded charges of \$2,334 related to the initial accounting for recent acquisitions and charges of \$1,039 due to a change in Venezuelan labor law, which provides for increased employee severance obligations. Foreign currency exchange rates had a \$13,166 unfavorable translation impact in 2012.

**Selling, General & Administrative ("SG&A") Expenses:** SG&A expenses increased 12.6% to \$495,221 during 2012 compared with \$439,775 in 2011. The increase was primarily due to higher bonus expense of \$20,439, incremental SG&A expenses from acquisitions of \$15,403, higher general and administrative spending primarily related to additional employee compensation costs of \$12,692, higher U.S. retirement costs of \$3,986 and higher legal expenses of \$2,142 partially offset by foreign currency translation of \$8,821.

**Rationalization and Asset Impairment Charges (Gains):** In 2012, the Company recorded \$9,354 in charges primarily related to rationalization actions initiated in 2012. See "Rationalization and Asset Impairments" for additional information.

**Interest Income:** Interest income increased to \$3,988 in 2012 from \$3,121 in 2011. The increase was largely due to international entities earning more favorable interest rates.

**Equity Earnings in Affiliates:** Equity earnings in affiliates were \$5,007 in 2012 compared with earnings of \$5,385 in 2011. The decrease was due to a decrease in earnings of \$542 in Chile being partially offset by an increase in earnings of \$164 in Turkey.

**Interest Expense:** Interest expense decreased to \$4,191 in 2012 from \$6,704 in 2011, primarily as a result of lower levels of debt in the current period.

**Income Taxes:** The Company recorded \$112,354 of tax expense on pre-tax income of \$369,570, resulting in an effective tax rate of 30.4% for 2012. The effective income tax rate is lower than the Company's statutory rate primarily due to income earned in lower tax rate jurisdictions and the utilization of foreign tax loss carry-forwards for which valuation allowances had been previously provided.

The effective income tax rate of 28.0% for 2011 was lower than the Company's statutory rate primarily due to income earned in lower tax rate jurisdictions, the utilization of foreign tax loss carry-forwards for which valuation allowances had been previously provided and a tax benefit of \$4,844 for tax audit settlements.

**Net Income:** Net income for 2012 was \$257,411 compared with \$217,186 in the prior year. Diluted earnings per share for 2012 were \$3.06 compared with diluted earnings of \$2.56 per share in 2011. Foreign currency exchange rate movements had an unfavorable translation effect of \$2,879 and a favorable translation effect of \$2,948 on Net income for 2012 and 2011, respectively.

## Segment Results

Net Sales: The table below summarizes the impacts of volume, acquisition, price and foreign currency exchange rates on Net sales for the twelve months ended December 31, 2012:

Operating Segments	Net Sales 2011	Change in Net Sales due to:				Price	Foreign Exchange
		Volume	Acquisitions				
North America Welding	\$ 1,309,499	\$ 112,898	\$ 124,830		\$ 37,124	\$(3,533 )	
Europe Welding	508,692	(36,199 )	8,322		4,874	(33,462 )	
Asia Pacific Welding	376,276	(54,289 )	—		1,646	849	
South America Welding	156,684	(1,284 )	—		15,584	(9,501 )	
The Harris Products Group	343,458	13,683	—		(13,427 )	(9,357 )	
Consolidated	\$ 2,694,609	\$ 34,809	\$ 133,152		\$ 45,801	\$(55,004)	
% Change							
North America Welding		8.6	% 9.5	%	2.8	% (0.3	%)
Europe Welding		(7.1	%) 1.6	%	1.0	% (6.6	%)
Asia Pacific Welding		(14.4	%) —		0.4	% 0.2	%
South America Welding		(0.8	%) —		9.9	% (6.1	%)
The Harris Products Group		4.0	% —		(3.9	%) (2.7	%)
Consolidated		1.3	% 4.9				

% The SERP provides participants with supplementary retirement benefits determined as the excess of (a) the amount of pension calculated in accordance with the provisions of the SERP over (b) the amount of pension payable from the registered plan in which the executive participates. The SERP benefits are computed as the sum of the products of two formulas: one applicable to years of service with BCFPI, and the other applicable to certain years of service with prior employers recognized under the SERP.

The first formula is 2% per year of service with BCFPI multiplied by final average pay, which is defined as the

average base salary (shown under the salary heading in the Summary Compensation Table) for the 36 months preceding retirement plus 50% of the average incentive target. The incentive component in the final average pay represents 18% of base salary for service before 1999 and 25% of base salary for service after 1998. The second formula is 1.6% per year of recognized service with prior employers multiplied by final average pay, as defined in the previous formula.

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The following tables show the estimated annual pension benefits payable to Mr. Stuart upon retirement at age 65 under the registered plan and the SERP based on the two SERP formulas. Benefits are payable on a joint and 60% survivor basis if the executive has an eligible spouse at retirement, and otherwise for life with a 10-year guarantee. Both tables assume retirement on December 31, 2005, with payments beginning at age 65. The first table shows the benefits payable for service with BCFPI and the second table shows the benefits payable for recognized service with prior employers. The benefits will not be reduced by any offset for government payments.

## Canada Retirement Plans

## Table of Estimated Benefits for Service with BCFPI

US\$

Final Average	10-Years	15-Years
Earnings	Service	Service
500,000	100,000	150,000
550,000	110,000	165,000
600,000	120,000	180,000

As of December 31, 2005, Mr. Stuart earned 12.33 years of service with BCFPI; his final average pay is \$538,076 (Can\$626,617) for years of service before 1999, and \$569,996 (Can\$663,789) for years of service after 1998. Both average pay amounts have been converted from Canadian dollars to U.S. dollars using the exchange rate used for year-end 2005 disclosure purposes.

## Canada Retirement Plans

## Table of Estimated Benefits for Service with Prior Employers Recognized under the Plans

US\$

Final Average	20-Years	25-Years
Earnings	Service	Service
500,000	160,000	200,000
550,000	176,000	220,000

600,000	192,000	240,000
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As of December 31, 2005, Mr. Steuart earned 23.67 years of service with prior employers for which he receives credit under the SERP and the registered plan. The final average pay used to compute his benefits attributable to those years of service is \$538,076 (Can\$626,617), converted from Canadian dollars to U.S. dollars using the exchange rate used for year-end 2005 disclosure purposes. The SERP provides that benefits payable to a participant who retires before age 60 are subject to a reduction of .5% for each full month of retirement before age 60. There are no change in control provisions in the SERP.

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**Item No. 2 Approval of Bowater's 2006 Stock  
Option and**

**Restricted Stock Plan**

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A proposal will be presented at the Annual Shareholders Meeting to approve the Bowater Incorporated 2006 Stock Option and Restricted Stock Plan (the Plan). The Plan was approved by the Board of Directors on March 29, 2006, subject to stockholder approval. A summary of the material provisions of the Plan is set forth below. A copy of the Plan is set forth in Appendix A.

Subject to the approval of the stockholders of Bowater at the annual meeting of its shareholders, the Plan shall be effective as of January 1, 2006 (the Effective Date) and, if approved, will continue in effect until terminated by the Board; provided, however, that no awards may be granted under the Plan after the ten-year anniversary of the Effective Date. However, any awards that are outstanding after Plan termination shall remain subject to the terms of the Plan.

*Purpose.* The Plan has been established by Bowater to (i) attract and retain persons eligible to participate in the Plan; (ii) motivate Participants, by means of appropriate incentives, to achieve long-range goals; (iii) provide incentive compensation opportunities that are competitive with those of other similar companies; and (iv) further identify Participants' interests with those of Bowater's other shareholders through compensation that is based on Bowater's ordinary shares of stock; and thereby promote the long-term financial interest of Bowater and the Subsidiaries, including the growth in value of Bowater's equity and enhancement of long-term stockholder return. To achieve these objectives, the Plan provides for the grant of non-qualified and incentive stock options, stock appreciation rights (SARs), full value awards and cash incentive awards.

Bowater has proposed the Plan at this time because it believes in the merits of linking executives' overall compensation opportunities to the enhancement of long-term stockholder return. In addition, without the Plan there would not be sufficient shares available under the prior stock option plans to make the contemplated 2006 equity awards to executives in accordance with compensation policy described in the Human Resource and

Compensation Committee Report on Executive Compensation. Bowater uses equity-based compensation, such as options and other Common Stock related awards, as key elements of its executives' compensation packages. Since Bowater believes it is important for the employees and directors of Bowater and its subsidiaries to have an equity interest in Bowater, and to be eligible to receive cash incentive awards, the Board of Directors has approved the Plan, and is recommending it to shareholders for approval. Because of the challenging market conditions facing Bowater, the new Plan is necessary so Bowater can continue making equity awards to employees and directors at competitive levels to attract the best talent.

The Plan includes the following provisions:

- n No Repricing. Bowater has never repriced underwater stock options and option repricing is prohibited without shareholder approval under the Plan.
  
- n Minimum Vesting Periods. The Plan provides that awards may not vest sooner than one-third per year over three years unless they vest sooner by virtue of an event specified by the Board other than the passage of time (or unless they are granted in lieu of other compensation or as an employment inducement).
  
- n Independent Committee Administration. The Plan will be administered by a committee of the Board ( Committee ) whose members satisfy the non-employee director requirements of Rule 16b-3 under the Securities Exchange Act of 1934 ( Exchange Act ) and the outside director requirement of Internal Revenue Code Section 162(m).



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- n No Discount Stock Options. The Plan prohibits the grant of a stock option with an exercise price less than the fair market value of our Stock on the date of grant.
  
- n Material Revisions to the Plan Require Stockholder Approval. The Plan states that a material revision to the Plan will not be effective unless approved by the Corporation's shareholders.

*General.* The Plan is administered by the Human Resources and Compensation Committee (the Committee). The Committee selects from the eligible individuals those persons to whom awards under the Plan will be granted (Participants), the types of awards to be granted and the applicable terms, conditions, performance criteria, restrictions and other provisions of such awards. The Committee may delegate all or any portion of its responsibilities or powers under the Plan to persons selected by it. If the Committee ceases to exist, or for any other reason determined by the Board of Directors of Bowater (the Board) and to the extent not prohibited by applicable law or the applicable rules of any stock exchange, the Board may take any action under the Plan that would otherwise be the responsibility of the Committee.

The maximum number of shares that may be delivered to Participants and their beneficiaries under the Plan is 3,000,000 shares of Common Stock. Shares covered by an award that are not delivered on an unrestricted basis (because the award is forfeited or canceled) shall not count toward the 3,000,000 authorized shares.

The following additional limits apply to awards under the Plan: (i) no more than 3,000,000 shares of Common Stock for incentive stock options may be delivered to Participants and their beneficiaries under the Plan; (ii) the maximum number of shares of Common Stock that may be covered by options and SARs granted to any one Participant in any one calendar year may not exceed 300,000 shares; (iii) the maximum number of shares of Common Stock that may be delivered pursuant to full value awards shall be 3,000,000 shares of Common Stock; (iv) the maximum number of shares that may be delivered pursuant to full value awards intended to be performance-based compensation (as described below) granted to any one Participant during any one-calendar-year period, regardless of whether settlement of the award is to occur prior to, at the time of, or after the time of vesting, may not exceed 200,000 shares; (v) the maximum amount of cash incentive awards intended to be performance-based compensation payable to any one Participant with respect to any performance period shall

equal \$200,000 multiplied by the number of calendar months included in the performance period.

The shares of Common Stock with respect to which awards may be made under the Plan shall be shares currently authorized but unissued or, to the extent permitted by applicable law, currently held or acquired by Bowater as treasury shares, including shares purchased in the open market or in private transactions. At the discretion of the Committee, an award under the Plan may be settled in cash rather than Common Stock. The closing price with respect to the Common Stock on March 15, 2006, was \$29.38 per share.

If the Plan is approved, Bowater's full dilution level will be 12.4%. This level assumes all outstanding options are in the money and exercisable even though all outstanding options were underwater (with exercise prices above \$30.00) as of March 15, 2006. There are approximately 210,750 options expiring in 2007 and 261,000 options expiring in 2008 with exercise prices of \$41.89 and \$48.60, respectively. Shares of Common Stock outstanding as of March 15, 2006 are 57,359,742, with 4,851,399 options granted and unexercised, having an average exercise price of \$44.57 and average years remaining of 5.9 years. The level of full dilution also assumes all 3,000,000 shares will actually be issued under the Plan.

Bowater's historical grants under its equity plans illustrate its commitment to appropriately managing equity compensation. For each of the years from 2002 to 2005, Bowater has awarded

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stock options and restricted stock awards averaging 1.3% of shares outstanding. Assuming the Plan is approved, the awards made in January 2006 would represent 1.3% of the outstanding share balance as of March 15, 2006.

The Committee and the Board have structured the 2006 Plan to permit awards of restricted stock and performance shares, in addition to stock options. These types of awards, which may be tied to specified performance criteria, can provide equivalent value to recipients while utilizing less shares of Common Stock, and are therefore less dilutive to existing shareholders. In accordance with the compensation policy for 2006 described on page 18 under Human Resources and Compensation Committee Report on Executive Compensation - Key Elements and Policies for Compensation of Executive Officers, it is anticipated that future equity awards to key executives, to other employees and to non-employee directors will include restricted stock or forms of cash compensation that are based on the value of Common Stock, as well as options, reducing substantially the number of shares that might otherwise be issued under the Plan.

The Committee may use shares of Common Stock available under the Plan as the form of payment for compensation, grants or rights earned or due under any other compensation plans or arrangements of Bowater or a subsidiary, including the plans and arrangements of Bowater or a subsidiary assumed in business combinations.

In the event of a corporate transaction involving Bowater (including, without limitation, any stock dividend, stock split, extraordinary cash dividend, recapitalization, reorganization, merger, consolidation, split-up, spin-off, combination or exchange of shares), the Committee may adjust awards to preserve the benefits or potential benefits of the awards. Action by the Committee may include: (i) adjustment of the number and kind of shares which may be delivered under the Plan; (ii) adjustment of the number and kind of shares subject to outstanding awards; (iii) adjustment of the exercise price of outstanding options and SARs; and (iv) any other adjustments that the Committee determines to be equitable, which may include, without limitation, (A) replacement of awards with other awards which the Committee determines have comparable value and which are based on stock of a company resulting from the transaction, and (B) cancellation of the award in return for cash payment of the current value of the award, determined as though the award is fully vested at the time of payment, provided that in the case of an option or SAR, the amount of such payment may be the excess of value of

the Common Stock subject to the option or SAR at the time of the transaction over the exercise price.

Except as otherwise provided by the Committee, awards under the Plan are not transferable except as designated by the Participant by will or by laws of descent and distribution.

*Eligibility.* All employees and directors of Bowater or its subsidiaries, as well as consultants and other persons providing services to Bowater or its subsidiaries, are eligible to become Participants in the Plan, except that non-employees may not be granted incentive stock options. As of December 31, 2005, Bowater and its subsidiaries had approximately 8,000 employees. The specific employees who initially will be granted awards under the Plan and the type and amount of any such awards will be determined by the Committee.

*Options.* The Committee may grant an incentive stock option or non-qualified stock option to purchase the Common Stock at an exercise price determined under the option. Except as described below, the exercise price for an option shall not be less than the fair market value of the Common Stock at the time the option is granted. The exercise price of an option may not be decreased after the date of grant nor may an option be surrendered to Bowater as consideration for the grant of a replacement option with a lower exercise price, except as approved by Bowater's shareholders or as adjusted for corporate transactions described above. In addition, the Committee

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may grant options with an exercise price less than the fair market value of the common stock at the time of grant in replacement for awards under other plans assumed in connection with business combinations if the Committee determines that doing so is appropriate to preserve the benefit of the awards being replaced.

The option shall be exercisable in accordance with the terms established by the Committee. The full purchase price of each share of Common Stock purchased upon the exercise of any option shall be paid at the time of exercise of an option. Except as otherwise determined by the Committee, the purchase price of an option shall be payable in cash, in Common Stock (valued at fair market value as of the day of exercise), or a combination thereof. The Committee, in its discretion, may impose such conditions, restrictions, and contingencies on Common Stock acquired pursuant to the exercise of an option as the Committee determines to be desirable. In no event will an option expire more than ten years after the grant date.

*Stock Appreciation Rights.* An SAR entitles the Participant to receive the amount (in cash or stock) by which the fair market value of a specified number of shares on the exercise date exceeds an exercise price established by the Committee. Except as described below, the exercise price for an SAR shall not be less than the fair market value of the Common Stock at the time the SAR is granted or, if less, the exercise price of the tandem option. In addition, the Committee may grant SARs with an exercise price less than the fair market value of the common stock at the time of grant in replacement for awards under other plans assumed in connection with business combinations if the Committee determines that doing so is appropriate to preserve the benefit of the awards being replaced. The Committee may grant an SAR independent of any option grant and may grant an option and SAR in tandem with each other, and SARs and options granted in tandem may be granted on different dates but may have the same exercise price. The SAR shall be exercisable in accordance with the terms established by the Committee. The Committee, in its discretion, may impose such conditions, restrictions, and contingencies on Common Stock acquired pursuant to the exercise of an SAR as the Committee determines to be desirable. In no event will an SAR expire more than ten years after the grant date.

*Full Value Awards.* The following types of full value awards may be granted, as determined by the Committee:

- n The Committee may grant shares of Common Stock that may be in return for previously performed services or in return for the Participant surrendering other compensation that may be due.
  
- n The Committee may grant shares of Common Stock that are contingent on the achievement of performance or other objectives during a specified period.
  
- n The Committee may grant shares of stock subject to a risk of forfeiture or other restrictions that lapse upon the achievement of one or more goals relating to completion of service by the Participant, or the achievement of performance or other objectives.

Any such awards shall be subject to such other conditions, restrictions and contingencies as the Committee determines.

*Cash Incentive Awards.* The Committee may grant cash incentive awards (including the right to receive payment of stock having the value equivalent to the cash otherwise payable) that may be contingent on achievement of a Participant's performance objectives over a specified period established by the Committee. The grant of cash incentive awards may also be subject to such other conditions, restrictions and contingencies, as determined by the Committee.

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*Restrictions on Awards.* If the right to become vested in an award is conditioned on the completion of a specified period of service with Bowater or the subsidiaries, without achievement of performance measures (as described below) or other performance objectives being required as a condition of vesting, and without it being granted in lieu of other compensation, then the required period of service for full vesting shall not be less than three years or ratably over a three-year period (subject to accelerated vesting, to the extent provided by the Committee, in the event of the Participant's death, disability, retirement, change of control or involuntary termination). This restriction shall not apply to an award granted as an inducement to a person being hired or re-hired.

*\$1 Million Limit.* A U.S. income tax deduction for Bowater will generally be unavailable for Bowater for annual compensation in excess of \$1 million paid to any of the five most highly compensated officers of a public corporation. However, amounts that constitute performance-based compensation are not counted toward the \$1 million limit. It is expected that, generally, options and SARs granted under the Plan will satisfy the requirements for performance-based compensation. The Committee may designate whether any awards being granted to any Participant are intended to be performance-based compensation as that term is used in section 162(m) of the Code. Any such awards designated as intended to be performance-based compensation shall be conditioned on the achievement of one or more performance measures, to the extent required by Code section 162(m). The performance measures that may be used for such awards shall be based on any one or more of the following Company, Subsidiary, operating unit or division performance measures as selected by the Committee: total stockholder return; growth in revenues, sales, net income, stock price, and/or earnings per share; return on assets, net assets, and/or capital; return on shareholders' equity; debt/equity ratio; working capital; safety; quality; Bowater's financial performance versus peers; cost reduction; productivity; market mix; or economic value added; or any combination thereof. Each goal may be expressed on an absolute and/or relative basis, may be based on or otherwise employ comparisons based on internal targets, the past performance of Bowater and/or the past or current performance of other companies, and in the case of earnings-based measures, may use or employ comparisons relating to capital, shareholders' equity and/or shares outstanding, investments or to assets or net assets.

*Change Of Control.* The Plan provides that the occurrence of a change in control shall have the effect, if any, with respect to an award, as provided by the Committee. For purposes of the Plan, a change in control is

generally deemed to occur when:

- n any person becomes the beneficial owner of Common Stock representing 20% or more of the combined voting power of Bowater, but not including securities of a beneficial owner acquired pursuant to an agreement allowing the acquisition of up to and including 50% of such voting power approved by two-thirds of the members of the Board who were Board members before such person became a beneficial owner;
  
- n the date that Bowater's shareholders approve a merger, consolidation or reorganization of Bowater with another corporation or other person, unless, immediately following such merger, consolidation or reorganization, (A) at least 50% of the combined voting power of the outstanding securities of the resulting entity would be held in the aggregate by the shareholders of Bowater as of the record date for such approval, or (B) at least 50% of the Board members who were Board members prior to the event that would constitute the change in control are members of the Board or similar body of the resulting entity;
  
- n the date Bowater sells or otherwise transfers all or substantially all of its assets to another corporation or person, unless, immediately after such sale or transfer, (A) at least 50% of the combined voting power of the outstanding securities of the resulting entity would be held in the aggregate by the shareholders of Bowater as determined immediately prior to such



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transaction, or (B) at least 50% of the Board members who were Board members prior to the event that would constitute the change in control are members of the Board or similar body of the resulting entity; or

- n the date on which less than 50% of the total membership of the Board consists of Board members who were Board members prior to the event that would constitute the change in control.

*Amendment and Termination.* The Plan may be amended or terminated at any time by the Board, and the Board or the Committee may amend any award granted under the Plan, provided that no amendment or termination may adversely affect the rights of any Participant under the Award granted prior to the date such amendment is adopted without the Participant's written consent. The Board may not amend the provision of the Plan related to repricing without approval of shareholders. Approval by Bowater's shareholders will be required for any material revision (as defined under the NSYE listing standards) to the terms of the Plan. The Plan will remain in effect as long as any awards under it are outstanding, but no new awards may be granted after the ten-year anniversary of the Effective Date.

**United States Income Tax Considerations**

Under present Federal income tax laws, awards granted under the Plan will have the following tax consequences:

*Non-Qualified Options.* The grant of a non-qualified option ( NQO ) will not result in taxable income to the Participant. Except as described below, the Participant will realize ordinary income at the time of exercise in an amount equal to the excess of the fair market value of the shares acquired over the exercise price for those shares, and Bowater will be entitled to a corresponding deduction. Gains or losses realized by the Participant upon disposition of such shares will be treated as capital gains and losses, with the basis in such shares equal to the fair market value of the shares at the time of exercise.

The exercise of an NQO through the delivery of previously acquired stock will generally be treated as a non-taxable, like-kind exchange as to the number of shares surrendered and the identical number of shares received under the option. That number of shares will take the same basis and,

for capital gains purposes, the same holding period as the shares that are given up. The value of the shares received upon such an exchange that are in excess of the number given up will be includible as ordinary income to the Participant at the time of the exercise. The excess shares will have a new holding period for capital gain purposes and a basis equal to the value of such shares determined at the time of exercise.

*Incentive Stock Options.* The grant of an incentive stock option ( ISO ) will not result in taxable income to the Participant. The exercise of an ISO will not result in taxable income to the Participant provided that the Participant was, without a break in service, an employee of Bowater or a subsidiary during the period beginning on the date of the grant of the option and ending on the date three months prior to the date of exercise (one year prior to the date of exercise if the Participant is disabled, as that term is defined in the Code).

The excess of the fair market value of the shares at the time of the exercise of an ISO over the exercise price is an adjustment that is included in the calculation of the Participant's alternative minimum taxable income for the tax year in which the ISO is exercised. For purposes of determining the Participant's alternative minimum tax liability for the year of disposition of the shares acquired pursuant to the ISO exercise, the Participant will have a basis in those shares equal to the fair market value of the shares at the time of exercise.

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If the Participant does not sell or otherwise dispose of the stock within two years from the date of the grant of the ISO or within one year after receiving the transfer of such stock, then, upon disposition of such shares, any amount realized in excess of the exercise price will be taxed to the Participant as capital gain, and Bowater will not be entitled to any deduction for Federal income tax purposes. A capital loss will be recognized to the extent that the amount realized is less than the exercise price.

If the foregoing holding period requirements are not met, the Participant will generally realize ordinary income, and a corresponding deduction will be allowed to Bowater, at the time of the disposition of the shares, in an amount equal to the lesser of (i) the excess of the fair market value of the shares on the date of exercise over the exercise price, or (ii) the excess, if any, of the amount realized upon disposition of the shares over the exercise price. If the amount realized exceeds the value of the shares on the date of exercise, any additional amount will be capital gain. If the amount realized is less than the exercise price, the Participant will recognize no income, and a capital loss will be recognized equal to the excess of the exercise price over the amount realized upon the disposition of the shares.

The exercise of an ISO through the exchange of previously acquired stock will generally be treated in the same manner as such an exchange would be treated in connection with the exercise of an NQO; that is, as a non-taxable, like-kind exchange as to the number of shares given up and the identical number of shares received under the option. That number of shares will take the same basis and, for capital gain purposes, the same holding period as the shares that are given up. However, such holding period will not be credited for purposes of the one-year holding period required for the new shares to receive ISO treatment. Shares received in excess of the number of shares given up will have a new holding period and will have a basis of zero or, if any cash was paid as part of the exercise price, the excess shares received will have a basis equal to the amount of the cash. If a disqualifying disposition (a disposition before the end of the applicable holding period) occurs with respect to any of the shares received from the exchange, it will be treated as a disqualifying disposition of the shares with the lowest basis.

If the exercise price of an ISO is paid with shares of stock of Bowater acquired through a prior exercise of an ISO, gain will be realized on the shares given up (and will be taxed as ordinary income) if those shares have not been held for the minimum ISO holding period (two years from

the date of grant and one year from the date of transfer), but the exchange will not affect the tax treatment, as described in the immediately preceding paragraph, of the shares received.

*Stock Appreciation Rights.* The grant of an SAR will not result in taxable income to the Participant. Upon exercise of an SAR, the amount of cash or the fair market value of shares received will be taxable to the Participant as ordinary income, and a corresponding deduction will be allowed to Bowater. Gains or losses realized by the Participant upon disposition of such shares will be treated as capital gains and losses, with the basis in such shares equal to the fair market value of the shares at the time of exercise.

*Full Value Awards.* A Participant who has been granted a full value award will not realize taxable income at the time of grant, and Bowater will not be entitled to a deduction at that time, if the grant is subject to a risk of forfeiture or other restrictions that will lapse upon the achievement of other objectives, assuming that the restrictions constitute a substantial risk of forfeiture for Federal income tax purposes. Upon the vesting of shares subject to an award, the holder will realize ordinary income in an amount equal to the then fair market value of those shares, and Bowater will be entitled to a corresponding deduction. Gains or losses realized by the Participant upon disposition of such shares will be treated as capital gains and losses, with the basis in such shares equal to the fair market value of the shares at the time of vesting. Dividends paid to the holder during the restriction period will also be compensation income to the Participant and deductible as such by Bowater.

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*Cash Incentive Awards.* A Participant will realize taxable income at the time the cash incentive award is distributed, and Bowater will be entitled to a corresponding deduction.

*Change In Control.* Any acceleration of the vesting or payment of awards under the Plan in the event of a change in control in Bowater may cause part or all of the consideration involved to be treated as an excess parachute payment under the Internal Revenue Code, which may subject the Participant to a 20% excise tax and which may not be deductible by Bowater.

*Vote Required.* Approval of the Plan requires the affirmative vote of holders of a majority of the shares voting on the issue at the Annual Meeting. Abstentions are counted as a vote against this proposal. Broker non-votes have no effect upon the vote to approve the Plan.

*New Plan Benefits.* Set forth below is information concerning stock option grants and restricted stock unit grants that the Committee has made under the Plan, contingent upon shareholder approval of the Plan. These grants are a combination of stock unit awards made in recognition of the achievement of Bowater's annual incentive plan goals, for which no cash awards were paid, and equity incentive awards designed to achieve Bowater's target compensation levels, as discussed on page 18 under the section of the Human Resources and Compensation Committee Report entitled Key Elements and Policies for Compensation of Executive Officers.

The Committee has not authorized grants of specific numbers of shares or options under the Plan. Rather, the Committee has apportioned the dollar value for awards made in recognition of the achievement of Bowater's annual incentive plan goals (\$13.4 million) and equity incentive awards (\$6.8 million) into awards for each Participant. The awards made in recognition of the achievement of Bowater's annual incentive plan goals will consist of restricted stock unit awards that would be subject to a service-based, two-year cliff vesting schedule (ending December 31, 2007) with prorated vesting if the Participant retires for both executives and all other employees.

The restricted stock units awarded as equity incentives to non-executive employees and certain lower-ranked executives will all have a service based three-year cliff

vesting schedule. For Bowater's senior executives, 37.5% of the equity incentive awards will be allocated as stock options and the remaining 62.5% will be allocated as restricted stock units. Half of the senior executives restricted stock unit awards will have a service based three-year cliff vesting schedule and the remaining half will vest if certain performance targets are met. If Bowater has positive earnings per share during the three-year period beginning January 1, 2006 and ending December 31, 2008 (that is, if Bowater's cumulative net earnings for the three-year period are positive), the total award will vest. If Bowater has positive earnings per share for any one calendar year during the three-year period, one-third of the award will vest for each such year. Earnings per share and net earnings will be reflected in Bowater's published financial statements.

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The dollar value of the awards described above will be converted into a specific number of options or restricted stock units based on the average of the high and low price of Bowater's common stock seven days prior to the annual meeting (the "Strike Price"). The number of restricted stock units will be determined by dividing the dollar amount of each award by the Strike Price. The number of options will be determined using the Black-Scholes valuation methodology based on the Strike Price. The following chart illustrates the number of options or restricted stock units that would be awarded if the Strike Price equaled \$29.14, which is the average of the high and low price of Bowater's common stock on March 15, 2006:

**New Plan Benefits - 2006 Stock Option and Restricted Stock Plan**

**Persons receiving Equity Awards**

<b>under the 2006 Stock Option Plan</b>	<b>Number of Shares Subject to Options<sup>(1)</sup></b>	<b>Number of Restricted Stock Units <sup>(2)</sup></b>
Arnold M. Nemirow	0	0
David G. Maffucci	12,250	15,200
R. Donald Newman	12,250	17,350
Pierre Monahan	5,800	11,950
David J. Steuart	5,800	13,350
E. Patrick Duffy	0	0
All Executive Officers as a Group	80,400	142,250 <sup>(3)</sup>
All Employees (except executive officers)	20,100	516,850

(1) As determined using the Black-Scholes valuation methodology based on a per share price of \$29.14, which was the average of the high and low price of Bowater's common stock on March 15, 2006.

(2) As determined by dividing the dollar amount of the awards based on a per unit price of \$29.14, which was the average of the high and low price of Bowater's common stock on March 15, 2006.

(3) Excludes 50,000 restricted stock units that Bowater has agreed to grant to David J. Paterson.

**The Board of Directors unanimously recommends a vote FOR the approval of the 2006 Stock Option and Restricted Stock Plan.**

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### **Section 16(a) Beneficial Ownership Reporting Compliance**

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Section 16(a) of the Exchange Act requires Bowater's directors, executive officers and 10% shareholders to file reports of holdings and transactions in Common Stock and Exchangeable Shares with the SEC. Based on a review of Section 16(a) reports received by Bowater and written representations from its directors and executive officers, Bowater believes that all of its executive officers, directors and 10% shareholders have made all filings required to be made under Section 16(a) for 2005 except Mr. Rolls, who filed one Form 4 three days late with respect to a single acquisition of shares due to an administrative error.

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### **Related Party Transactions**

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Company director L. Jacques Ménard is the chairman of the board of directors of BMO Nesbitt Burns and president of its affiliate BMO Financial Group, Québec. BMO Nesbitt Burns was a member of the initial purchasers syndicate for Bowater's June 2003 private placement of an aggregate principal amount of \$400 million of 6.5% Senior Notes due 2013 and a member of the underwriters syndicate for Bowater's March 2004 public offering of an aggregate principal amount of \$250 million of Floating Rate Senior Notes due 2010. The principal amount of notes allotted to BMO Nesbitt Burns in these transactions was \$32.0 million and \$17.5 million, respectively, and BMO Nesbitt Burns received an initial purchasers' or underwriters' discount of \$400,000 and



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\$262,500, respectively, in these transactions. In addition, BMO Nesbitt Burns is assisting Bowater with the sale of certain of its Canadian assets. Although the terms of the engagement have not yet been finalized, Bowater anticipates paying BMO Nesbitt Burns a customary fee if the sale is consummated. The Bank of Montreal, an affiliate of BMO Nesbitt Burns, is one of the creditors under the Bowater Incorporated revolving credit agreement. At December 31, 2005, the Bank of Montreal's commitments under the revolving credit agreement were \$55.0 million. Mr. Ménard did not receive any portion of BMO Nesbitt Burns' or the Bank of Montreal's fees as direct compensation and benefited from these transactions only to the extent that BMO Nesbitt Burns and the Bank of Montreal, as entities, benefited. Bowater believes that its arrangements with BMO Nesbitt Burns and the Bank of Montreal are on terms as favorable as could be obtained from unrelated parties.

Company director Bruce W. Van Saun is Vice Chairman and Chief Financial Officer of The Bank of New York Company Inc. The Bank of New York is the registrar of Bowater's common stock and is the trustee on various debt and pension obligations of Bowater. The Bank of New York was a member of the initial purchasers syndicate for Bowater's June 2003 private placement of an aggregate principal amount of \$400 million of 6.5% Senior Notes due 2013 and a member of the underwriters syndicate for Bowater's March 2004 public offering of an aggregate principal amount of \$250 million of Floating Rate Senior Notes due 2010. The principal amount of notes allotted to The Bank of New York in these transactions was \$17.3 million and \$10.3 million, respectively, and The Bank of New York received an initial purchasers' or underwriters' discount of \$216,650 and \$154,688, respectively, in these transactions. The Bank of New York is one of the creditors under the Bowater Incorporated revolving credit agreement. At December 31, 2005, the bank's commitments under the revolving credit agreement were \$25.0 million. Mr. Van Saun did not receive any portion of The Bank of New York's fees as direct compensation and benefited from these transactions only to the extent that The Bank of New York, as an entity, benefited. Bowater believes that its arrangements with bank are on terms as favorable as could be obtained from unrelated parties.

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**Report of the Audit Committee of the Board  
of Directors**

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*The following report does not constitute soliciting material and is not considered filed or incorporated by reference into any other filing by Bowater under the Securities Act of*

*1933, as amended, or the Securities Exchange Act of 1934, as amended.*

The Board of Directors has adopted a written charter for the Audit Committee, which is available at Bowater's website (<http://www.bowater.com>). The Audit Committee is currently comprised of four Outside Directors, all of whom the Board of Directors has determined are independent as defined under the revised listing standards of the NYSE and new standards of the SEC adopted under the Sarbanes-Oxley Act. The Board of Directors has determined that Audit Committee Chairman John A. Rolls and Mr. Bruce W. Van Saun are each an audit committee financial expert as defined by the SEC.

In carrying out its responsibilities, the Audit Committee has:

- n Reviewed and discussed the audited financial statements for the year ended December 31, 2005, with Bowater's management and Bowater's independent registered public accounting firm, KPMG LLP;
- n Discussed with KPMG LLP the matters required to be discussed by the Statement on Auditing Standards No. 61, *Communication with Audit Committees*; and

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n Received from KPMG LLP written disclosures regarding auditor independence and the letter required by Independence Standards Board Standard No. 1, *Independence Discussion with Audit Committees*, and discussed with the firm its independence from Bowater and its management.

Based on the review and discussions described above, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in Bowater's Annual Report on Form 10-K for the year ended December 31, 2005, for filing with the SEC.

All members of the Audit Committee concur in this report.

John A. Rolls (Chairman)

Gordon D. Giffin

Bruce W. Van Saun

Togo D. West, Jr.

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**Item No. 3: Appointment of Independent**
**Registered Public Accounting Firm**


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The Board of Directors, acting through its Audit Committee, appointed KPMG LLP as independent registered public accounting firm for Bowater to audit its consolidated financial statements for the year ended December 31, 2006. KPMG LLP currently serves Bowater and its subsidiaries as independent registered public accounting firm and from time to time advises Bowater on tax and other matters. Representatives of KPMG LLP are expected to be present at the Annual Meeting, will have the opportunity to make a statement if they desire to do so, and are expected to be available to respond to appropriate questions from shareholders.

The table below and the accompanying footnotes set forth the fees paid by Bowater to its independent registered public accounting firm KPMG LLP for the periods and in the categories indicated.

	<b>Fiscal 2005</b>	<b>Fiscal 2004</b>
<b>Audit Fees and Services</b>	<hr/>	<hr/>
	(in thousands)	(in thousands)
Audit Fees	\$ 3,000	\$ 3,683
Audit-Related Fees <sup>(1)</sup>	\$ 263	235
Tax Fees <sup>(2)</sup>	\$ 182	250
All Other Fees <sup>(3)</sup>	\$ 155	73
	<hr/>	<hr/>
<b>Total Fees for all Services</b>	<b>\$ 3,600</b>	<b>\$ 4,241</b>

(1) Audit-Related Fees in 2005 and 2004 consisted principally of fees for audits of financial statements of certain employee benefit plans and other attestation engagements.

(2) Tax Fees consisted of fees for tax compliance (\$158,000 in 2005 and \$109,000 in 2004) and for tax planning and consulting (\$24,000 in 2005 and \$141,000 in 2004).

(3) All Other Fees in 2005 and 2004 consisted principally of fees for sustainable forest audits in Canada, and an information technology security assessment in 2005 (\$75,000).

Bowater's Audit Committee has adopted a policy requiring that the Audit Committee pre-approve all audit and non-audit services (including audit-related, tax and other services) performed by Bowater's independent registered public accounting firm, and the Audit Committee pre-approved all audit and permissible non-audit services provided by KPMG LLP since May 6, 2003. Under policies and procedures adopted by the Audit Committee, the terms and fees of the annual audit services engagement are subject to approval by the Audit Committee prior to the rendering of the services. The Audit Committee also reviews and approves non-audit services prior to the rendering of the services. The Audit Committee may not approve the provision of non-audit services that the SEC prohibits independent auditors from performing for their audit clients or that are otherwise inconsistent with the independent auditor's independence. The Audit Committee is required to establish annually a budget for services to be performed by Bowater's independent accountants, and Bowater's management is required to track the independent auditor's fees against the budget and report at least annually to the committee.

Bowater's Chief Financial Officer, Controller or other officer designated by the Board must submit, jointly with the independent registered public accounting firm, requests for the independent registered public accounting firm to provide services to the Audit Committee that require pre-approval. Each request must include a statement as to whether both the independent registered public accounting firm and the submitting officer view the provision of the requested services as consistent with the SEC's rules on auditor independence. The request must be sufficiently detailed to enable the Audit Committee to precisely identify the services requested. The Audit Committee may delegate pre-approval authority to its chair or one or more other committee members but not

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to Bowater's management. Any committee members with delegated authority must report all pre-approval decisions to the Audit Committee at its next scheduled meeting.

The Audit Committee has considered whether the provision of these services is compatible with maintaining KPMG LLP's independence. The results of the vote will be considered when appointing an independent accounting firm in 2007.

**The Board of Directors unanimously recommends a vote FOR the ratification of KPMG LLP as Bowater's independent registered public accounting firm for 2006.**

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**Proposals by Shareholders**

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A shareholder who wishes to present a proposal for inclusion in Bowater's proxy materials relating to the Annual Meeting of Shareholders to be held in 2007 should submit his or her proposal on or before December 10, 2006, to Bowater's Secretary, 55 East Camperdown Way, Post Office Box 1028, Greenville, South Carolina 29602-1028. With respect to a shareholder proposal for the 2007 Annual Meeting that is not intended to be included in the proxy materials relating to the meeting, Bowater must receive the proposal by the earlier of January 10, 2007, or 10 days after notice or public disclosure of the annual meeting is made or given to shareholders. After that date, the proposal will not be considered timely. Shareholders submitting proposals for inclusion in the proxy statement and form of proxy must comply with the proxy rules under the Securities Exchange Act of 1934, as amended, and all shareholders submitting proposals must comply with the Bylaw requirements described below.

Bowater's Bylaws require timely advance written notice of shareholder nominations of director candidates and of any other proposals to be presented at an annual meeting of shareholders. In the case of director nominations by shareholders, the Bylaws require that 120 days advance written notice be delivered to Bowater's Secretary (at the address indicated above). The notice must be given, either by personal delivery or by United States mail, postage prepaid, to Bowater's Secretary no later than: (a) with respect to an election to be held at an annual meeting of shareholders, 120 days prior to the anniversary date of the

immediately preceding annual meeting (this deadline will be January 10, 2007, for the 2007 Annual Meeting); and (b) with respect to an election to be held at a special meeting of shareholders for the election of directors, the close of business on the seventh day following the date on which notice of such meeting is first given to shareholders. In the case of other proposals by shareholders at an annual meeting, the Bylaws require that advance written notice be delivered to Bowater's Secretary (at the address indicated above). The notice must be received by Bowater's Secretary by the earlier of: (y) 120 days prior to the anniversary date of the immediately preceding annual meeting (this deadline will be January 10, 2007, for the 2007 Annual Meeting); or (z) 10 days after notice or public disclosure of the date of the annual meeting was given or made to shareholders. The Bylaws contain specific requirements with respect to the contents of each of these notices. A copy of the Bylaws is available upon request to Bowater's Secretary at the address indicated above. For director nominations, the notice is required to contain the following:

- n the name and address of the nominating stockholder and the person or persons being nominated;
  
- n the class and number of shares held of record, held beneficially and represented by proxy by the nominating shareholder as of the meeting's record date (if established) and as of the date of the notice;
  
- n a representation by the nominating shareholder that he or she intends to appear in person or by proxy at the meeting to nominate the person or persons specified in the notice;

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- n a description of all arrangements and understandings between the nominating stockholder and each nominee and any other person or persons (naming them) pursuant to which the nomination is being made by the stockholder;
  
- n all other information regarding each proposed nominee that would have been required to be included in a proxy statement filed pursuant to the proxy rules of the Securities and Exchange Commission had the nominee been nominated by Bowater's Board of Directors; and
  
- n the consent in writing of each proposed nominee to serve as a director of Bowater if elected.

In the case of recommendations by shareholders for candidates to be considered for director nomination by the Nominating and Governance Committee, Bowater's policy is to require that advance written notice be delivered to Bowater's Secretary (at the address indicated above). The timing and content requirements for these recommendations are the same as those for director nominations by shareholders, which are described above.

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### **Expenses of Solicitation**

Bowater will bear the cost of soliciting proxies. In addition to soliciting proxies by mail, it is expected that some of Bowater's officers and regular employees may solicit, without additional compensation, proxies by telephone, e-mail or oral communication. Morrow & Co., Inc. has been retained to assist in soliciting proxies for a fee of \$19,500, plus expenses. Bowater has requested that brokerage houses and other custodians, nominees and fiduciaries forward soliciting materials to their principals, the beneficial owners of Bowater Common Stock and Exchangeable Shares, and will reimburse them for their reasonable out-of-pocket expenses in so doing.

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### **Financial and Governance Information**

**Bowater's 2005 Annual Report to Shareholders is enclosed. Bowater will provide without charge to any shareholder of record as of March 15, 2006, who requests in writing, a copy of its 2005 Annual Report to**



**Shareholders (which includes Bowater's 2005 Annual Report on Form 10-K, without exhibits), its corporate governance principles, and its available committee charters. Please direct any such request to Bowater Incorporated, 55 East Camperdown Way, Post Office Box 1028, Greenville, South Carolina 29602-1028, Attention: Investor Relations Department. Copies may also be obtained online through <http://www.bowater.com>.**

By order of the Board of Directors,

Ronald T. Lindsay

*Senior Vice President - General Counsel and Secretary*

April 7, 2006

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**Appendix A to the Proxy Statement**

**BOWATER  
INCORPORATED**

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**2006 STOCK OPTION AND RESTRICTED  
STOCK PLAN**

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**SECTION 1**

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**GENERAL**

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*1.1 Purpose.* The Bowater Incorporated 2006 Stock Option and Restricted Stock Plan (the *Plan*) has been established by Bowater Incorporated (the *Company*) to (i) attract and retain persons eligible to participate in the Plan; (ii) motivate Participants, by means of appropriate incentives, to achieve long-range goals; (iii) provide incentive compensation opportunities that are competitive with those of other similar companies; and (iv) further identify Participants' interests with those of the Company's other stockholders through compensation that is based on the Company's common stock; and thereby promote the long-term financial interest of the Company and the Subsidiaries, including the growth in value of the Company's equity and enhancement of long-term stockholder return.

*1.2 Participation.* Subject to the terms and conditions of the Plan, the Committee shall determine and designate, from time to time, from among the Eligible Individuals, those persons who will be granted one or more Awards under the Plan, and thereby become Participants in the Plan.

*1.3 Operation, Administration, and Definitions.* The operation and administration of the Plan, including the Awards made under the Plan, shall be subject to the provisions of Section 6 (relating to operation and administration). Capitalized terms in the Plan shall be defined as set forth in the Plan (including the definition

provisions of Section 10).

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## SECTION 2

### OPTIONS AND SARS

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#### *2.1 Definitions.*

(a) The grant of an Option entitles the Participant to purchase shares of Stock at an Exercise Price established by the Committee. Any Option granted under this Section 2 may be either an incentive stock option (an ISO) or a non-qualified option (an NQO), as determined in the discretion of the Committee. An ISO is an Option that is intended to satisfy the requirements applicable to an incentive stock option described in section 422(b) of the Code. An NQO is an Option that is not intended to be an incentive stock option as that term is described in section 422(b) of the Code.

(b) A stock appreciation right (an SAR) entitles the Participant to receive, in cash or Stock (as determined in accordance with subsection 6.7), value equal to (or otherwise based on) the excess of: (a) the Fair Market Value of a specified number of shares of Stock at the time of exercise; over (b) an Exercise Price established by the Committee.

*2.2 Exercise Price.* The Exercise Price of each Option and SAR granted under this Section 2 shall be established by the Committee or shall be determined by a method established by the Committee at the time the Option or SAR is granted. The Exercise Price shall not be less than 100% of the Fair Market Value of a share of Stock on the date of grant (or, if greater, the par value of a share of Stock).

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*2.3 Exercise.* An Option and an SAR shall be exercisable in accordance with such terms and conditions and during such periods as may be established by the Committee. In no event, however, shall an Option or SAR expire later than ten years after the date of its grant.

*2.4 Payment of Option Exercise Price.* The payment of the Exercise Price of an Option granted under this Section 2 shall be subject to the following:

(a) Subject to the following provisions of this subsection 2.4, the full Exercise Price for shares of Stock purchased upon the exercise of any Option shall be paid at the time of such exercise (except that, in the case of an exercise arrangement approved by the Committee and described in paragraph 2.4(c), payment may be made as soon as practicable after the exercise).

(b) Subject to applicable law, the Exercise Price shall be payable in cash or by tendering, by either actual delivery of shares or by attestation, shares of Stock acceptable to the Committee, and valued at Fair Market Value as of the day of exercise, or in any combination thereof, as determined by the Committee; provided that, except as otherwise provided by the Committee, payments made with shares of Stock in accordance with this paragraph (b) shall be limited to shares held by the Participant for not less than six months prior to the payment date.

(c) Subject to applicable law, the Committee may permit a Participant to elect to pay the Exercise Price upon the exercise of an Option by irrevocably authorizing a third party to sell shares of Stock (or a sufficient portion of the shares) acquired upon exercise of the Option and remit to the Company a sufficient portion of the sale proceeds to pay the entire Exercise Price and any tax withholding resulting from such exercise.

*2.5 No Repricing.* Except for either adjustments pursuant to paragraph 6.2(f) (relating to the adjustment of shares), or reductions of the Exercise Price approved by the Company's stockholders, the Exercise Price for any outstanding Option may not be decreased after the date of grant nor may an outstanding Option granted under the Plan be surrendered to the Company as consideration for the grant of a replacement Option with a lower exercise price.

*2.6 Grants of Options and SARs.* An Option may but need not be in tandem with an SAR, and an SAR may but need not be in tandem with an Option (in either case, regardless of whether the original award was granted under this Plan or another plan or arrangement). If an Option is in tandem with an SAR, the exercise price of both the Option and SAR shall be the same, and the exercise of the Option or SAR with respect to a share of Stock shall cancel the corresponding tandem SAR or Option right with respect to such share. If an SAR is in tandem with an Option but is granted after the grant of the Option, or if an Option is in tandem with an SAR but is granted after the grant of the SAR, the later granted tandem Award shall have the same exercise price as the earlier granted Award, but the exercise price for the later granted Award may be less than the Fair Market Value of the Stock at the time of such grant.

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### **SECTION 3**

#### **FULL VALUE AWARDS**

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*3.1 Definition.* A Full Value Award is a grant of one or more shares of Stock or a right to receive one or more shares of Stock in the future, with such grant subject to one or more of the following, as determined by the Committee:

(a) The grant shall be in consideration of a Participant's previously performed services, or surrender of other compensation that may be due.

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(b) The grant shall be contingent on the achievement of performance or other objectives during a specified period.

(c) The grant shall be subject to a risk of forfeiture or other restrictions that will lapse upon the achievement of one or more goals relating to completion of service by the Participant, or achievement of performance or other objectives.

The grant of Full Value Awards may also be subject to such other conditions, restrictions and contingencies, as determined by the Committee.

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**SECTION 4**

**CASH INCENTIVE AWARDS**

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A Cash Incentive Award is the grant of a right to receive a payment of cash (or in the discretion of the Committee, Stock having value equivalent to the cash otherwise payable) that is contingent on achievement of performance objectives over a specified period established by the Committee. The grant of Cash Incentive Awards may also be subject to such other conditions, restrictions and contingencies, as determined by the Committee.

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**SECTION 5**

**RESTRICTIONS ON AWARDS**

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*5.1 Performance-Based Compensation.* The Committee may designate an Award granted to any Participant as Performance-Based Compensation. To the extent required by Code section 162(m), any Full Value Award so designated shall be conditioned on the achievement of one or more performance objectives. The performance objectives shall be based on the Performance Measures selected by the Committee. For Awards under this Section 5 intended to be Performance-Based Compensation, the grant of the Awards and the establishment of the Performance Measures shall be made during the period required under Code section 162(m).

*5.2 Three-Year Vesting.* If the right to become vested in an Award is conditioned on the completion of a specified period of service with the Company or the Subsidiaries, without achievement of Performance Measures or other performance objectives (whether or not related to Performance Measures) being required as a condition of vesting, and without it being granted in lieu of other compensation, then the required period of service for full vesting shall be not less than three years or ratably over a three-year period (subject to acceleration of vesting, to the extent permitted by the Committee, in the event of the Participant's death, disability, retirement, Change in Control or involuntary termination); provided, however, that the foregoing limitation of this subsection 5.2 not apply to an Award that is granted as an inducement to a person being hired or rehired by the Company or any of its Subsidiaries.

*5.3 Performance Measures.* The Performance Measures shall be based on any one or more of the following Company, Subsidiary, operating unit or division performance measures: total stockholder return; growth in revenues, sales, net income, stock price, and/or earnings per share; return on assets, net assets, and/or capital; return on stockholders' equity; debt/equity ratio; working capital; safety; quality; the Company's financial performance versus peers; cost reduction; productivity; market mix; or economic value added; or any combination thereof. Each goal may be expressed on an absolute and/or relative basis, may be based on or otherwise employ comparisons based on internal targets, the past performance of the Company and/or the past or current performance of other companies, and in the case of earnings-based measures, may use or employ comparisons relating to capital, stockholders' equity and/or shares outstanding, investments or to assets or net assets.

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**SECTION 6**

**OPERATION AND ADMINISTRATION**

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*6.1 Effective Date.* Subject to the approval of the stockholders of the Company at the Company's annual meeting of its stockholders, the Plan shall be effective as of January 1, 2006 (the Effective Date); provided, however, that Awards may be granted contingent on approval of the Plan by the stockholders of the Company at such annual meeting. In the event of Plan termination, the terms of the Plan shall remain in effect as long as any Awards under it are outstanding; provided, however, that no Awards may be granted under the Plan after the ten-year anniversary of the Effective Date.

*6.2 Shares and Other Amounts Subject to Plan.* The shares of Stock for which Awards may be granted under the Plan shall be subject to the following:

(a) The shares of Stock with respect to which Awards may be made under the Plan shall be shares currently authorized but unissued or, to the extent permitted by applicable law, currently held or acquired by the Company as treasury shares, including shares purchased in the open market or in private transactions.

(b) Subject to the following provisions of this subsection 6.2, the maximum number of shares of Stock that may be delivered to Participants and their beneficiaries under the Plan shall be 3,000,000 shares.

(c) To the extent provided by the Committee, any Award may be settled in cash rather than Stock, although if an Award provides for settlement in Stock, all shares of Stock covered by the Award shall be counted toward the number of shares listed in Section 6.2(b).

(d) Any shares of Stock covered by an Award that are not delivered to a Participant or beneficiary because the Award is forfeited or canceled shall not be counted toward the number of shares listed in Section 6.2(b).



(e) Subject to paragraph 6.2(f), the following additional maximums are imposed under the Plan.

(i) The maximum number of shares of Stock that may be delivered to Participants and their beneficiaries with respect to ISOs granted under the Plan shall be 3,000,000 shares.

(ii) The maximum number of shares that may be covered by Awards granted to any one Participant during any one calendar-year period pursuant to Section 2 (relating to Options and SARs) shall be 300,000 shares. For purposes of this paragraph (ii), if an Option is in tandem with an SAR, such that the exercise of the Option or SAR with respect to a share of Stock cancels the tandem SAR or Option right, respectively, with respect to such share, the tandem Option and SAR rights with respect to each share of Stock shall be counted as covering but one share of Stock for purposes of applying the limitations of this paragraph (ii).

(iii) The maximum number of shares of Stock that may be issued in conjunction with Awards granted pursuant to Section 3 (relating to Full Value Awards) and Section 4 (relating to Cash Incentive Awards, but only to the extent they are settled in Stock) shall be 3,000,000 shares.

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(iv) For Full Value Awards that are intended to be Performance-Based Compensation, no more than 200,000 shares of Stock may be delivered pursuant to such Awards granted to any one Participant during any one-calendar-year period (regardless of whether settlement of the Award is to occur prior to, at the time of, or after the time of vesting); provided that Awards described in this paragraph (iv) that are intended to be Performance-Based Compensation shall be subject to the following:

(A) If the Awards are denominated in Stock but an equivalent amount of cash is delivered in lieu of delivery of shares of Stock, the foregoing limit shall be applied based on the methodology used by the Committee to convert the number of shares of Stock into cash.

(B) If delivery of Stock or cash is deferred until after shares of Stock have been earned, any adjustment in the amount delivered to reflect actual or deemed investment experience after the date the shares are earned shall be disregarded.

(v) For Cash Incentive Awards that are intended to be Performance-Based Compensation, the maximum amount payable to any Participant with respect to any performance period shall equal \$200,000 multiplied by the number of calendar months included in that performance period; provided that Awards described in this paragraph (v) that are intended to be Performance-Based Compensation, shall be subject to the following:

(A) If the Awards are denominated in cash but an equivalent amount of Stock is delivered in lieu of delivery of cash, the foregoing limit shall be applied to the cash based on the methodology used by the Committee to convert the cash into shares of Stock.

(B) If delivery of Stock or cash is deferred until after cash has been earned, any adjustment in the amount delivered to reflect actual or deemed investment experience after the date the cash is earned shall be disregarded.

(f) In the event of a corporate transaction involving the Company (including, without limitation, any stock dividend, stock split, extraordinary cash dividend,

recapitalization, reorganization, merger, consolidation, split-up, spin-off, sale of assets or subsidiaries, combination or exchange of shares), the Committee may adjust Awards to preserve the benefits or potential benefits of the Awards. Action by the Committee may include: (i) adjustment of the number and kind of shares which may be delivered under the Plan; (ii) adjustment of the number and kind of shares subject to outstanding Awards; (iii) adjustment of the Exercise Price of outstanding Options and SARs; and (iv) any other adjustments that the Committee determines to be equitable (which may include, without limitation, (I) replacement of Awards with other Awards which the Committee determines have comparable value and which are based on stock of a company resulting from the transaction, and (II) cancellation of the Award in return for cash payment of the current value of the Award, determined as though the Award is fully vested at the time of payment, provided that in the case of an Option or SAR, the amount of such payment may be the excess of value of the Stock subject to the Option or SAR at the time of the transaction over the exercise price).

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*6.3 General Restrictions.* Delivery of shares of Stock or other amounts under the Plan shall be subject to the following:

(a) Notwithstanding any other provision of the Plan, the Company shall have no obligation to deliver any shares of Stock or make any other distribution of benefits under the Plan unless such delivery or distribution complies with all applicable laws (including, without limitation, the requirements of the Securities Act of 1933), and the applicable requirements of any securities exchange or similar entity.

(b) To the extent that the Plan provides for issuance of stock certificates to reflect the issuance of shares of Stock, the issuance may be effected on a non-certificated basis, to the extent not prohibited by applicable law or the applicable rules of any stock exchange.

*6.4 Tax Withholding.* All distributions under the Plan are subject to withholding of all applicable taxes, and the Committee may condition the delivery of any shares or other benefits under the Plan on satisfaction of the applicable withholding obligations. Except as otherwise provided by the Committee, such withholding obligations may be satisfied (i) through cash payment by the Participant; (ii) through the surrender of shares of Stock which the Participant already owns (provided, however, that to the extent shares described in this clause (ii) are used to satisfy more than the minimum statutory withholding obligation, as described below, then, except as otherwise provided by the Committee, payments made with shares of Stock in accordance with this clause (ii) shall be limited to shares held by the Participant for not less than six months prior to the payment date); or (iii) through the surrender of shares of Stock to which the Participant is otherwise entitled under the Plan, provided, however, that such shares under this clause (iii) may be used to satisfy not more than the Company's minimum statutory withholding obligation (based on minimum statutory withholding rates for Federal and state tax purposes, including payroll taxes, that are applicable to such supplemental taxable income).

*6.5 Grant and Use of Awards.* The grant and use of Awards under the Plan shall be subject to the following:

(a) In the discretion of the Committee, a Participant may be granted any Award permitted under the provisions of the Plan, and more than one Award may be granted to a Participant. Subject to subsection 2.5 (relating to repricing), Awards may be granted as alternatives to or replacement of awards granted or outstanding under the Plan, or any other plan or arrangement of the Company or a Subsidiary (including a plan or arrangement of a business or entity, all or a portion of which is acquired by the Company or a Subsidiary).

(b) Subject to the overall limitation on the number of shares of Stock that may be delivered under the Plan in Section 6.2(b), the Committee may use available shares of Stock as the form of payment for compensation, grants or rights earned or due under any other compensation plans or arrangements of the Company or a Subsidiary, including the plans and arrangements of the Company or a Subsidiary assumed in business combinations.

(c) Notwithstanding the provisions of subsection 2.2, Options and SARs granted under the Plan in replacement for awards under plans and arrangements of a company assumed in business combinations may provide for exercise prices that are less than the Fair Market Value of the Stock at the time of the replacement grants, if the Committee determines that such exercise price is appropriate to preserve the economic benefit of the award.

*6.6 Dividends and Dividend Equivalents.* An Award (including without limitation an Option or SAR Award) may provide the Participant with the right to receive dividend or dividend

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equivalent payments with respect to Stock subject to the Award (both before and after the Stock subject to the Award is earned, vested, or acquired), which payments may be either made currently or credited to an account for the Participant, and may be settled in cash or Stock, as determined by the Committee. Any such settlements, and any such crediting of dividends or dividend equivalents or reinvestment in shares of Stock, may be subject to such conditions, restrictions and contingencies as the Committee shall establish, including the reinvestment of such credited amounts in Stock equivalents.

*6.7 Settlement of Awards.* The obligation to make payments and distributions with respect to Awards may be satisfied through cash payments, the delivery of shares of Stock, the granting of replacement Awards, or combination thereof as the Committee shall determine. Satisfaction of any such obligations under an Award, which is sometimes referred to as settlement of the Award, may be subject to such conditions, restrictions and contingencies as the Committee shall determine. The Committee may permit or require the deferral of any Award payment or distribution, subject to such rules and procedures as it may establish, which may include provisions for the payment or crediting of interest or dividend equivalents, and may include converting such credits into deferred Stock equivalents. Each Subsidiary shall be liable for payment of cash due under the Plan with respect to any Participant to the extent that such benefits are attributable to the services rendered for that Subsidiary by the Participant. Any disputes relating to liability of a Subsidiary for cash payments shall be resolved by the Committee.

*6.8 Transferability.* Except as otherwise provided by the Committee, Awards under the Plan are not transferable except as designated by the Participant by will or by the laws of descent and distribution.

*6.9 Form and Time of Elections.* Unless otherwise specified herein, each election required or permitted to be made by any Participant or other person entitled to benefits under the Plan, and any permitted modification, or revocation thereof, shall be in writing filed with the Committee at such times, in such form, and subject to such restrictions and limitations, not inconsistent with the terms of the Plan, as the Committee shall require.

*6.10 Agreement With Company.* An Award under the Plan shall be subject to such terms and conditions, not

inconsistent with the Plan, as the Committee shall, in its sole discretion, prescribe. The terms and conditions of any Award to any Participant shall be reflected in such form of written (including electronic) document as is determined by the Committee. A copy of such document shall be provided to the Participant, and the Committee may, but need not require that the Participant sign a copy of such document. Such document is referred to in the Plan as an Award Agreement regardless of whether any Participant signature is required.

*6.11 Action by Company or Subsidiary.* Any action required or permitted to be taken by the Company or any Subsidiary shall be by resolution of its board of directors, or by action of one or more members of the board (including a committee of the board) who are duly authorized to act for the board, or (except to the extent prohibited by applicable law or applicable rules of any stock exchange) by a duly authorized officer of such company.

*6.12 Gender and Number.* Where the context admits, words in any gender shall include any other gender, words in the singular shall include the plural and the plural shall include the singular.

*6.13 Limitation of Implied Rights.*

(a) Neither a Participant nor any other person shall, by reason of participation in the Plan, acquire any right in or title to any assets, funds or property of the Company or any

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Subsidiary whatsoever, including, without limitation, any specific funds, assets, or other property which the Company or any Subsidiary, in its sole discretion, may set aside in anticipation of a liability under the Plan. A Participant shall have only a contractual right to the Stock or amounts, if any, payable under the Plan, unsecured by any assets of the Company or any Subsidiary, and nothing contained in the Plan shall constitute a guarantee that the assets of the Company or any Subsidiary shall be sufficient to pay any benefits to any person.

(b) The Plan does not constitute a contract of employment, and selection as a Participant will not give any participating employee the right to be retained in the employ of the Company or any Subsidiary, or the right to continue to provide services to the Company or any subsidiary, nor any right or claim to any benefit under the Plan, unless such right or claim has specifically accrued under the terms of the Plan. Except as otherwise provided in the Plan, no Award under the Plan shall confer upon the holder thereof any rights as a stockholder of the Company prior to the date on which the individual fulfills all conditions for receipt of such rights.

*6.14 Evidence.* Evidence required of anyone under the Plan may be by certificate, affidavit, document or other information which the person acting on it considers pertinent and reliable, and signed, made or presented by the proper party or parties.

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**SECTION 7**

**CHANGE IN CONTROL**

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Subject to the provisions of paragraph 6.2(f) (relating to the adjustment of shares), the occurrence of a Change in Control shall have the effect, if any, with respect to any Award as set forth in the Award Agreement or, to the extent not prohibited by the Plan or the Award Agreement, as provided by the Committee.

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**SECTION 8**

**COMMITTEE**

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*8.1. Administration.* The authority to control and manage the operation and administration of the Plan shall be vested in a committee (the Committee) in accordance with this Section 8. The Committee shall be selected by the Board, and shall consist solely of two or more members of the Board who qualify as non-employee directors as defined in Rule 16b-3 under the Securities Exchange Act of 1934 and as outside directors as defined in Treasury Regulation Section 1.162-27(e)(3). If the Committee does not exist, or for any other reason determined by the Board, and to the extent not prohibited by applicable law or the applicable rules of any stock exchange, the Board may take any action under the Plan that would otherwise be the responsibility of the Committee.

*8.2. Powers of Committee.* The Committee's administration of the Plan shall be subject to the following:

(a) Subject to the provisions of the Plan, the Committee will have the authority and discretion to select from among the Eligible Individuals those persons who shall receive Awards, to determine the time or times of receipt, to determine the types of Awards and the number of shares covered by the Awards, to establish the terms, conditions, performance criteria, restrictions, and other provisions of such Awards, and (subject to the restrictions imposed by Section 9) to amend, cancel, or suspend Awards.

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(b) To the extent that the Committee determines that the restrictions imposed by the Plan preclude the achievement of the material purposes of the Awards in jurisdictions outside the United States, the Committee will have the authority and discretion to modify those restrictions as the Committee determines to be necessary or appropriate to conform to applicable requirements or practices of jurisdictions outside of the United States.

(c) The Committee will have the authority and discretion to interpret the Plan, to establish, amend, and rescind any rules and regulations relating to the Plan, to determine the terms and provisions of any Award Agreement made pursuant to the Plan, and to make all other determinations that may be necessary or advisable for the administration of the Plan.

(d) Any interpretation of the Plan by the Committee and any decision made by it under the Plan is final and binding on all persons.

(e) In controlling and managing the operation and administration of the Plan, the Committee shall take action in a manner that conforms to the articles and by-laws of the Company, and applicable state corporate law.

*8.3. Delegation by Committee.* Except to the extent prohibited by applicable law or the applicable rules of a stock exchange, the Committee may allocate all or any portion of its responsibilities and powers to any one or more of its members and may delegate all or any part of its responsibilities and powers to any person or persons selected by it. Any such allocation or delegation may be revoked by the Committee at any time.

*8.4. Information to be Furnished to Committee.* The Company and Subsidiaries shall furnish the Committee with such data and information as it determines may be required for it to discharge its duties. The records of the Company and Subsidiaries as to an employee's or Participant's employment (or other provision of services), termination of employment (or cessation of the provision of services), leave of absence, reemployment and compensation shall be conclusive on all persons unless determined to be incorrect. Participants and other persons entitled to benefits under the Plan must furnish the Committee such evidence, data or information as the

Committee considers desirable to carry out the terms of the Plan.

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**SECTION 9**

**AMENDMENT AND TERMINATION**

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The Board may, at any time, amend or terminate the Plan, and the Board or the Committee may amend any Award Agreement, provided that no amendment or termination may, in the absence of written consent to the change by the affected Participant (or, if the Participant is not then living, the affected beneficiary), adversely affect the rights of any Participant or beneficiary under any Award granted under the Plan prior to the date such amendment is adopted by the Board (or the Committee, if applicable); and further provided that adjustments pursuant to paragraph 6.2(f) shall not be subject to the foregoing limitations of this Section 9; and further provided that the provisions of subsection 2.5 (relating to Option repricing) cannot be amended unless the amendment is approved by the Company's stockholders. Approval by the Company's stockholders will be required for any material revision to the terms of the Plan, with the determination of material revision to be made in accordance with the definition provided under the rules of the New York Stock Exchange. No amendment requiring stockholder approval under Treasury Regulation Section 1.162-27 or Section 422 of the Code shall be valid unless such stockholder approval is secured as provided therein.

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**SECTION 10**

**DEFINED TERMS**

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In addition to the other definitions contained herein, the following definitions shall apply:

(a) *Acquiring Person.* The term *Acquiring Person* means the Beneficial Owner, directly or indirectly, of Stock representing 20% or more of the combined voting power of the Company's then outstanding securities, not including (except as provided in clause (i) of the next sentence) securities of such Beneficial Owner acquired pursuant to an agreement allowing the acquisition of up to and including 50% of such voting power approved by two-thirds of the members of the Board who are Board members before the Person becomes the Beneficial Owner, directly or indirectly, of Stock representing 5% or more of the combined voting power of the Company's then outstanding securities. Notwithstanding the forgoing, (i) securities acquired pursuant to an agreement described in the preceding sentence will be included in determining whether a Beneficial Owner is an Acquiring Person if, subsequent to the approved acquisition, the Beneficial Owner acquires 5% or more of such voting power other than pursuant to such an agreement so approved and (ii) a Person shall not be an Acquiring Person if such Person is eligible to and files a Schedule 13G with respect to such Person's status as a Beneficial Owner of all Stock of the Company of which the Person is a Beneficial Owner.

(b) *Act.* The term *Act* means the Securities Exchange Act of 1934, as amended.

(c) *Affiliate.* The term *Affiliate* shall have the meaning ascribed to it in Rule 12b-2 of the General Rules and Regulations under the Act, as in effect on the date hereof.

(d) *Associate.* The term *Associate* shall have the meaning ascribed to it in Rule 12b-2 of the General Rules and Regulations under the Act, as in effect on the date hereof.

(e) *Award.* The term *Award* means any award or benefit granted under the Plan, including, without limitation, the

grant of Options, SARs, Full Value Awards, and Cash Incentive Awards.

(f) *Beneficial Owner.* The term *Beneficial Owner* of Stock means (i) a Person who beneficially owns such Stock, directly or indirectly, or (ii) a Person who has the right to acquire such Stock (whether such right is exercisable immediately or only with the passage of time) pursuant to any agreement, arrangement or understanding (whether or not in writing) or upon the exercise of conversion rights, exchange rights, warrants, options or otherwise.

(g) *Board.* The term *Board* means the Board of Directors of the Company.

(h) *Change in Control.* A *Change in Control* shall be deemed to occur upon:

(i) The date that any Person is or becomes an Acquiring Person;

(ii) The date that the Company's stockholders approve a merger, consolidation or reorganization of the Company with another corporation or other Person, unless, immediately following such merger, consolidation or reorganization, (A) at least 50% of the combined voting power of the outstanding securities of the resulting entity would be held in the aggregate by the stockholders of the Company as of such record

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date for such approval (provided that securities held by any individual or entity that is an Acquiring Person, or who would be an Acquiring Person if 5% were substituted for 20% in the definition of such term, shall not be counted as securities held by the stockholders of the Corporation, but shall be counted as outstanding securities for purposes of this determination), or (B) at least 50% of the Board of Directors or similar body of the resulting entity are Continuing Directors;

(iii) The date the Company sells or otherwise transfers all or substantially all of its assets to another corporation or other Person, unless, immediately after such sale or transfer, (A) at least 50% of the combined voting power of the then-outstanding securities of the resulting entity immediately following such transaction is held in the aggregate by the Company's stockholders as determined immediately prior to such transaction (provided that securities held by any individual or entity that is an Acquiring Person, or who would be an Acquiring Person if 5% were substituted for 20% in the definition of such term, shall not be counted as securities held by the stockholders of the Corporation, but shall be counted as outstanding securities for purposes of this determination), or (B) at least 50% of the Board of Directors or similar body of the resulting entity are Continuing Directors; or

(iv) The date on which less than fifty percent (50%) of the total membership of the Board consists of Continuing Directors.

(i) *Code*. The term *Code* means the Internal Revenue Code of 1986, as amended. A reference to any provision of the Code shall include reference to any successor provision of the Code.

(j) *Continuing Director*. The term *Continuing Director* means any member of the Board who (i) was a member of the Board prior to the date of the event that would constitute a Change in Control, and any successor of a Continuing Director while such successor is a member of the Board, (ii) is not an Acquiring Person or Affiliate or Associate of an Acquiring Person, and (iii) is recommended or elected to succeed the Continuing Director by a majority of the Continuing Directors.

(k) *Eligible Individual.* For purposes of the Plan, the term *Eligible Individual* means any employee of the Company or a Subsidiary, any director, or consultants or other persons providing services to the Company or a Subsidiary; provided, however, that an ISO may only be granted to an employee of the Company or a Subsidiary. An Award may be granted to an employee or other individual providing services, in connection with hiring, retention or otherwise, prior to the date the employee or individual first performs services for the Company or the Subsidiaries, provided that such Awards shall not become vested prior to the date the employee or service provider first performs such services.

(l) *Fair Market Value.* Fair Market Value for a particular date means the simple arithmetic mean between the highest and lowest prices per share at which the Common Stock is traded as reported for the New York Stock Exchange Composite Transactions for that date (or, if not a business day, the next preceding business day), or if not so traded, the simple arithmetic mean between the closing bid-and-asked prices thereof as reported for such Exchange on that date, rounded to the nearest number within two decimal places.

(m) *Performance-Based Compensation.* The term *Performance-Based Compensation* shall have the meaning ascribed to it under Code section 162(m) and the regulations thereunder.

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(n) *Person*. The term *Person* means any individual, firm, corporation, partnership, trust or other entity.

(o) *Subsidiaries*. For purposes of the Plan, the term *Subsidiary* means any corporation, partnership, joint venture or other entity during any period in which at least a fifty percent voting or profits interest is owned, directly or indirectly, by the Company (or by any entity that is a successor to the Company), and any other business venture designated by the Committee in which the Company (or any entity that is a successor to the Company) has a significant interest, as determined in the discretion of the Committee.

(p) *Stock*. The term *Stock* means shares of common stock of the Company.

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**NOTICE OF ANNUAL  
MEETING  
  
AND  
  
PROXY STATEMENT**

**DATE AND TIME:**

**Wednesday, May 10, 2006**

**at 11:00 a.m.**

**PLACE:**

**The Gunter Theatre**

**300 South Main Street**

**Greenville, SC 29601**

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**Please sign your proxy or voting instruction  
card**

**and return it in the enclosed postage-paid  
envelope.**

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**BOWATER INCORPORATED**

**P**

**Proxy Solicited on Behalf of the Board of Directors**

**R of the Company for Annual Meeting May 10, 2006**

**O** The undersigned appoints William G. Harvey and Ronald T. Lindsay, or either one of them, each with full power of substitution, as proxies for the undersigned, to vote all of the shares of common stock of Bowater Incorporated held of record by the undersigned on **X** March 15, 2006, at the annual meeting of shareholders to be held May 10, 2006, and any adjournment.

**Y** **This proxy when properly executed will be voted in the manner directed herein by the undersigned shareholder. If no direction is made, the proxyholders will vote this proxy FOR Proposal 1, FOR Proposal 2 and FOR Proposal 3. Proxyholders will vote, in their discretion, upon any other business that may properly come before the annual meeting and any adjournment.**

You are encouraged to specify your choices by marking the appropriate boxes (SEE REVERSE SIDE) but you need not mark any boxes if you wish to vote in accordance with the Board of Directors recommendations.

SEE  
REVERSE  
SIDE

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**The Board of Directors recommends a vote FOR Proposal 1.**

1. Election of Directors

For all		
Nominees	Withhold Authority	Exceptions*
Listed	(To vote for all	(As indicated to the
Below	nominees listed	contrary below)
	below)	

Togo D. West, Jr.; Richard B. Evans; Bruce W. Van Saun;  
David J. Paterson

**(INSTRUCTIONS: To withhold authority to vote for any individual nominee, mark the Exceptions box and write that nominee's name in the space provided below.)**

\*EXCEPTIONS \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

**The Board of Directors recommends a vote FOR Proposal 2.**

2. Proposal to approve Bowater's 2006 Stock Option and Restricted Stock Plan

For                      Against                      Abstain

**The Board of Directors recommends a vote FOR Proposal 3.**

3. Proposal to ratify the appointment of KPMG LLP as the independent registered public accounting firm for the 2006 fiscal year

For                      Against                      Abstain

4. At their discretion upon such other business that may properly come before the annual meeting and any adjournment.

Dated: \_\_\_\_\_  
\_\_\_\_\_, 2006  
(Please be sure to insert date)

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
(Signature)

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
(Signature if held jointly)

(Signature should conform exactly to name shown on this proxy card. Executors, administrators, guardians, trustees, attorneys and officers signing for corporations should give full title.)

**Vote MUST be indicated by x in black or blue ink. x**

**Sign, Date and Return the Proxy Card Promptly Using the Enclosed Envelope.**