UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007

Or

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

For the transition period from to
Commission File Number 1-13515

FOREST OIL CORPORATION

(Exact name of registrant as specified in its charter)

New York	**25-0484900**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

707 17th Street, Suite 3600 Denver, Colorado 80202
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: **(303) 812-1400**

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. ý Yes o No

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

Large accelerated filer ý Accelerated filer o Non-accelerated filer o

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

As of April 30, 2007 there were 63,053,239 shares of the registrant's common stock, par value $.10 per share, outstanding.

FOREST OIL CORPORATION
INDEX TO FORM 10-Q
March 31, 2007

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

FOREST OIL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)
(In Thousands, Except Share Data)

	March 31, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17,086	33,164
Accounts receivable	141,821	125,446
Derivative instruments	17,508	53,205
Deferred tax asset	365	
Other current assets	65,926	49,185
Total current assets	242,706	261,000
Property and equipment, at cost:		
Oil and gas properties, full cost method of accounting:		
Proved, net of accumulated depletion of $2,331,625 and $2,265,018	2,601,815	2,486,153
Unproved	244,228	261,259
Net oil and gas properties	2,846,043	2,747,412
Other property and equipment, net of accumulated depreciation and amortization of $34,157 and $32,504	48,445	42,514
Net property and equipment	2,894,488	2,789,926
Derivative instruments	6,804	15,019
Goodwill	86,385	86,246
Other assets	38,902	36,881
	$ 3,269,285	3,189,072
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 216,856	224,933
Accrued interest	20,419	6,235
Derivative instruments	10,774	1,294
Current portion of long-term debt	2,500	2,500
Asset retirement obligations	3,055	2,694
Deferred income taxes		14,907
Other current liabilities	10,877	11,378
Total current liabilities	264,481	263,941
Long-term debt	1,245,810	1,204,709
Asset retirement obligations	62,758	61,408
Derivative instruments	5,256	811
Deferred income taxes	211,127	191,957
Other liabilities	34,116	32,240

	March 31, 2007	December 31, 2006
Total liabilities	1,823,548	1,755,066
Shareholders' equity:		
Preferred stock, none issued and outstanding		
Common stock, 63,039,391 and 62,998,155 shares issued and outstanding	6,304	6,300
Capital surplus	1,218,814	1,215,660
Retained earnings	143,647	137,796
Accumulated other comprehensive income	76,972	74,250
Total shareholders' equity	1,445,737	1,434,006
	$ 3,269,285	3,189,072

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended March 31,	
	2007	**2006**
	(In Thousands, Except Per Share Amounts)	
Revenue:		
Oil and gas sales:		
Natural gas	$ 97,297	127,053
Oil, condensate, and natural gas liquids	85,259	92,043
Total oil and gas sales	182,556	219,096
Marketing, processing, and other	53	2,350
Total revenue	182,609	221,446
Operating expenses:		
Lease operating expenses	36,040	45,331
Production and property taxes	7,910	10,728
Transportation and processing costs	4,194	4,729
General and administrative (including stock-based compensation)	12,971	17,136
Depreciation and depletion	60,459	77,668
Accretion of asset retirement obligations	1,275	3,352
Spin-off and merger costs		5,416
Total operating expenses	122,849	164,360
Earnings from operations	59,760	57,086
Other income and expense:		
Interest expense	24,353	15,151
Unrealized losses on derivative instruments, net	57,838	24,114
Realized (gains) losses on derivative instruments, net	(25,134)	3,915
Unrealized foreign currency exchange gain	(49)	
Gain on sale of assets	(7,176)	
Other (income) expense, net	(888)	860
Total other income and expense	48,944	44,040
Earnings before income taxes and discontinued operations	10,816	13,046
Income tax expense:		
Current	878	1,002
Deferred	3,047	10,795
Total income tax expense	3,925	11,797
Earnings from continuing operations	6,891	1,249
Income from discontinued operations, net of tax		2,422
Net earnings	$ 6,891	3,671

	Three Months Ended March 31,	
Basic earnings per common share:		
Earnings from continuing operations	$ .11	.02
Income from discontinued operations, net of tax		.04
Basic earnings per common share	$ .11	.06
Diluted earnings per common share:		
Earnings from continuing operations	$ .11	.02
Income from discontinued operations, net of tax		.04
Diluted earnings per common share	$ .11	.06

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(Unaudited)

	Common Stock Shares	Common Stock Amount	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
	(In Thousands)					
Balances at December 31, 2006	62,998	$ 6,300	1,215,660	137,796	74,250	1,434,006
Exercise of stock options	40	4	776			780
Employee stock purchase plan	8	1	217			218
Restricted stock issued, net of cancellations	(7)	(1)	(278)			(279)
Amortization of stock-based compensation			2,439			2,439
Adoption of FIN 48				(1,040)		(1,040)
Comprehensive earnings:						
Net earnings				6,891		6,891
Increase in unfunded postretirement benefits, net of tax					(104)	(104)
Foreign currency translation					2,826	2,826
Total comprehensive earnings						9,613
Balances at March 31, 2007	63,039	$ 6,304	1,218,814	143,647	76,972	1,445,737

See accompanying Notes to Condensed Consolidated Financial Statements.

FOREST OIL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31,	
	2007	**2006**
	(In Thousands)	
Operating activities:		
Net earnings	$ 6,891	3,671
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and depletion	60,459	77,668
Accretion of asset retirement obligations	1,275	3,352
Stock-based compensation	1,796	7,315
Unrealized losses on derivative instruments, net	57,838	24,114
Amortization of deferred derivative losses		15,204
Gain on sale of assets	(7,176)	
Deferred income tax expense	3,047	12,022
Other, net	(1,129)	886
Changes in operating assets and liabilities, net of effects of acquisition and divestitures:		
Accounts receivable	(9,392)	(13,988)
Other current assets	(14,562)	(20,716)
Accounts payable	(41,148)	(6,499)
Accrued interest and other current liabilities	16,939	11,506
Net cash provided by operating activities	74,838	114,535
Investing activities:		
Capital expenditures for property and equipment:		
Exploration, development, and acquisition costs	(135,486)	(465,175)
Other fixed assets	(7,510)	(2,643)
Proceeds from sales of assets	1,661	1,018
Other, net		106
Net cash used by investing activities	(141,335)	(466,694)
Financing activities:		
Proceeds from bank borrowings	182,027	674,818
Repayments of bank borrowings	(139,759)	(325,415)
Repayments of term loans	(625)	
Proceeds from the exercise of options and from employee stock purchase plan	997	2,250
Other, net	8,463	(24)
Net cash provided by financing activities	51,103	351,629
Effect of exchange rate changes on cash	(684)	(391)
Net decrease in cash and cash equivalents	(16,078)	(921)
Cash and cash equivalents at beginning of period	33,164	7,231
Cash and cash equivalents at end of period	$ 17,086	6,310
Cash paid during the period for:		
Interest	$ 11,600	3,080
Income taxes	574	1,969

See accompanying Notes to Condensed Consolidated Financial Statements.

4

FOREST OIL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(1) BASIS OF PRESENTATION

The Condensed Consolidated Financial Statements included herein are unaudited and include the accounts of Forest Oil Corporation and its consolidated subsidiaries (collectively, "Forest" or the "Company"). In the opinion of management, all adjustments, consisting of normal recurring accruals, have been made which are necessary for a fair presentation of the financial position of Forest at March 31, 2007, the results of its operations for the three months ended March 31, 2007 and 2006, and its cash flows for the three months ended March 31, 2007 and 2006. Interim results are not necessarily indicative of expected annual results because of the impact of fluctuations in prices received for liquids (oil, condensate, and natural gas liquids) and natural gas and other factors.

In the course of preparing the Condensed Consolidated Financial Statements, management makes various assumptions, judgments, and estimates to determine the reported amount of assets, liabilities, revenue, and expenses, and in the disclosures of commitments and contingencies. Changes in these assumptions, judgments, and estimates will occur as a result of the passage of time and the occurrence of future events and, accordingly, actual results could differ from amounts initially established.

The more significant areas requiring the use of assumptions, judgments, and estimates relate to volumes of oil and gas reserves used in calculating depletion, the amount of future net revenues used in computing the ceiling test limitations, and the amount of future capital costs and abandonment obligations used in such calculations. Assumptions, judgments, and estimates are also required in determining impairments of undeveloped properties, valuing deferred tax assets, and estimating fair values of derivative instruments.

Certain amounts in the prior year financial statements have been reclassified to conform to the 2007 financial statement presentation.

For a more complete understanding of Forest's operations, financial position, and accounting policies, reference is made to the consolidated financial statements of Forest, and related notes thereto, filed with Forest's Annual Report on Form 10-K for the year ended December 31, 2006, previously filed with the Securities and Exchange Commission.

(2) ACQUISITIONS AND DIVESTITURES

Acquisitions

Pending Acquisition of Houston Exploration

On January 7, 2007, Forest announced it had entered into a definitive agreement and plan of merger pursuant to which The Houston Exploration Company ("Houston Exploration") will merge with and into Forest in a stock and cash transaction totaling approximately $1.5 billion plus the assumption of debt. Houston Exploration is an independent natural gas and oil producer engaged in the exploration, development, exploitation, and acquisition of natural gas and oil reserves in North America with operations in the following four producing areas in the United States: South Texas, East Texas, the Arkoma Basin of Arkansas, and the Uinta and DJ Basins in the Rocky Mountains. The boards of directors of Forest and Houston Exploration have each unanimously approved the transaction. The transaction is subject to customary conditions, including both Forest shareholder and Houston Exploration stockholder approvals. Forest management and its board of directors will continue in their current positions with Forest following the completion of the merger. The merger is expected to close in early June 2007, as soon as practicable following Forest shareholder approval and Houston Exploration stockholder approval and satisfaction of the closing conditions.

Under the terms of the merger agreement, Houston Exploration stockholders are to receive total consideration equal to 0.84 shares of Forest common stock and $26.25 in cash for each share of Houston Exploration common stock outstanding. This represents estimated merger consideration of 23.8 million shares of Forest common stock and cash of approximately $740 million, or $52.47 per share, to be received by the Houston Exploration stockholders (based on the closing price of Forest's common stock on January 5, 2007 and the number of shares of Houston Exploration common stock outstanding on April 30, 2007 and subject to increase in the event that any additional shares of Houston Exploration common stock are issued prior to the merger closing date in connection with the exercise of outstanding stock options pursuant to the terms of the merger agreement). The actual amount of total cash and stock consideration to be received by each Houston Exploration stockholder will be determined by elections, an equalization formula, and a proration procedure. It is anticipated that the transaction will be tax free to Houston Exploration and the stock portion of the consideration will be received tax free by its stockholders. The cash component of the acquisition is expected to be financed under an amended and restated revolving credit facility of up to $1.4 billion for which JPMorgan Chase Bank, N.A. has provided us a commitment letter. In connection with the pending acquisition of Houston Exploration, Forest may elect to access the debt capital markets to finance a portion of the cash component of the merger consideration and the related transactions or to refinance borrowings under its bank credit facilities.

Cotton Valley Acquisition

On March 31, 2006, Forest completed the acquisition of oil and gas properties located primarily in the Cotton Valley trend in East Texas. Forest paid approximately $255 million, as adjusted to reflect an economic effective date of February 1, 2006, for properties with an estimated 110 Bcfe of estimated proved reserves at the time the acquisition was announced in February 2006 and production that averaged 13 MMcfe per day in January 2006. Forest acquired approximately 26,000 net acres in the fields, of which approximately 14,000 net acres were undeveloped. Forest funded this acquisition utilizing its bank credit facilities.

Divestitures

Spin-off and Merger of Offshore Gulf of Mexico Operations

On March 2, 2006, Forest completed the spin-off of its offshore Gulf of Mexico operations by means of a special dividend, which consisted of a pro rata spin-off (the "Spin-off") of all outstanding shares of Forest Energy Resources, Inc. (hereinafter known as Mariner Energy Resources, Inc. or "MERI"), a total of 50,637,010 shares of common stock, to holders of record of Forest common stock as of the close of business on February 21, 2006. Immediately following the Spin-off, MERI was merged with a subsidiary of Mariner Energy, Inc. ("Mariner") (the "Merger"). Mariner's common stock commenced trading on the New York Stock Exchange on March 3, 2006.

The Spin-off was a tax-free transaction for federal income tax purposes. Prior to the Merger, as part of the Spin-off, MERI paid Forest approximately $176.1 million. The $176.1 million was drawn on a newly created bank credit facility established by MERI immediately prior to the Spin-off. This credit facility and associated liability were included in the Spin-off. Subsequent to the closing, Forest received additional net cash proceeds of $21.7 million from MERI for a total of $197.8 million. As of April 30, 2007, in accordance with the transaction agreements, Forest and MERI had submitted post-closing adjustments from which Forest paid MERI approximately $5.8 million, which is subject to further adjustment.

The table below sets forth the assets and liabilities included in the Spin-off (in thousands):

Working capital	$	(12,383)
Proved oil and gas properties, net of accumulated depletion		1,033,289
Unproved oil and gas properties		38,523
Other assets		7,919
Derivative instruments		(17,087)
MERI credit facility		(176,102)
Asset retirement obligations		(150,182)
Deferred income taxes		(184,483)
Other liabilities		(225)
Accumulated other comprehensive income		7,549
Net decrease to capital surplus and retained earnings	$	546,818

The following table presents the revenues and direct operating expenses of the offshore Gulf of Mexico operations reported in the Condensed Consolidated Statements of Operations for the three months ended March 31, 2006. As the spin-off of the offshore Gulf of Mexico operations were concluded in 2006, the Company did not have operating activity from offshore Gulf of Mexico operations during the comparative period in 2007.

		Period Ended March 31, 2006
		(In Thousands)
Oil and gas revenues	$	46,289
Oil and gas production expense:		
Lease operating expenses		18,296
Transportation and processing costs		344
Production and property taxes		151
Oil and gas revenues in excess of direct operating expenses	$	27,498

Sale of ProMark Discontinued Operations

On March 1, 2004, the Company sold the assets and business operations of Producers Marketing, Ltd. ("ProMark") to Cinergy Canada, Inc. ("Cinergy") for $11.2 million CDN. As a result of the sale, ProMark's results of operations were reported as discontinued operations in the historical financial statements. Under the terms of the purchase and sale agreement, Forest may receive additional contingent consideration over a period of five years through February 2009. During the three months ended March 31, 2006, Forest recognized an additional $3.6 million contingent payment ($2.4 million net of tax), which has been reflected as income from discontinued operations in the Condensed Consolidated Statements of Operations. No contingent payments are expected in 2007.

Other Disposition

In February 2007, Forest sold its overriding royalty interests in Australia for net proceeds of $7.2 million which resulted in a gain on the sale of $7.2 million ($4.5 million net of tax). As of March 31, 2007, Forest had received an initial payment of $.7 million and received the remaining proceeds in April and May 2007.

(3) EARNINGS PER SHARE AND COMPREHENSIVE EARNINGS (LOSS)

Earnings per Share

Basic earnings per share is computed by dividing net earnings attributable to common stock by the weighted average number of common shares outstanding during each period, excluding treasury shares.

Diluted earnings per share is computed by adjusting the average number of common shares outstanding for the dilutive effect, if any, of stock options, unvested restricted stock grants, and unvested phantom stock units. The following sets forth the calculation of basic and diluted earnings per share:

		Three Months Ended March 31,	
		2007	2006
		(In Thousands, Except Per Share Amounts)	
Earnings from continuing operations	$	6,891	1,249
Income from discontinued operations, net of tax			2,422
Net earnings	$	6,891	3,671
Weighted average common shares outstanding during the period		62,393	62,115
Add dilutive effects of stock options, unvested restricted stock grants, and unvested phantom stock units		1,341	1,055
Weighted average common shares outstanding, including the effects of dilutive securities		63,734	63,170
Basic earnings per share:			
From continuing operations	$	.11	.02
From discontinued operations			.04
Basic earnings per share	$	.11	.06
Diluted earnings per share:			
From continuing operations	$	.11	.02
From discontinued operations			.04
Diluted earnings per share	$	.11	.06

Comprehensive Earnings (Loss)

Comprehensive earnings (loss) is a term used to refer to net earnings plus other comprehensive income (loss). Other comprehensive income (loss) is comprised of revenues, expenses, gains, and losses that under generally accepted accounting principles are reported as separate components of shareholders' equity instead of net earnings. Items included in Forest's other comprehensive income (loss) for the three months ended March 31, 2007 and 2006 are foreign currency gains (losses) related to the translation of the assets and liabilities of Forest's Canadian operations, changes in the unfunded postretirement benefits, and unrealized gains (losses) related to the changes in the fair value of derivative instruments designated as cash flow hedges.

The components of comprehensive earnings (loss) are as follows:

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
	(In Thousands)	
Net earnings	$ 6,891	3,671
Other comprehensive income (loss):		
Foreign currency translation gains (losses)	2,826	(1,930)
Unfunded postretirement benefits, net of tax	(104)	83
Unrealized gain on derivative instruments, net of tax		77,074
Total comprehensive earnings	$ 9,613	78,898

(4) STOCK-BASED COMPENSATION

The table below sets forth total stock-based compensation recorded during the three months ended March 31, 2007 under the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 (Revised), *Share-Based Payment* ("SFAS 123(R)") the remaining unamortized amounts and the weighted average amortization period remaining as of March 31, 2007.

	Stock Options	Restricted Stock	Phantom Stock Units	Total[(1)]
	(In Thousands)			
Three Months Ended March 31, 2007:				
Total stock-based compensation costs	$ 933	1,433	224	2,590
Less: stock-based compensation costs capitalized	(309)	(420)	(138)	(867)
Stock-based compensation costs expensed	$ 624	1,013	86	1,723
Unamortized stock-based compensation costs as of March 31, 2007	$ 5,034	9,541	1,839[(2)]	16,414
Weighted average amortization period remaining	1.5 years	1.6 years	1.8 years	1.6 years

(1) The Company also maintains an employee stock purchase plan (which is not included in the table above) under which $.1 million of compensation cost was recognized for the three months ended March 31, 2007 under the provisions of SFAS 123(R).

(2) Based on the closing price of the Company's common stock on March 31, 2007.

Stock Options

The following table summarizes stock option activity in the Company's stock-based compensation plans for the quarter ended March 31, 2007.

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (In Thousands)[1]	Number of Shares Exercisable
Outstanding at January 1, 2007	3,328,279	$ 18.80	$ 46,279	2,338,751
Granted at fair value				
Exercised	(39,826)	19.54	536	
Cancelled	(3,043)	20.60		
Outstanding at March 31, 2007	3,285,410	18.79	49,128	2,541,824

(1) The intrinsic value of a stock option is the amount by which the current market value of the underlying stock exceeds the exercise price of the option.

Restricted Stock and Phantom Stock Units

The following table summarizes the restricted stock and phantom stock unit activity for the quarter ended March 31, 2007.

	Restricted Stock		Phantom Stock Units	
	Number of Shares	Weighted Average Grant Date Fair Value	Number of Shares	Weighted Average Grant Date Fair Value
Unvested at January 1, 2007	627,450	$ 43.15	77,950	$ 44.32
Awarded	2,500	32.01	3,500	30.88
Vested	(20,200)	25.25		
Forfeited	(800)	46.07	(100)	46.07
Unvested at March 31, 2007	608,950	43.70	81,350	43.74

The restricted stock and phantom stock units generally vest on the third anniversary of the date of the award, but may vest earlier upon a qualifying disability, death, retirement, or a change in control of the Company in accordance with the term of the underlying agreement. The phantom stock units can be settled in cash, shares of common stock, or a combination of both. The phantom stock units have been accounted for as a liability within the consolidated financial statements.

(5) DEBT

Components of debt are as follows:

	March 31, 2007				December 31, 2006			
	Principal	**Unamortized Premium (Discount)**	**Other(2)**	**Total**	**Principal**	**Unamortized Premium (Discount)**	**Other(2)**	**Total**
	(In Thousands)							
U.S. Credit Facility	$ 55,000			55,000	23,000			23,000
Canadian Credit Facility	95,271			95,271	84,094			84,094
Term Loan Agreements(1)	374,375			374,375	375,000			375,000
8% Senior Notes due 2008	265,000	(122)	2,780	267,658	265,000	(146)	3,346	268,200
8% Senior Notes due 2011	285,000	6,135	3,945	295,080	285,000	6,458	4,152	295,610
7 3/4% Senior Notes due 2014	150,000	(1,691)	12,617	160,926	150,000	(1,751)	13,056	161,305
Total debt	1,224,646	4,322	19,342	1,248,310	1,182,094	4,561	20,554	1,207,209
Less: current portion of long-term debt	2,500			2,500	2,500			2,500
Long-term debt	$ 1,222,146	4,322	19,342	1,245,810	1,179,594	4,561	20,554	1,204,709

(1) In December 2006, two of Forest's wholly-owned subsidiaries, Forest Alaska Operating LLC and Forest Alaska Holding LLC, entered into term loan financing arrangements in the aggregate principal amount of $375 million. The financing is comprised of two term loan agreements, including a $250 million first lien credit agreement and a $125 million second lien credit agreement. The term loans mature in December 2010 and December 2011, respectively, and are non-recourse to Forest.

(2) Represents the unamortized portion of gains realized upon termination of interest rate swaps that were accounted for as fair value hedges. The gains are being amortized as a reduction of interest expense over the terms of the notes.

Term Loan Agreements

On December 8, 2006, Forest, through its wholly-owned subsidiaries Forest Alaska Operating LLC and Forest Alaska Holding LLC (together "Forest Alaska"), issued, on a non-recourse basis to Forest, term loan financing facilities in the aggregate principal amount of $375 million. The issuance was comprised of two term loan facilities, including a $250 million first lien credit agreement and a $125 million second lien credit agreement (together the "Credit Agreements"). The loan proceeds were used to fund a $350 million distribution to Forest, which Forest used to pay down its U.S. credit facility, and to provide Forest Alaska working capital for its operations and pay transaction fees and expenses. Interest on the loans are based on an adjusted LIBO rate ("LIBOR") (LIBOR plus 3.50% under the first lien credit agreement and LIBOR plus 6.50% under the second lien credit agreement) or on a rate based on the federal funds rate (federal funds rate plus 3.0% under the first lien credit agreement and federal funds rate plus 6.0% under the second lien credit agreement), at the election of Forest Alaska. The loans under the first lien agreement will become due on December 8, 2010 and the loans under the second lien agreement will become due on December 8, 2011. The Credit Agreements are secured by substantially all of Forest Alaska's assets.

Partial repayments on the loans outstanding under the first lien agreement are due at the end of each calendar quarter, while the loans under the second lien agreement are scheduled for repayment on the maturity date. In addition, Forest Alaska is obligated to make mandatory prepayments annually using its excess cash flow and the proceeds associated with certain equity issuances, asset sales, and incurrence of additional indebtedness. Under certain circumstances involving a change in control involving Forest Alaska, the Credit Agreements also require Forest Alaska to offer to repurchase outstanding loans and purchase loans put to it by the lenders and, depending on the date of any such repurchase, the repurchase price may include a premium. Upon an event of default, a majority of the lenders under each of the Credit Agreements may request the agent to declare the loans immediately payable. Under certain circumstances involving insolvency, the loans will automatically become immediately due and payable.

The Credit Agreements include terms and covenants that place limitations on certain types of activities that may be conducted by Forest Alaska. The terms include restrictions or requirements with respect to additional debt, liens, investments, hedging activities, acquisitions, dividends, mergers, sales of assets, transactions with affiliates, and capital expenditures. In addition, the Credit Agreements include financial covenants addressing limitations on present value to total debt and first lien debt, interest coverage and leverage ratios. In the event Forest Alaska should not meet the prescribed financial or non-financial covenants and enter into a default position, the creditor may take action to terminate the committed term loan facilities and declare amounts outstanding to be immediately due and payable in whole or in part including accrued interest.

The Credit Agreements contain a covenant requiring that, for rolling time periods equal to four consecutive fiscal quarters, Forest Alaska may not have a "Leverage Ratio" greater than a defined amount. The Leverage Ratio is the ratio of (i) the total debt outstanding under the Credit Agreements at the end of the applicable four quarters to (ii) Forest Alaska's net income plus interest expense, depreciation, depletion expense, amortization expense, incomes taxes, exploration expense, and other non-cash charges and expenses, subject to certain adjustments (defined in the Credit Agreements as "Consolidated EBITDAX"), for the applicable four quarters. In addition, the first lien credit agreement (but not the second lien credit agreement) contains a covenant requiring that, for the same rolling time periods, Forest Alaska may not have an "Interest Coverage Ratio" less than a defined amount. The Interest Coverage Ratio is the ratio of (i) Forest Alaska's Consolidated EBITDAX for the applicable four quarters to (ii) the total interest expense under the two credit agreements, subject to certain adjustments, for the same time period.

In April 2007, based on a preliminary assessment of Forest Alaska's results of operations through March 31, 2007, Forest Alaska believed that it would likely fail to meet the Leverage Ratio and Interest Coverage Ratio requirements for the four-quarter period that ended on March 31, 2007. Unless waived by the lenders of more than 50 percent of the outstanding debt under the Forest Alaska Credit Agreements, a failure to meet the Leverage Ratio and the Interest Coverage ratio constitutes an event of default, entitling the lenders to declare the Credit Agreements terminated and demand immediate payment by Forest Alaska of all outstanding borrowings at par (approximately $374 million as of March 31, 2007), accrued interest, and unpaid accrued fees. On April 26, 2007, Forest Alaska entered into amendments to the first lien credit agreement and second lien credit agreement, which amended certain definitions in the Credit Agreements and added a new provision to Article VII of the first lien credit agreement. Forest Alaska believes that the amendments to the Credit Agreements will prevent any default with respect to the four quarters ended March 31, 2007.

(6) PROPERTY AND EQUIPMENT

Forest uses the full cost method of accounting for oil and gas properties. Separate cost centers are maintained for each country in which Forest has operations. During the periods presented, Forest's primary oil and gas operations were conducted in the United States and Canada. All costs incurred in the acquisition, exploration, and development of properties (including costs of surrendered and abandoned leaseholds, delay lease rentals, dry holes, and overhead related to exploration and development activities) and the fair value of estimated future costs of site restoration, dismantlement, and abandonment activities are capitalized. Forest capitalized $8.2 million and $11.1 million of general and administrative costs (including stock-based compensation) during the three months ended March 31, 2007 and 2006, respectively. Interest costs related to significant unproved properties that are under development are also capitalized to oil and gas properties. During the three months ended March 31, 2007 and 2006, the Company capitalized approximately $.8 million and $.7 million, respectively, of interest expense attributed to unproved properties.

Investments in unproved properties, including related capitalized interest costs, are not depleted pending determination of the existence of proved reserves. Unproved properties are assessed periodically to ascertain whether impairment has occurred. Unproved properties whose costs are individually significant are assessed individually by considering the primary lease terms of the properties, the holding period of the properties, and geographic and geologic data obtained relating to the properties. Where it is not practicable to assess individually the amount of impairment of properties for which costs are not individually significant, such properties are grouped for purposes of assessing impairment. The amount of impairment assessed is added to the costs to be amortized, or is reported as a period expense, as appropriate.

Pursuant to full cost accounting rules, the Company must perform a ceiling test each quarter on its proved oil and gas assets. The ceiling test provides that capitalized costs less related accumulated depletion and deferred income taxes for each cost center may not exceed the sum of (1) the present value of future net revenue from estimated production of proved oil and gas reserves using current prices, including the effects of derivative instruments but excluding the future cash outflows associated with settling asset retirement obligations that have been accrued on the balance sheet, at a discount factor of 10%; plus (2) the cost of properties not being amortized, if any; plus (3) the lower of cost or estimated fair value of unproved properties included in the costs being amortized, if any; less (4) income tax effects related to differences in the book and tax basis of oil and gas properties. Should the net capitalized costs for a cost center exceed the sum of the components noted above, an impairment charge would be recognized to the extent of the excess capitalized costs. There were no ceiling test impairments of oil and gas properties in 2007 or 2006, although the Company's Canadian full cost pool, in particular, could be adversely impacted by moderate declines in commodity prices.

Gain or loss is not recognized on the sale of oil and gas properties unless the sale significantly alters the relationship between capitalized costs and estimated proved oil and gas reserves attributable to a cost center.

Depletion of proved oil and gas properties is computed on the units-of-production method, whereby capitalized costs, as adjusted for future development costs and asset retirement obligations, are amortized over the total estimated proved reserves. Furniture and fixtures, computer hardware and software, and other equipment are depreciated on the straight-line or declining balance method, based upon estimated useful lives of the assets ranging from three to 15 years.

(7) ASSET RETIREMENT OBLIGATIONS

Forest records estimated future asset retirement obligations pursuant to the provisions of Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* ("SFAS 143"). SFAS No. 143 requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred with a corresponding increase in the carrying amount of the related long-lived asset. Subsequent to initial measurement, the asset retirement liability is required to be accreted each period to its present value. Capitalized costs are depleted as a component of the full cost pool using the units-of-production method. Forest's asset retirement obligations consist of costs related to the plugging of wells, the removal of facilities and equipment, and site restoration on oil and gas properties.

The following table summarizes the activity for Forest's asset retirement obligations for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31,	
	2007	2006
	(In Thousands)	
Asset retirement obligations at beginning of period	$ 64,102	211,554
Accretion expense	1,275	3,352
Liabilities incurred	693	202
Liabilities assumed		1,009
Liabilities included in the Spin-off		(150,182)
Liabilities settled	(563)	(4,379)
Revisions of estimated liabilities	175	(484)
Impact of foreign currency exchange rate	131	(73)
Asset retirement obligations at end of period	65,813	60,999
Less: current asset retirement obligations	3,055	1,497
Long-term asset retirement obligations	$ 62,758	59,502

(8) EMPLOYEE BENEFITS

The following table sets forth the components of the net periodic cost of Forest's defined benefit pension plans and postretirement benefits in the United States for the three months ended March 31, 2007 and 2006:

	Pension Benefits		Postretirement Benefits	
	Three Months Ended March 31,			
	2007	2006	2007	2006
	(In Thousands)			
Service cost	$		103	169
Interest cost	553	548	94	118
Curtailment gain[1]				(1,851)
Expected return on plan assets	(641)	(608)		
Recognized actuarial loss	195	227	(22)	
Total net periodic expense	$ 107	167	175	(1,564)

(1) Forest recognized a $1.9 million curtailment gain in connection with the Spin-off on March 2, 2006. This gain was recorded as a reduction in general and administrative expense for the three months ended March 31, 2006.

(9) DERIVATIVE INSTRUMENTS

Forest periodically enters into derivative instruments such as swap, basis swap, and collar agreements in order to provide a measure of stability to Forest's cash flows in an environment of volatile oil and gas prices and to manage the exposure to commodity price risk. Forest's commodity derivative instruments generally serve as effective economic hedges of commodity price exposure; however, various circumstances can cause commodity hedges to not qualify for cash flow hedge accounting either at the inception of the hedge or during the term of the hedge. When the criteria for cash flow hedge accounting are not met or when cash flow hedging is not elected, realized gains and losses (i.e., cash settlements) are recorded in other income and expense in the Condensed Consolidated Statements of Operations. Similarly, changes in the fair value of the derivative instruments are recorded as unrealized gains or losses in the Condensed Consolidated Statements of Operations. In contrast, cash settlements for derivative instruments that qualify for hedge accounting are recorded as additions to or reductions of oil and gas revenues while changes in fair value of cash flow hedges are recognized, to the extent the hedge is effective, in other comprehensive income until the hedged item is recognized in earnings.

As a result of production deferrals experienced in the Gulf of Mexico related to hurricanes Katrina and Rita, Forest was required to discontinue cash flow hedge accounting on some of its natural gas and oil hedges during the third and fourth quarters of 2005. Additionally, as a result of the Spin-off on March 2, 2006, additional commodity swaps and collars formerly designated as cash flow hedges of offshore Gulf of Mexico production also no longer qualified for cash flow hedge accounting. Because a significant portion of the Company's derivatives no longer qualified for cash flow hedge accounting and to increase clarity in its financial statements, the Company elected to discontinue cash flow hedge accounting prospectively for all of its remaining commodity derivatives beginning in March 2006. This change in reporting has not impacted the Company's reported cash flows, although the results of operations have been affected by mark-to-market gains and losses, which fluctuate with volatile oil and gas prices. Subsequent to March 2006, the Company has recognized all mark-to-market gains and losses in earnings, rather than deferring such amounts in accumulated other comprehensive income included in shareholders' equity.

The table below summarizes the realized and unrealized losses (gains) Forest incurred related to its oil and gas derivative instruments for the periods indicated.

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
	(In Thousands)	
Realized losses on derivatives designated as cash flow hedges[1]	$	36,680
Realized (gains) losses on derivatives not designated as cash flow hedges[2]	(25,134)	3,915
Ineffectiveness recognized on derivatives designated as cash flow hedges[2]		(5,573)
Unrealized losses on derivatives not designated as cash flow hedges[2]	57,888	29,687
Total realized and unrealized losses recorded	$ 32,754	64,709

(1) Included in oil and gas sales in the Condensed Consolidated Statements of Operations.

(2) Included in other income and expense in the Condensed Consolidated Statements of Operations.

The tables below set forth Forest's outstanding commodity swaps and collars as of March 31, 2007:

	Swaps			
	Natural Gas (NYMEX HH)		Oil (NYMEX WTI)	
	Bbtu per Day	Weighted Average Hedged Price per MMBtu	Barrels per Day	Weighted Average Hedged Price per Bbl
Second Quarter 2007	60	$ 7.88	7,000	$ 70.03
Third Quarter 2007	60	7.88	7,000	70.03
Fourth Quarter 2007	60	7.88	7,000	70.03
Calendar 2008			6,500	69.72
Calendar 2009			4,500	69.01
Calendar 2010			1,500	72.95

	Costless Collars			
	Natural Gas (NYMEX HH)		Oil (NYMEX WTI)	
	Bbtu per Day	Weighted Average Hedged Floor and Ceiling Price per MMBtu	Barrels per Day	Weighted Average Hedged Floor and Ceiling Price per Bbl
Second Quarter 2007	35	$ 8.76/11.70	4,000	$ 65.81/87.18
Third Quarter 2007	35	8.76/11.70	4,000	65.81/87.18
Fourth Quarter 2007	35	8.76/11.70	4,000	65.81/87.18
Calendar 2008	10	7.75/9.57		

	Three-Way Costless Collars	
	Natural Gas (NYMEX HH)	
	Bbtu per Day	Weighted Average Hedged Lower Floor, Upper Floor, and Ceiling Price per MMBtu
Calendar 2008	20	$ 6.00/8.00/10.00

The Company also uses basis swaps in connection with natural gas swaps in order to fix the price differential between the NYMEX price and the index price at which the natural gas production is sold. At March 31, 2007, there were three basis swaps in place covering 35.0 Bbtu per day for the remainder of 2007.

At March 31, 2007, the fair values of Forest's commodity derivative contracts is presented on the Condensed Consolidated Balance Sheet as liabilities of $16.0 million (of which $10.8 million was classified as current) and assets of $24.3 million (of which $17.5 million was classified as current). Forest is exposed to risks associated with swap and collar agreements arising from movements in the prices of oil and natural gas and from the unlikely event of non-performance by the counterparties to the swap and collar agreements.

In April 2007, the Company entered into an additional collar agreement. The table below sets forth the weighted average terms of the agreement.

	Costless Collar	
	Natural Gas (NYMEX HH)	
	Bbtu per Day	Weighted Average Hedged Floor and Ceiling Price per MMBtu
Calendar 2008	10	$ 8.00/10.50

Interest Rate Swaps

The Company may enter into interest rate swap agreements in an attempt to normalize the mix of fixed and floating interest rates within its debt portfolio. Unrealized gains, losses, or any settlements are recorded in other income and expense in the Consolidated Statement of Operations.

In fulfillment of requirements under Forest Alaska's Credit Agreements, Forest Alaska entered into two floating to fixed interest rate swaps. In March 2007, Forest Alaska entered into a $75 million floating to fixed interest rate swap for three years at a one month LIBOR fixed rate of 4.80%. At March 31, 2007, the fair value of Forest's interest rate derivative contract was an asset of $.1 million. In April 2007, Forest Alaska entered into a $112.5 million floating to fixed interest rate swap for three years at a one month LIBOR fixed rate of 4.96%. For the three months ended March 31, 2007, the Company recorded an unrealized gain related to the interest rate swap of $.1 million.

(10) GEOGRAPHICAL SEGMENTS

Segment information has been prepared in accordance with Statement of Financial Accounting Standards No. 131, *Disclosures About Segments of an Enterprise and Related Information*. At March 31, 2007, Forest conducts operations in one industry segment, that being the oil and gas exploration and production industry, and had three reportable geographical business segments: United States, Canada, and International. Forest's remaining activities are not significant and therefore are not reported as a separate segment, but are included as a reconciling item in the information below. The segments were determined based upon the geographical location of operations in each business segment. The segment data presented below was prepared on the same basis as the Condensed Consolidated Financial Statements. Effective in the third quarter of 2006, Forest decreased the number of reportable segments from five to three to correspond to the same number of cost centers under the full cost accounting rules. Segment information previously reported has been modified to conform to the current presentation.

	Oil and Gas Operations			
	Three Months Ended March 31, 2007			
	United States	**Canada**	**International**	**Total Company**
	(In Thousands)			
Revenue	$ 137,424	45,132		182,556
Expenses:				
Lease operating expenses	28,635	7,405		36,040
Production and property taxes	7,220	690		7,910
Transportation and processing costs	1,713	2,481		4,194
Depletion	41,232	18,431		59,663
Accretion of asset retirement obligations	1,002	261	12	1,275
Earnings (loss) from operations	$ 57,622	15,864	(12)	73,474
Capital expenditures	$ 98,538	56,262	629	155,429
Goodwill	$ 71,377	15,008		86,385

A reconciliation of segment earnings (loss) from operations to consolidated earnings before income taxes and discontinued operations is as follows:

	Three Months Ended March 31, 2007
	(In Thousands)
Earnings from operations for reportable segments	$ 73,474
Marketing, processing, and other	53
General and administrative expense (including stock-based compensation)	(12,971)
Administrative asset depreciation	(796)
Interest expense	(24,353)
Unrealized losses on derivative instruments, net	(57,838)
Realized gains on derivative instruments, net	25,134
Unrealized foreign currency exchange gain	49
Gain on sale of assets	7,176
Other income, net	888
Earnings before income taxes and discontinued operations	$ 10,816

	Oil and Gas Operations			
	Three Months Ended March 31, 2006			
	United States	Canada	International	Total Company
	(In Thousands)			
Revenue	$ 174,590	44,506		219,096
Expenses:				
Lease operating expenses	39,019	6,312		45,331
Production and property taxes	10,016	712		10,728
Transportation and processing costs	2,856	1,873		4,729
Depletion	57,917	18,939		76,856
Accretion of asset retirement obligations	3,092	249	11	3,352
Earnings (loss) from operations	$ 61,690	16,421	(11)	78,100
Capital expenditures	$ 423,833	49,687	874	474,394
Goodwill	$ 71,377	15,607		86,984

A reconciliation of segment earnings (loss) from operations to consolidated earnings before income taxes and discontinued operations is as follows:

	Three Months Ended March 31, 2006
	(In Thousands)
Earnings from operations for reportable segments	$ 78,100
Marketing, processing, and other	2,350
General and administrative expense (including stock-based compensation)	(17,136)
Administrative asset depreciation	(812)
Spin-off and merger costs	(5,416)
Interest expense	(15,151)
Unrealized losses on derivative instruments, net	(24,114)
Realized losses on derivative instruments, net	(3,915)
Other expense, net	(860)
Earnings before income taxes and discontinued operations	$ 13,046

(11) CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The Company's 8% Senior Notes due 2008, 8% Senior Notes due 2011, and $7^{3}/_{4}$% Senior Notes due 2014 have been fully and unconditionally guaranteed by a wholly-owned subsidiary of the Company (the "Subsidiary Guarantor"). The Company's remaining subsidiaries (the "Non-Guarantor Subsidiaries") have not provided guarantees. Based on this distinction, the following presents condensed consolidating financial information as of March 31, 2007 and December 31, 2006 and for the three months ended March 31, 2007 and 2006 on an issuer (parent company), guarantor subsidiary, non-guarantor subsidiary, eliminating entries, and consolidated basis. Elimination entries presented are necessary to combine the entities.

CONDENSED CONSOLIDATING BALANCE SHEETS
(Unaudited)
(In Thousands)

	March 31, 2007					December 31, 2006				
	Parent Company	Guarantor Subsidiary	Combined Non-Guarantor Subsidiaries	Eliminations	Consolidated	Parent Company	Guarantor Subsidiary	Combined Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS										
Current assets:										
Cash and cash equivalents	$ 1,079	237	15,770		**17,086**	771	126	32,267		**33,164**
Accounts receivable	47,022	7,656	93,751	(6,608)	**141,821**	48,010	9,428	69,709	(1,701)	**125,446**
Other current assets	51,781	7,031	24,987		**83,799**	82,227	2,380	17,783		**102,390**
Total current assets	99,882	14,924	134,508	(6,608)	**242,706**	131,008	11,934	119,759	(1,701)	**261,000**
Property and equipment, at cost	2,883,213	241,430	2,135,627		**5,260,270**	2,819,163	236,143	2,032,142		**5,087,448**
Less accumulated depreciation, depletion and amortization	1,629,371	67,740	668,671		**2,365,782**	1,605,072	63,624	628,826		**2,297,522**
Net property and equipment	1,253,842	173,690	1,466,956		**2,894,488**	1,214,091	172,519	1,403,316		**2,789,926**
Investment in subsidiaries	658,292			(658,292)		648,250			(648,250)	
Note receivable from subsidiary	68,840			(68,840)		59,497			(59,497)	
Due to (from) parent and subsidiaries	241,935	(10,482)	(231,453)			236,075	(16,276)	(219,799)		
Other assets	82,877	1	49,213		**132,091**	91,673	1	46,472		**138,146**
	$ 2,405,668	178,133	1,419,224	(733,740)	**3,269,285**	2,380,594	168,178	1,349,748	(709,448)	**3,189,072**
LIABILITIES AND SHAREHOLDERS' EQUITY										
Current liabilities:										
Accounts payable	$ 123,327	8,913	91,224	(6,608)	**216,856**	147,397	8,394	70,843	(1,701)	**224,933**
			2,500		**2,500**			2,500		**2,500**

	March 31, 2007					December 31, 2006				
Current portion of long-term debt										
Other current liabilities	37,617	130	7,378		**45,125**	33,978	(2,111)	4,641		**36,508**
Total current liabilities	160,944	9,043	101,102	(6,608)	**264,481**	181,375	6,283	77,984	(1,701)	**263,941**
Long-term debt	778,664		467,146		**1,245,810**	748,115		456,594		**1,204,709**
Notes payable to parent			68,840	(68,840)				59,497	(59,497)	
Other liabilities	61,239	1,882	39,009		**102,130**	57,496	1,831	35,132		**94,459**
Deferred income taxes	(40,916)	41,048	210,995		**211,127**	(40,398)	40,949	191,406		**191,957**
Total liabilities	959,931	51,973	887,092	(75,448)	**1,823,548**	946,588	49,063	820,613	(61,198)	**1,755,066**
Shareholders' equity	1,445,737	126,160	532,132	(658,292)	**1,445,737**	1,434,006	119,115	529,135	(648,250)	**1,434,006**
	$ 2,405,668	178,133	1,419,224	(733,740)	**3,269,285**	2,380,594	168,178	1,349,748	(709,448)	**3,189,072**

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS
(Unaudited)
(In Thousands)

	March 31, 2007					**March 31, 2006**				
	Parent Company	**Guarantor Subsidiary**	**Combined Non-Guarantor Subsidiaries**	**Eliminations**	**Consolidated**	**Parent Company**	**Guarantor Subsidiary**	**Combined Non-Guarantor Subsidiaries**	**Eliminations**	**Consolidated**
Revenue:										
Natural gas	$ 43,588	3,152	50,557		**97,297**	76,363	4,564	46,126		**127,053**
Oil, condensate, and natural gas liquids	38,111	11,890	35,258		**85,259**	58,912	11,582	21,549		**92,043**
Marketing, processing, and other	52	(49)	1,865	(1,815)	**53**	491	(16)	1,962	(87)	**2,350**
Total revenue	81,751	14,993	87,680	(1,815)	**182,609**	135,766	16,130	69,637	(87)	**221,446**
Operating expenses:										
Lease operating expenses	12,818	4,515	18,776	(69)	**36,040**	34,438	2,747	8,121	25	**45,331**
Other direct operating costs	6,964	1,307	3,833		**12,104**	8,835	1,884	4,738		**15,457**
General and administrative (including stock-based compensation	9,903	31	3,037		**12,971**	14,801	60	2,275		**17,136**
Depreciation and depletion	24,145	4,117	32,200	(3)	**60,459**	45,005	5,377	27,286		**77,668**
Other operating expenses	573	40	662		**1,275**	8,403	30	335		**8,768**
Total operating expenses	54,403	10,010	58,508	(72)	**122,849**	111,482	10,098	42,755	25	**164,360**
Earnings from operations	27,348	4,983	29,172	(1,743)	**59,760**	24,284	6,032	26,882	(112)	**57,086**
Equity earnings in subsidiaries	8,938			(8,938)		18,480			(18,480)	
Other income and expense:										
Interest expense	12,012	7	15,765	(3,431)	**24,353**	13,695	35	3,256	(1,835)	**15,151**
Unrealized (gains) losses on derivative instruments, net	36,730	6,983	14,125		**57,838**	19,448	2,256	2,410		**24,114**

	March 31, 2007					March 31, 2006				
Realized losses (gains) on derivative instruments, net	(16,759)	(3,185)	(5,190)		**(25,134)**	2,954	709	252		**3,915**
Other (income) expense, net	(3,189)	154	(8,509)	3,431	**(8,113)**	(902)	35	(108)	1,835	**860**
Total other income and expense	28,794	3,959	16,191		**48,944**	35,195	3,035	5,810		**44,040**
Earnings before income taxes and discontinued operations	7,492	1,024	12,981	(10,681)	**10,816**	7,569	2,997	21,072	(18,592)	**13,046**
Income tax expense:	601	273	3,051		**3,925**	3,898	2,922	4,977		**11,797**
Earnings from continuing operations	6,891	751	9,930	(10,681)	**6,891**	3,671	75	16,095	(18,592)	**1,249**
Income from discontinued operations, net of tax								2,422		**2,422**
Net earnings	$ 6,891	751	9,930	(10,681)	**6,891**	3,671	75	18,517	(18,592)	**3,671**

23

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS
(Unaudited)
(In Thousands)

	March 31, 2007				March 31, 2006			
	Parent Company	**Guarantor Subsidiary**	**Combined Non-Guarantor Subsidiaries**	**Consolidated**	**Parent Company**	**Guarantor Subsidiary**	**Combined Non-Guarantor Subsidiaries**	**Consolidated**
Operating activities:								
Net earnings	$ (3,790)	751	9,930	**6,891**	(14,575)	75	18,171	**3,671**
Adjustments to reconcile net earnings to net cash provided by operating activities:								
Depreciation and depletion	24,145	4,117	32,197	**60,459**	45,005	5,377	27,286	**77,668**
Unrealized (gains) losses on derivative instruments, net	36,730	6,983	14,125	**57,838**	19,448	2,256	2,410	**24,114**
Deferred income tax expense	266	273	2,508	**3,047**	2,928	2,922	6,172	**12,022**
Other, net	798	39	(6,071)	**(5,234)**	26,184	29	544	**26,757**
Changes in operating assets and liabilities, net of effects of acquisitions and divestitures:								
Accounts receivable	988	1,772	(12,152)	**(9,392)**	(13,846)	1,726	(1,868)	**(13,988)**
Other current assets	(10,083)	235	(4,714)	**(14,562)**	(22,318)	(95)	1,697	**(20,716)**
Accounts payable	(32,759)	(398)	(7,991)	**(41,148)**	(8,940)	(3,826)	6,267	**(6,499)**
Accrued interest and other current liabilities	15,172	(91)	1,858	**16,939**	13,633	(74)	(2,053)	**11,506**
Net cash provided by operating activities	31,467	13,681	29,690	**74,838**	47,519	8,390	58,626	**114,535**
Investing activities:								
Capital expenditures for property and equipment	(61,955)	(4,509)	(76,532)	**(142,996)**	(372,567)	(8,323)	(86,928)	**(467,818)**
Other, net	7,625		(5,964)	**1,661**	(457)		1,581	**1,124**
Net cash used by investing activities	(54,330)	(4,509)	(82,496)	**(141,335)**	(373,024)	(8,323)	(85,347)	**(466,694)**
Financing activities:								
Proceeds from bank borrowings	153,000		29,027	**182,027**	654,102		20,716	**674,818**
Repayments of bank borrowings	(121,000)		(18,759)	**(139,759)**	(316,000)		(9,415)	**(325,415)**
Net activity in investments from subsidiaries	(14,870)	(9,258)	24,128		(14,553)	266	14,287	
Other, net	6,041	197	2,597	**8,835**	2,250		(24)	**2,226**
Net cash provided (used) by financing activities	23,171	(9,061)	36,993	**51,103**	325,799	266	25,564	**351,629**
Effect of exchange rate changes on cash			(684)	**(684)**			(391)	**(391)**
Net increase (decrease) in cash and cash equivalents	308	111	(16,497)	**(16,078)**	294	333	(1,548)	**(921)**
Cash and cash equivalents at beginning of period	771	126	32,267	**33,164**	2,076	(114)	5,269	**7,231**
Cash and cash equivalents at end of period	$ 1,079	237	15,770	**17,086**	2,370	219	3,721	**6,310**

(12) RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes,"* an interpretation of FAS 109, *"Accounting for Income Taxes"* ("FIN 48"), to create a single model to address accounting for uncertainty in income tax positions. FIN 48 clarifies the accounting for income taxes, by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The Company adopted FIN 48 on January 1, 2007. As a result of the implementation of FIN 48 the Company recognized a liability for uncertain tax benefits of approximately $1.0 million which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. The adoption of FIN 48 increased the Company's previously recognized liability for uncertain tax benefits of $.5 million to $1.5 million. The $1.5 million liability does not relate to uncertainties about the timing of items of income or deduction and would affect the Company's effective tax rate if recognized in the Company's income tax provision. The Company records interest accrued related to unrecognized tax benefits in interest expense and penalties in other expense, to the extent they apply. The Company recognized no significant interest or penalties at the date of its adoption of FIN 48.

There was no change in the amount of unrecognized tax benefits during the three months ended March 31, 2007. Furthermore, the Company does not expect any significant change in the total amounts of unrecognized tax benefits within the 12 months ending March 31, 2008.

The statute of limitations is closed for the Company's U.S. federal income tax returns for years ending before and including December 31, 2002. Pre-acquisition returns of acquired businesses are also closed for tax years ending before and including December 31, 2002. However, the Company has utilized, and will continue to utilize, net operating losses ("NOLs") (including NOLs of acquired businesses) in its open tax years. The earliest available NOLs were generated in the tax year beginning January 1, 1989, but are potentially subject to adjustment by the federal tax authorities in the tax year in which they are utilized. Thus, the Company's earliest U.S. federal income tax return that is closed to potential audit adjustments is the tax year ending December 31, 1988. The Company's most recent Canadian income tax return that is closed to potential audit adjustments is the tax year ended December 31, 2002.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *"Fair Value Measurements"* ("SFAS 157"). This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We have not determined the effect, if any, the adoption of this statement will have on our financial position or results of operations.

In February 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 159, *"The Fair Value Option for Financial Assets and Financial Liabilities"* ("SFAS 159"). This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This statement expands the use of fair value measurement and applies to entities that elect the fair value option. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We have not determined the effect, if any, the adoption of this statement will have on our financial position or results of operations.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forest Oil Corporation ("Forest") is an independent oil and gas company engaged in the acquisition, exploration, development, and production of natural gas and liquids in North America and selected international locations. Forest was incorporated in New York in 1924, as the successor to a company formed in 1916, and has been a publicly held company since 1969.

The following discussion and analysis should be read in conjunction with Forest's Condensed Consolidated Financial Statements and Notes thereto, the information under the heading "Forward-Looking Statements" below, and the information included in Forest's 2006 Annual Report on Form 10-K under the heading "Risk Factors", and "Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies, Estimates, Judgments, and Assumptions." Unless the context otherwise indicates, references in this quarterly report on Form 10-Q to "Forest," "we," "ours," "us," or like terms refer to Forest Oil Corporation and its subsidiaries.

2007 OVERVIEW

Pending Acquisition of Houston Exploration

On January 7, 2007, Forest announced it had entered into a definitive agreement and plan of merger pursuant to which The Houston Exploration Company ("Houston Exploration") will merge with and into Forest in a stock and cash transaction totaling approximately $1.5 billion plus the assumption of debt. Houston Exploration is an independent natural gas and oil producer engaged in the exploration, development, exploitation, and acquisition of natural gas and oil reserves in North America with operations in the following four producing areas in the United States: South Texas, East Texas, the Arkoma Basin of Arkansas, and the Uinta and DJ Basins in the Rocky Mountains. The boards of directors of Forest and Houston Exploration have each unanimously approved the transaction. The transaction is subject to customary conditions, including both Forest shareholder and Houston Exploration stockholder approvals. Forest management and its board of directors will continue in their current positions with Forest following the completion of the merger. The merger is expected to close in early June 2007, as soon as practicable following Forest shareholder approval and Houston Exploration stockholder approval and satisfaction of the closing conditions.

Under the terms of the merger agreement, Houston Exploration stockholders are to receive total consideration equal to 0.84 shares of Forest common stock and $26.25 in cash for each share of Houston Exploration common stock outstanding. This represents estimated merger consideration of 23.8 million shares of Forest common stock and cash of approximately $740 million, or $52.47 per share, to be received by the Houston Exploration stockholders (based on the closing price of Forest's common stock on January 5, 2007 and the number of shares of Houston Exploration common stock outstanding on April 30, 2007 and subject to increase in the event that any additional shares of Houston Exploration common stock are issued prior to the merger closing date in connection with the exercise of outstanding stock options pursuant to the terms of the merger agreement). The actual amount of total cash and stock consideration to be received by each Houston Exploration stockholder will be determined by elections, an equalization formula, and a proration procedure. It is anticipated that the transaction will be tax free to Houston Exploration and the stock portion of the consideration will be received tax free by its stockholders. The cash component of the acquisition is expected to be financed under an amended and restated revolving credit facility of up to $1.4 billion for which JPMorgan Chase Bank, N.A. has provided us a commitment letter.

At the request of Forest, and in connection with the pending merger, Houston Exploration commenced a tender offer and consent solicitation to repurchase any or all of its $175 million senior subordinated notes immediately prior to the completion of the merger. Houston Exploration expects to fund the repurchase with cash on hand and borrowings under its revolving credit facility.

In the event the merger is not consummated, Forest has agreed to reimburse Houston Exploration for all expenses and indemnify it against certain liabilities associated with the repurchase. In the event the merger is consummated but the consent solicitation is delayed, terminated or otherwise modified in a manner that does not result in the adoption of the proposed amendments, then following the closing of the pending merger and pursuant to the terms of the existing indenture, Forest will be required to offer to purchase any or all of the notes at a price equal to 101% of the aggregate principle amount, plus accrued and unpaid interest and liquidated damages.

In connection with the pending acquisition of Houston Exploration, Forest may elect to access the debt capital markets to finance a portion of the cash component of the merger consideration and the related transactions or to refinance borrowings under its bank credit facilities.

Production Increase

Production from the Retained Properties (see definition below) increased 6% during the three months ended March 31, 2007 from the corresponding period in 2006. The production increase is discussed further in Results of Operations, *Oil and Gas Production and Revenues*, below.

Sale of Australian Royalty Interests

In February 2007, Forest sold its overriding royalty interests in Australia for net proceeds of $7.2 million which resulted in a gain on the sale of $7.2 million ($4.5 million net of tax). As of March 31, 2006, Forest had received an initial payment of $.7 million and received the remaining proceeds in April and May 2007.

RESULTS OF OPERATIONS

General

On March 2, 2006, Forest completed the spin-off of its Gulf of Mexico operations. The revenues and expenses associated with the offshore Gulf of Mexico operations are only included in the consolidated results of operations through February 28, 2006. As a result, the operational results for the three month period of 2007 presented are not comparable to the corresponding period in 2006. In the following discussions, revenues and expenses directly attributable with the properties included in the spin-off of the Gulf of Mexico operations (the "Spin-off Properties") and those retained (the "Retained Properties") are discussed separately.

Oil and Gas Production and Revenues

Production volumes, revenues, and weighted average sales prices by product and location for the three months ended March 31, 2007 and 2006 were as follows:

	Three Months Ended March 31,								
	2007					2006			
	Gas		Oil	NGLs	Total	Gas	Oil	NGLs	Total
	(MMcf)		(MBbls)	(MBbls)	(MMcfe)	(MMcf)	(MBbls)	(MBbls)	(MMcfe)
Production volumes:									
Retained Properties:									
United States		10,347	1,110	441	**19,653**	9,291	1,143	336	**18,165**
Canada		5,974	206	59	**7,564**	5,729	191	97	**7,457**
Total Retained Properties		16,321	1,316	500	**27,217**	15,020	1,334	433	**25,622**
Spin-off Properties						6,378	193	82	**8,028**
Totals		16,321	1,316	500	**27,217**	21,398	1,527	515	**33,650**
Revenues (in thousands):									
Retained Properties:									
United States	$	64,074	60,606	12,744	**137,424**	65,379	67,481	9,801	**142,661**
United States hedging losses						(7,707)	(6,653)		**(14,360)**
Canada		33,223	10,089	1,820	**45,132**	32,332	8,077	4,097	**44,506**
Total Retained Properties		97,297	70,695	14,564	**182,556**	90,004	68,905	13,898	**172,807**
Spin-off Properties						53,975	11,614	3,020	**68,609**
Spin-off Properties hedging losses						(16,926)	(5,394)		**(22,320)**
Total Spin-off Properties						37,049	6,220	3,020	**46,289**
Totals	$	97,297	70,695	14,564	**182,556**	127,053	75,125	16,918	**219,096**
Average sales price:									
Retained Properties:									
United States	$	6.19	54.60	28.90	**6.99**	7.04	59.04	29.17	**7.85**
United States hedging losses						(.83)	(5.82)		**(.79)**
Canada		5.56	48.98	30.85	**5.97**	5.64	42.29	42.24	**5.97**
Total Retained Properties		5.96	53.72	29.13	**6.71**	5.99	51.65	32.10	**6.74**

	Three Months Ended March 31,							
Spin-off Properties					8.46	60.18	36.83	**8.55**
Spin-off Properties hedging losses					(2.65)	(27.95)		**(2.78)**
Total Spin-off Properties					5.81	32.23	36.83	**5.77**
Totals	$ 5.96	53.72	29.13	**6.71**	5.94	49.20	32.85	**6.51**

Net oil and gas production from the Retained Properties in the first quarter of 2007 was 27.2 Bcfe or an average of 302.4 MMcfe per day, a 6% increase from 25.6 Bcfe or an average of 284.7 MMcfe per day in the first quarter of 2006. The net increase in oil and gas production for the period was primarily attributable to the acquisition and subsequent development of the Cotton Valley assets which were acquired on March 31, 2006.

Oil and natural gas revenues from the Retained Properties were $182.6 million during the three months ended March 31, 2007, a 6% increase as compared to $172.8 million for the same period in the prior year, which included realized hedging losses of $14.4 million. The increase in oil and natural gas revenues was due to the 6% increase in production and a $14.4 million decrease in hedging losses on derivatives accounted for as cash flow hedges, offset by an 8% decrease in average realized sales price before the effects of hedging. No hedging gains or losses were included in the average sales prices presented for the first quarter of 2007 given our election to discontinue cash flow hedge accounting effective in March 2006. See *Realized and Unrealized Gains and Losses on Derivative Instruments* below for information on gains and losses recognized on derivative instruments not designated as cash flow hedges.

Oil and Gas Production Expense

The table below sets forth the detail of oil and gas production expense, for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31,					
	2007			2006		
	Retained Properties	Spin-off Properties	Total	Retained Properties	Spin-off Properties	Total
	(In Thousands, Except per Mcfe Data)					
Lease operating expenses:						
Direct operating expense and overhead	$ 32,421		**32,421**	24,919	9,535	**34,454**
Workover expense	3,619		**3,619**	2,116	8,761	**10,877**
Lease operating expenses	$ 36,040		**36,040**	27,035	18,296	**45,331**
Lease operating expenses per Mcfe	$ 1.32		**1.32**	1.06	2.28	**1.35**
Production and property taxes	$ 7,910		**7,910**	10,577	151	**10,728**
Production and property taxes per Mcfe	$ .29		**.29**	.41	.02	**.32**
Transportation and processing costs	$ 4,194		**4,194**	4,385	344	**4,729**
Transportation and processing costs per Mcfe	$ .15		**.15**	.17	.04	**.14**

Lease operating expenses in the first quarter of 2007 for the Retained Properties increased 33%, or $9.0 million, to $36.0 million from $27.0 million in the first quarter of 2006. On a per-Mcfe basis, lease operating expenses increased 25% to $1.32 per Mcfe in the first quarter of 2007 from $1.06 per Mcfe in the first quarter of 2006. The increase in lease operating costs was primarily attributable to an increase in repairs and maintenance costs incurred in non-operated properties in Alaska. Production and property taxes on the Retained Properties decreased by 25% or $2.7 million during the first quarter of 2007 as compared to the prior year's first quarter. The decrease from the prior year was attributable to lower commodity prices, lower state severance tax rates, and additional severance tax incentive credits recognized during the first quarter of 2007 than compared to the same period in the prior year. Transportation and processing costs for the Retained Properties decreased slightly to $4.2 million or $.15 per Mcfe in the three months ended March 31, 2007 from $4.4 million or $.17 per Mcfe for the corresponding 2006 period.

General and Administrative Expense

The following table summarizes the components of general and administrative expense and stock-based compensation expense incurred during the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31,	
	2007	2006
	(In Thousands, Except per Mcfe Data)	
Total general and administrative costs	$ 18,515	15,344
General and administrative costs capitalized	(7,340)	(6,062)
General and administrative expense	$ 11,175	9,282
General and administrative expense per Mcfe	$ .41	.28
Total stock-based compensation costs	$ 2,663	12,853
Stock-based compensation costs capitalized	(867)	(4,999)
Stock-based compensation expense	$ 1,796	7,854
Stock-based compensation expense per Mcfe	$ .07	.23
Total general administrative expense including stock-based compensation	$ 12,971	17,136

The increase in general and administrative expense of $1.9 million for the three month period in 2007 as compared to the same period in 2006 is primarily related to increased employee salary and benefit costs. Stock-based compensation expense decreased $6.1 million during the three month period in 2007 as compared to the same period in 2006 and is the result of the partial settlement of our restricted stock awards and phantom stock unit awards in connection with the spin-off of the Gulf of Mexico operations during the first quarter of 2006.

Depreciation and Depletion

Depreciation, depletion and amortization expense ("DD&A") for the three months ended March 31, 2007 was $60.5 million compared to $77.7 million for the same period in 2006. On an equivalent Mcf basis, DD&A expense was $2.22 per Mcfe for the three months ended March 31, 2007 as compared to $2.31 per Mcfe for the same period in the prior year. The decrease of $.09 per Mcfe was primarily due to the spin-off of our offshore Gulf of Mexico properties on March 2, 2006.

Interest Expense

Interest expense in the first quarter of 2007 totaled $24.4 million compared to $15.2 million in the first quarter of 2006. The increase in interest expense during the period in 2007 as compared to the corresponding period in 2006 was due to increased average debt balances and higher average interest rates caused by the term loans issued by Forest's wholly-owned subsidiaries, Forest Alaska Operating LLC and Forest Alaska Holding LLC (together "Forest Alaska").

Realized and Unrealized Gains and Losses on Derivative Instruments

In March 2006, Forest elected to discontinue cash flow hedge accounting for all of its derivative instruments. As a result, subsequent to March 2006, Forest has recognized mark-to-market gains and losses in earnings, rather than deferring such amounts in accumulated other comprehensive income included in shareholders' equity. In addition, cash settlement on derivative instruments are recorded as realized hedging gains and losses in other income and expense in the Condensed Consolidated

Statements of Operations rather than an adjustment to oil and gas revenues. This change in reporting has had no impact on Forest's reported cash flows, although results of operations have been affected by mark-to-market gains and losses, which fluctuate with volatile oil and gas prices. See Note 9 to the Condensed Consolidated Financial Statements.

The table below sets forth realized and unrealized gains and losses on oil and natural gas derivatives recognized under "Other income and expense" in our Condensed Consolidated Statements of Operations for the periods indicated. During the first quarter ended March 31, 2007, Forest terminated two oil swaps covering 1,000 barrels per day in 2009 and 500 barrels per day in 2010 for total proceeds of $6.9 million. This amount has been included in realized gains and losses on derivative instruments during the quarter ended March 31, 2007.

	Three Months Ended March 31,					
	2007			2006		
	Oil Derivatives	Natural Gas Derivatives	Total	Oil Derivatives	Natural Gas Derivatives	Total
	(In Thousands)					
Unrealized losses (gains)	$ 25,861	32,027	57,888	31,355	(7,241)	24,114
Realized (gains) losses	(17,077)	(8,057)	(25,134)	4,378	(463)	3,915

Current and Deferred Income Tax Expense

Forest recorded income tax expense of $3.9 million in the three months ended March 31, 2007 as compared with $11.8 million in the same period of 2006. The reduction in income tax expense was primarily due to significant non-recurring tax adjustments made in 2006. Together, non-deductible costs and state income tax rate adjustments related to the spin-off of the offshore Gulf of Mexico operations added approximately $6.9 million to the income tax expense reflected in first three months of 2006. Other items causing the decrease in income tax expense relate to lower financial statement income and reduced statutory rates that are applicable in 2007 with respect to Canada and the state of Texas.

Discontinued Operations

On March 1, 2004, Forest sold the assets and business operations of Producers Marketing, Ltd. ("ProMark") to Cinergy Canada, Inc. ("Cinergy") for $11.2 million CDN. As a result of the sale, ProMark's results of operations were reported as discontinued operations in the historical financial statements. Under the terms of the purchase and sale agreement, Forest may receive additional contingent consideration payments over a period of five years through February 2009. During the three months ended March 31, 2006, Forest recognized an additional $3.6 million contingent payment ($2.4 million net of tax) due under the agreement, which has been reflected as income from discontinued operations in the Condensed Consolidated Statements of Operations. No contingent payments are expected to be received in 2007.

Liquidity and Capital Resources

In 2007, as in 2006, we expect our cash flow from operations to be our primary source of liquidity to meet operating expenses and fund capital expenditures other than large acquisitions. Any remaining cash flow from operations will be available for acquisitions, in whole or in part, or other corporate purposes, including the repayment of indebtedness.

The prices we receive for our oil and natural gas production have a significant impact on operating cash flows. While significant price declines in 2007 would adversely affect the amount of cash flow generated from operations, we utilize a hedging program to partially mitigate that risk. As of May 1, 2007, Forest has hedged approximately 44 Bcfe of its remaining 2007 production. This level of hedging provides a measure of certainty of the cash flow we will receive for a large portion of our production through 2007. Depending on changes in oil and gas futures markets and management's view of underlying oil and natural gas supply and demand trends, we may increase or decrease our current hedging positions. For further information concerning our hedging contracts, see Item 3 "Quantitative and Qualitative Disclosures about Market Risk Commodity Price Risk," below.

Our $600 million revolving bank credit facilities, which we entered into in September 2004, provide another source of liquidity. These credit facilities, which mature in September 2009, are used to fund daily operating activities and acquisitions in the United States and Canada as needed. See "Bank Credit Facilities" below for details.

The public capital markets have been our principal source of funds to finance large acquisitions. We have issued debt and equity securities in both public and private offerings in the past, and we expect that these sources of capital will continue to be available to us in the future for acquisitions. In July 2004, we filed a shelf registration statement that allows Forest to issue equity and debt securities of up to $600 million, all of which is still available. Nevertheless, ready access to capital on reasonable terms can be impacted by our debt ratings assigned by independent rating agencies and are subject to many uncertainties, including restrictions contained in our bank credit facilities and indentures for our senior notes, macroeconomic factors outside of our control, and other risks as explained in Part 1, Item 1A "Risk Factors" of our 2006 Annual Report on Form 10-K and Part II, Item 1A of this report.

In connection with the pending acquisition of Houston Exploration, Forest may elect to access the debt capital markets to finance a portion of the cash component of the merger consideration and the related transactions or to refinance borrowings under its credit facilities. Also, in conjunction with the announcement of the pending acquisition of Houston Exploration, we announced our plans to sell our Alaska business unit and certain other non-core assets, which should provide another source of liquidity in 2007.

In addition to the aforementioned transactions, we believe that our available cash, cash provided by operating activities, and funds available under our bank credit facilities will be sufficient to fund our operating, interest, and general and administrative expenses, our capital expenditure budget, and our short-term contractual obligations at current levels for the foreseeable future.

Bank Credit Facilities

Forest currently has credit facilities totaling $600 million, consisting of a $500 million U.S. credit facility through a syndicate of banks led by JPMorgan Chase Bank and a $100 million Canadian credit facility through a syndicate of banks led by JPMorgan Chase Bank, Toronto Branch. The credit facilities mature in September 2009. Subject to the agreement of Forest and the applicable lenders, the size of the credit facilities may be increased by $200 million in the aggregate.

Availability under the credit facilities is based either on certain financial covenants included in the credit facilities or on the loan value assigned to Forest's oil and gas properties. If Forest's corporate credit rating by Moody's is "Ba1" or higher and "BB+" or higher by S&P, availability under the credit facilities may, at Forest's election, be governed by certain financial covenants. Alternatively, if Forest's senior unsecured long-term debt credit rating is "Ba2" or lower by Moody's or "BB" or lower by S&P, availability under the credit facilities will be governed by a borrowing base ("Global Borrowing Base"). Currently, the amount available under the credit facilities is determined by the Global Borrowing Base. Effective September 29, 2006, the syndicate of banks approved a Global Borrowing Base of $900 million; however, Forest did not elect to change the Global Borrowing Base allocation and the U.S. allocated borrowing base was kept at $500 million and the Canadian allocated borrowing base was kept at $100 million.

The determination of the Global Borrowing Base is made by the lenders taking into consideration the estimated value of Forest's oil and gas properties in accordance with the lenders' customary practices for oil and gas loans. This process involves reviewing Forest's estimated proved reserves and their valuation. While the Global Borrowing Base is in effect, it is redetermined semi-annually, and the available borrowing amount could be increased or decreased as a result of such redeterminations. In addition, Forest and the lenders each have discretion at any time, but not more often than once during any calendar year, to have the Global Borrowing Base redetermined. A revision to Forest's reserves may prompt such a request on the part of the lenders, which could possibly result in a reduction in the Global Borrowing Base and availability under the credit facilities. If outstanding borrowings under either of the credit facilities exceed the applicable portion of the Global Borrowing Base, Forest would be required to repay the excess amount within a prescribed period. If we are unable to pay the excess amount, it would cause an event of default.

The credit facilities include terms and covenants that place limitations on certain types of activities, including restrictions or requirements with respect to additional debt, liens, asset sales, hedging activities, investments, dividends, mergers, and acquisitions. The credit facilities also include several financial covenants. Availability, interest rates, security requirements, and other terms of borrowing under the credit facilities will vary based on Forest's credit ratings and financial condition, as determined by certain financial tests. In particular, any time that availability is not determined by the Global Borrowing Base, the amount available and our ability to borrow under the credit facilities is determined by certain financial covenants. Also, even when availability is determined by the Global Borrowing Base, certain financial covenants may affect the amount available and Forest's ability to borrow amounts under the credit facilities.

The credit facilities are collateralized by a portion of our assets. We are required to mortgage, and grant a security interest in, 75% of our consolidated proved oil and gas properties, measured by value. We have also pledged the stock of several subsidiaries to the lenders to secure the credit facilities. Under certain circumstances, we could be obligated to pledge additional assets as collateral. If our corporate credit ratings by Moody's and S&P improve and meet pre-established levels, the collateral requirements would not apply and, at our request, the banks would release their liens and security interests on our properties.

At March 31, 2007, there were outstanding borrowings of $55.0 million under the U.S. credit facility at a weighted average interest rate of 6.63%, and there were outstanding borrowings of $95.3 million under the Canadian credit facility at a weighted average interest rate of 5.65%. We also had used the credit facilities for approximately $3.3 million in letters of credit, leaving an unused borrowing amount under the Global Borrowing Base of approximately $446.4 million at March 31, 2007. At April 30, 2007, there were outstanding borrowings of $80.0 million under the U.S. credit facility at a weighted average interest rate of 6.63%, and there were outstanding borrowings of $87.1 million under the Canadian credit facility at a weighted average interest rate of 5.69%. We also had used the credit facilities for approximately $3.3 million in letters of credit, leaving an unused borrowing amount under the Global Borrowing Base of approximately $429.6 million.

On January 5, 2007, Forest, J.P. Morgan Securities Inc., and JPMorgan Chase Bank, N.A. entered into a commitment letter and fee letter with respect to the financing of the merger with Houston Exploration and the related transactions and the refinancing of certain of Forest's existing debt. The commitment letter, as amended, provides for a commitment of an aggregate of up to $1.4 billion in financing under a five-year amended and restated revolving credit facility. Initially, we anticipate the commitments for the amended and restated U.S. and Canadian credit facilities will consist of a U.S. facility of up to $1.25 billion and a Canadian facility of up to $150 million. We expect the terms of the amended and restated credit facilities to be substantially similar to those of the existing credit facilities. We expect to finance the cash portion of the merger consideration, which is expected to be approximately $740 million in cash (based on the outstanding shares of Houston Exploration common stock on April 30, 2007 and subject to increase), through borrowings under these amended and restated credit facilities. Forest also expects to use these credit facilities to pay for related merger costs and expenses and for general corporate purposes following the merger. In addition, Forest intends to use the credit facilities, immediately after the merger occurs, to refinance borrowings incurred by Houston Exploration under its credit facility to fund the repurchase by Houston Exploration, immediately prior to the merger, of up to $175 million of its outstanding senior subordinated notes through a tender offer and consent solicitation, as requested by Forest. The commitment letter expires June 30, 2007 and is subject to customary closing conditions.

Term Loan Financing Agreements

On December 8, 2006, Forest Alaska issued, on a non-recourse basis to Forest, term loan financing facilities in the aggregate principal amount of $375 million. The issuance was comprised of two term loan facilities, including a $250 million first lien credit agreement and a $125 million second lien credit agreement (together the "Credit Agreements"). The loan proceeds were used to fund a $350 million distribution to Forest, which Forest used to pay down its U.S. credit facility, and to provide Forest Alaska working capital for its operations and pay transaction fees and expenses. Interest on the loans are based on an adjusted LIBO rate ("LIBOR") (LIBOR plus 3.50% under the first lien credit agreement and LIBOR plus 6.50% under the second lien credit agreement) or on a rate based on the federal funds rate (federal funds rate plus 3.0% under the first lien credit agreement and federal funds rate plus 6.0% under the second lien credit agreement), at the election of Forest Alaska. The loans under the first lien agreement will become due on December 8, 2010 and the loans under the second lien agreement will become due on December 8, 2011. The Credit Agreements are secured by substantially all of Forest Alaska's assets.

Partial repayments on the loans outstanding under the first lien agreement are due at the end of each calendar quarter, while the loans under the second lien agreement are scheduled for repayment on the maturity date. In addition, Forest Alaska is obligated to make mandatory prepayments annually using its excess cash flow and the proceeds associated with certain equity issuances, asset sales, and incurrence of additional indebtedness. Under certain circumstances involving a change in control involving Forest Alaska, the Credit Agreements also require Forest Alaska to offer to repurchase outstanding loans and purchase loans put to it by the lenders and, depending on the date of any such repurchase, the repurchase price may include a premium. Upon an event of default, a majority of the lenders under each of the Credit Agreements may request the agent to declare the loans immediately payable. Under certain circumstances involving insolvency, the loans will automatically become immediately due and payable.

The Credit Agreements include terms and covenants that place limitations on certain types of activities that may be conducted by Forest Alaska. The terms include restrictions or requirements with respect to additional debt, liens, investments, hedging activities, acquisitions, dividends, mergers, sales of assets, transactions with affiliates, and capital expenditures. In addition, the Credit Agreements include financial covenants addressing limitations on present value to total debt and first lien debt, interest coverage and leverage ratios. In the event Forest Alaska should not meet the prescribed financial or non-financial covenants and enter into a default position, the creditor may take action to terminate the committed term loan facilities and declare amounts outstanding to be immediately due and payable in whole or in part including accrued interest.

The Credit Agreements contain a covenant requiring that, for rolling time periods equal to four consecutive fiscal quarters, Forest Alaska may not have a "Leverage Ratio" greater than a defined amount. The Leverage Ratio is the ratio of (i) the total debt outstanding under the Credit Agreements at the end of the applicable four quarters to (ii) Forest Alaska's net income plus interest expense, depreciation, depletion expense, amortization expense, incomes taxes, exploration expense, and other non-cash charges and expenses, subject to certain adjustments (defined in the Credit Agreements as

"Consolidated EBITDAX"), for the applicable four quarters. In addition, the first lien credit agreement (but not the second lien credit agreement) contains a covenant requiring that, for the same rolling time periods, Forest Alaska may not have an "Interest Coverage Ratio" less than a defined amount. The Interest Coverage Ratio is the ratio of (i) Forest Alaska's Consolidated EBITDAX for the applicable four quarters to (ii) the total interest expense under the two credit agreements, subject to certain adjustments, for the same time period.

In April 2006, based on a preliminary assessment of Forest Alaska's results of operations through March 31, 2007, Forest Alaska believed that it would likely fail to meet the Leverage Ratio and Interest Coverage Ratio requirements for the four-quarter period that ended on March 31, 2007. Unless waived by the lenders of more than 50 percent of the outstanding debt under the Forest Alaska Credit Agreements, a failure to meet the Leverage Ratio and the Interest Coverage ratio constitutes an event of default, entitling the lenders to declare the Credit Agreements terminated and demand immediate payment by Forest Alaska of all outstanding borrowings at par (approximately $374 million as of March 31, 2007), accrued interest, and unpaid accrued fees. On April 26, 2007, Forest Alaska entered into amendments to the first lien credit agreement and second lien credit agreement, which amended certain definitions in the Credit Agreements and added a new provision to Article VII of the first lien credit agreement. Forest Alaska believes that the amendments to the Credit Agreements will prevent any default with respect to the four quarters ended March 31, 2007.

Cash Flow

Net cash provided by operating activities, net cash used by investing activities, and net cash provided by financing activities for the three months ended March 31, 2007 and 2006 were as follows:

	Three Months Ended March 31,	
	2007	**2006**
	(In Thousands)	
Net cash provided by operating activities	$ 74,838	114,535
Net cash used by investing activities	(141,335)	(466,694)
Net cash provided by financing activities	51,103	351,629

The decrease in net cash provided by operating activities in the three months ended March 31, 2007 compared to the same period of 2006 was due primarily to lower oil and gas revenues due to the spin-off of the offshore Gulf of Mexico operations. The decrease in cash used by investing activities in the three months ended March 31, 2007 was due primarily to the acquisition of oil and gas assets in the Cotton Valley trend in East Texas for approximately $255 million in the three months ended March 31, 2006, as well as lower capital expenditures for exploration and development in the three months ended March 31, 2007 as compared to the same period in 2006. Net cash provided by financing activities in the three months ended March 31, 2007 included net bank proceeds of $42.3 million and proceeds from the exercise of stock options of $1.0 million. Net cash provided by financing activities in the three months ended March 31, 2006 included net bank proceeds of $349.4 million, of which $176.1 million was drawn on a bank credit facility established by Mariner Energy Resources, Inc. in March 2006, immediately prior to the spin-off of the offshore Gulf of Mexico operations. This credit facility and associated liability was included in the spin-off of the offshore Gulf of Mexico operations. The 2006 period also included proceeds from the exercise of stock options of approximately $2.3 million.

Capital Expenditures

Expenditures for property acquisition, exploration, and development were as follows:

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
	(In Thousands)	
Property acquisition costs[1]:		
Proved properties	$	233,886
Unproved properties		51,400
		285,286
Exploration costs:		
Direct costs	40,043	74,145
Overhead capitalized	3,212	4,548
	43,255	78,693
Development costs:		
Direct costs	107,179	103,902
Overhead capitalized	4,995	6,513
	112,174	110,415
Total capital expenditures for property acquisition, exploration, and development[1] [2]	$ 155,429	474,394

(1) Total capital expenditures include both cash expenditures and accrued expenditures.

(2) Does not include the effect of estimated discounted asset retirement obligations.

For the three months ended March 31, 2007, expenditures for exploration and development activities totaled $155 million. Forest's anticipated expenditures for exploration and development in 2007 are estimated to range from $480 million to $520 million. Some of the factors impacting the level of capital expenditures in 2007 include crude oil and natural gas prices, the volatility in these prices, the cost and availability of oil field services, and weather disruptions.

Forward-Looking Statements

The information in this Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements, other than statements of historical facts or present facts, that address activities, events, outcomes, and other matters that Forest plans, expects, intends, assumes, believes, budgets, predicts, forecasts, projects, estimates, or anticipates (and other similar expressions) will, should, or may occur in the future are forward-looking statements. Generally, the words "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," variations of such words and similar expressions identify forward-looking statements, and any statements regarding Forest's future financial condition, results of operations and business, are also forward-looking statements. These forward-looking statements are based on our current expectations and assumptions about future events and are based on currently available information as to the outcome and timing of future events. When considering forward-looking statements, you should keep in mind the risk factors and other cautionary statements described under the heading "Risk Factors" included in Part I of our 2006 Annual Report on Form 10K.

These forward-looking statements appear in a number of places and include statements with respect to, among other things:

- estimates of our oil and gas reserves;
- estimates of our future natural gas and liquids production, including estimates of any increases in oil and gas production;
- the amount, nature and timing of capital expenditures, including future development costs, and availability of capital resources to fund capital expenditures;
- the amount, nature and timing of any synergies or other benefits expected to result from acquisitions, including the proposed merger with Houston Exploration;
- our outlook on oil and gas prices;
- the impact of political and regulatory developments;
- our future financial condition or results of operations and our future revenues and expenses; and
- our business strategy and other plans and objectives for future operations.

We caution you that these forward-looking statements are subject to all of the risks and uncertainties, most of which are difficult to predict and many of which are beyond our control, incident to the exploration for and development, production, and sale of oil and gas. These risks include, but are not limited to, commodity price volatility, inflation, lack of availability of drilling and production equipment and services, environmental risks, drilling and other operating risks, regulatory changes, the uncertainty inherent in estimating proved oil and natural gas reserves and in projecting future rates of production, cash flow and access to capital, the timing of development expenditures, and the other risks described in the Form 10-K under the caption "Risk Factors." The financial results of our foreign operations are also subject to currency exchange rate risks.

Reserve engineering is a process of estimating underground accumulations of oil and natural gas that cannot be measured in an exact way. The accuracy of any reserve estimate depends on the quality of available data, the interpretation of such data, and price and cost assumptions made by reservoir engineers. In addition, the results of drilling, testing, and production activities may justify revisions of estimates that were made previously. If significant, such revisions would change the schedule of any further production and development drilling. Accordingly, reserve estimates may differ significantly from the quantities of oil and natural gas that are ultimately recovered.

Factors that could cause actual results to differ materially from those contemplated by the forward-looking statements include, among others, the following factors related to the proposed merger with Houston Exploration:

- the ability to consummate the merger;
- difficulties and delays in achieving synergies and cost savings from the merger; and
- potential difficulties in meeting conditions set forth in the merger agreement.

Should one or more of the risks or uncertainties described above or elsewhere in this Form 10-Q occur, or should underlying assumptions prove incorrect, our actual results and plans could differ materially from those expressed in any forward-looking statements.

All forward-looking statements, expressed or implied, included in this Form 10-Q and attributable to Forest are expressly qualified in their entirety by this cautionary statement. This cautionary statement should also be considered in connection with any subsequent written or oral forward-looking statements that Forest or persons acting on its behalf may issue. Forest does not undertake to update any forward-looking statements to reflect events or circumstances after the date of filing this Form 10-Q with the Securities and Exchange Commission, except as required by law.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk, including the effects of adverse changes in commodity prices, foreign currency exchange rates, and interest rates as discussed below.

Commodity Price Risk

We produce and sell natural gas, crude oil, and natural gas liquids for our own account in the United States and Canada. As a result, our financial results are affected when prices for these commodities fluctuate. Such effects can be significant. In order to reduce the impact of fluctuations in prices on our revenues, or to protect the economics of property acquisitions, we make use of an oil and gas hedging strategy. Under our hedging strategy, we enter into commodity swaps, collars, and other financial instruments with counterparties who, in general, are participants in our credit facilities. These arrangements, which are based on prices available in the financial markets at the time the contracts are entered into, are settled in cash and do not require physical deliveries of hydrocarbons.

Swaps

In a typical commodity swap agreement, we receive the difference between a fixed price per unit of production and a price based on an agreed upon published, third-party index if the index price is lower than the fixed price. If the index price is higher, we pay the difference. By entering into swap agreements, we effectively fix the price that we will receive in the future for the hedged production. Our current swaps are settled in cash on a monthly basis. As of March 31, 2007, we had entered into the following swaps:

	Swaps					
	Natural Gas (NYMEX HH)			Oil (NYMEX WTI)		
	Bbtu per Day	Weighted Average Hedged Price per MMBtu	Fair Value (In Thousands)	Barrels per Day	Weighted Average Hedged Price per Bbl	Fair Value (In Thousands)
Second Quarter 2007	60	$ 7.88	$ 1,099	7,000	$ 70.03	$ 1,604
Third Quarter 2007	60	7.88	(1,162)	7,000	70.03	570
Fourth Quarter 2007	60	7.88	(5,680)	7,000	70.03	191
Calendar 2008				6,500	69.72	(783)
Calendar 2009				4,500	69.01	15
Calendar 2010				1,500	72.95	2,846

Forest also uses basis swaps in connection with natural gas swaps in order to fix the price differential between the NYMEX price and the index price at which the hedged gas is sold. At March 31, 2007, there were three basis swaps in place covering 35.0 Bbtu per day in 2007 with a fair market value of $.1 million.

Collars

Forest also enters into collar agreements with third parties. A collar agreement is similar to a swap agreement, except that we receive the difference between the floor price and the index price only if the index price is below the floor price; and we pay the difference between the ceiling price and the index price only if the index price is above the ceiling price. As of March 31, 2007, we had entered into the following collars:

	Costless Collars					
	Natural Gas (NYMEX HH)			Oil (NYMEX WTI)		
	Bbtu per Day	Weighted Average Hedged Floor and Ceiling Price per MMBtu	Fair Value (In Thousands)	Barrels per Day	Weighted Average Hedged Floor and Ceiling Price per Bbl	Fair Value (In Thousands)
Second Quarter 2007	35	$ 8.76/11.70	$ 3,769	4,000	$ 65.81/87.18	$ 666
Third Quarter 2007	35	8.76/11.70	3,327	4,000	65.81/87.18	971
Fourth Quarter 2007	35	8.76/11.70	2,142	4,000	65.81/87.18	1,050
Calendar 2008	10	7.75/9.57	(814)			

Three-Way Collars

Forest also enters into three-way collars with third parties. These instruments establish two floors and one ceiling. Upon settlement, if the index price is below the lowest floor, Forest receives the difference between the two floors. If the index price is between the two floors, Forest receives the difference between the higher of the two floors and the index price. If the index price is between the higher floor and the ceiling, Forest does not receive or pay any amounts. If the index price is above the ceiling, Forest pays the excess over the ceiling price. As of March 31, 2007, we had entered into the following three-way collars:

	Three-Way Costless Collars		
	Natural Gas (NYMEX HH)		
	Bbtu per Day	Weighted Average Hedged Lower Floor, Upper Floor, and Ceiling Price per MMBtu	Fair Value (In Thousands)
Calendar 2008	20	$ 6.00/8.00/10.00	$ (1,667)

The fair value of our commodity derivative instruments based on the futures prices quoted on March 31, 2007 was a net asset of approximately $8.2 million.

In April 2007, the Company entered into an additional collar agreement. The table below sets forth the weighted average terms of the agreement.

	Costless Collar	
	Natural Gas (NYMEX HH)	
	Bbtu per Day	Weighted Average Hedged Floor and Ceiling Price per MMBtu
Calendar 2008	10	$ 8.00/10.50

Interest Rate Swaps

In fulfillment of requirements required by the term loan agreements, Forest Alaska entered into two floating to fixed interest rate swaps. In March 2007, Forest Alaska entered into a $75 million floating to fixed interest rate swap for three years at a one month LIBOR fixed rate of 4.80%. At March 31, 2007, the fair value of Forest Alaska's interest rate derivative contract was an asset of $.1 million. In April 2007, Forest Alaska entered into a $112.5 million floating to fixed interest rate swap for three years at a one month LIBOR fixed rate of 4.96%.

Back to Index

eResearchTechnology, Inc. and Subsidiaries
Consolidated Balance Sheets

	December 31,	
	2002	**2003**
Assets		
Current Assets:		
Cash and cash equivalents	$ 17,443,000	$ 38,364,000
Short-term investments	9,307,000	13,558,000
Accounts receivable, net	6,954,000	13,947,000
Prepaid expenses and other	2,542,000	2,219,000
Deferred income taxes	485,000	277,000
Total current assets	36,731,000	68,365,000
Property and equipment, net	12,587,000	16,416,000
Goodwill	1,212,000	1,212,000
Investments in non-marketable securities	509,000	509,000
Other assets	21,000	168,000
Deferred income taxes	2,332,000	5,308,000
	$ 53,392,000	$ 91,978,000
Liabilities and Stockholders Equity		
Current Liabilities:		
Accounts payable	$ 2,000,000	$ 3,513,000
Accrued expenses	3,705,000	4,446,000
Income taxes payable	960,000	1,584,000
Current portion of capital lease obligations	599,000	644,000
Deferred revenues	4,774,000	12,401,000
Total current liabilities	12,038,000	22,588,000
Capital lease obligations, excluding current portion	774,000	131,000
Commitments and contingencies (Note 9)		
Stockholders Equity:		
Preferred stock $10.00 par value, 500,000 shares authorized, none issued and outstanding		
Common stock $.01 par value, 50,000,000 shares authorized, 34,386,573 and 36,490,609 shares issued and outstanding, respectively	344,000	365,000
Additional paid-in capital	40,692,000	54,420,000
Accumulated other comprehensive income	410,000	1,038,000
Retained earnings	2,363,000	16,826,000
Treasury stock, 2,686,500 and 2,708,346 shares at cost	(3,229,000)	(3,390,000)
Total stockholders equity	40,580,000	69,259,000
	$ 53,392,000	$ 91,978,000

The accompanying notes are an integral part of these statements.

Back to Index

eResearchTechnology, Inc. and Subsidiaries
Consolidated Statements of Operations

	Year Ended December 31,		
	2001	**2002**	**2003**
Net revenues:			
Licenses	$ 1,372,000	$ 2,119,000	$ 5,738,000
Services	26,625,000	39,407,000	61,104,000
Total net revenues	27,997,000	41,526,000	66,842,000
Costs of revenues:			
Cost of licenses	576,000	896,000	658,000
Cost of services	12,388,000	17,117,000	24,083,000
Total costs of revenues	12,964,000	18,013,000	24,741,000
Gross margin	15,033,000	23,513,000	42,101,000
Operating expenses:			
Selling and marketing	5,427,000	6,719,000	7,763,000
General and administrative	5,188,000	5,695,000	6,804,000
Research and development	4,865,000	4,256,000	4,564,000
Total operating expenses	15,480,000	16,670,000	19,131,000
Operating income (loss)	(447,000)	6,843,000	22,970,000
Other income, net	941,000	868,000	310,000
Investment impairment charge	(5,686,000)	—	—
Gain on sale of domestic CRO operation	1,422,000	35,000	—
Income (loss) before income taxes	(3,770,000)	7,746,000	23,280,000
Income tax provision (benefit)	(112,000)	1,596,000	8,817,000
Minority interest dividend	116,000	—	—
Net income (loss)	$ (3,774,000)	$ 6,150,000	$ 14,463,000
Basic net income (loss) per share	$ (0.12)	$ 0.20	$ 0.44
Diluted net income (loss) per share	$ (0.12)	$ 0.18	$ 0.40
Shares used to calculate basic net income (loss) per share	31,254,000	31,443,000	32,974,000
Shares used to calculate diluted net income (loss) per share	31,254,000	33,873,000	36,022,000

The accompanying notes are an integral part of these statements.

Back to Index

eResearchTechnology, Inc. and Subsidiaries
Consolidated Statements of Stockholders’ Equity

	Common Stock		Additional	Accumulated Other	Retained Earnings		
	Shares	Amount	Paid-in Capital	Comprehensive Income (Loss)	(Accumulated Deficit)	Treasury Stock	Total
Balance, December 31, 2000	33,618,093	$ 336,000	$ 38,600,000	$ (2,042,000)	$ (13,000)	$ (2,711,000)	$ 34,170,000
Comprehensive income (loss)							
Net loss	—	—	—	—	(3,774,000)	—	(3,774,000)
Reclassification adjustment for investment impairment losses on marketable securities	—	—	—	2,042,000	—	—	2,042,000
Unrealized gain on marketable securities	—	—	—	665,000	—	—	665,000
Total comprehensive loss	—	—	—	2,707,000	(3,774,000)	—	(1,067,000)
Purchase of treasury stock	—	—	—	—	—	(518,000)	(518,000)
Tax benefit from exercise of non-qualified stock options	—	—	10,000	—	—	—	10,000
Issuance of common stock options to non‑employee	—	—	29,000	—	—	—	29,000
Exercise of stock options	90,000	1,000	167,000	—	—	—	168,000
Balance, December 31, 2001	33,708,093	337,000	38,806,000	665,000	(3,787,000)	(3,229,000)	32,792,000
Comprehensive income (loss)							
Net income	—	—	—	—	6,150,000	—	6,150,000
Currency translation adjustment	—	—	—	410,000	—	—	410,000
Reclassification adjustment for unrealized gain on marketable securities	—	—	—	(665,000)	—	—	(665,000)
Total comprehensive income (loss)	—	—	—	(255,000)	6,150,000	—	5,895,000
Tax benefit from exercise of non-qualified stock options	—	—	686,000	—	—	—	686,000
Issuance of common stock options to non‑employee	—	—	42,000	—	—	—	42,000
Cancellation of fractional shares related to stock splits	(95)	—	—	—	—	—	—

Exercise of stock options	678,575	7,000	1,158,000	—	—	—	1,165,000
Balance, December 31, 2002	34,386,573	344,000	40,692,000	410,000	2,363,000	(3,229,000)	40,580,000
Comprehensive income							
Net income	—	—	—	—	14,463,000	—	14,463,000
Currency translation adjustment	—	—	—	628,000	—	—	628,000
Total comprehensive income	—	—	—	628,000	14,463,000	—	15,091,000
Tax benefit from exercise of non-qualified stock options	—	—	9,903,000	—	—	—	9,903,000
Cancellation of fractional shares related to stock splits	(2,416)	—	(46,000)	—	—	—	(46,000)
Exercise of stock options	2,106,452	21,000	3,871,000	—	—	(161,000)	3,731,000
Balance, December 31, 2003	36,490,609	$ 365,000	$ 54,420,000	$ 1,038,000	$ 16,826,000	$ (3,390,000)	$ 69,259,000

The accompanying notes are an integral part of these statements.

Back to Index

eResearchTechnology, Inc. and Subsidiaries
Consolidated Statements of Cash Flows

	Year Ended December 31,		
	2001	**2002**	**2003**
Operating activities:			
Net income (loss)	$ (3,774,000)	$ 6,150,000	$ 14,463,000
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Gain on sale of domestic CRO operation	(1,422,000)	(35,000)	—
Gain on sale of marketable securities	—	(419,000)	—
Depreciation and amortization	1,775,000	3,104,000	5,306,000
Issuance of stock options to non-employees	29,000	42,000	—
Stock option income tax benefits	—	686,000	9,895,000
Investment impairment charge	5,686,000	—	—
Changes in operating assets and liabilities:			
Accounts receivable	911,000	(932,000)	(6,731,000)
Prepaid expenses and other	1,287,000	(1,325,000)	155,000
Accounts payable	(362,000)	599,000	1,484,000
Accrued expenses	(810,000)	1,289,000	720,000
Income taxes	(310,000)	441,000	(2,258,000)
Deferred revenues	(22,000)	1,263,000	7,533,000
Net cash provided by operating activities	2,988,000	10,863,000	30,567,000
Investing activities:			
Purchases of property and equipment	(4,633,000)	(6,191,000)	(8,887,000)
Purchases of short-term investments	(8,213,000)	(4,057,000)	(12,435,000)
Proceeds from sales of short-term investments	6,894,000	1,816,000	8,184,000
Net proceeds from sale of domestic CRO operation	3,039,000	35,000	—
Proceeds from sales of marketable securities	—	2,449,000	—
Net cash used in investing activities	(2,913,000)	(5,948,000)	(13,138,000)
Financing activities:			
Purchase of convertible preferred stock in subsidiary	(9,500,000)	—	—
Repayment of capital lease obligations	(12,000)	(459,000)	(601,000)
Minority interest dividend paid	(639,000)	—	—
Proceeds from exercise of stock options	48,000	1,285,000	3,685,000
Repurchase of common stock for treasury	(518,000)	—	—
Net cash provided by (used in) financing activities	(10,621,000)	826,000	3,084,000
Effect of exchange rate changes on cash	—	338,000	408,000
Net increase (decrease) in cash and cash equivalents	(10,546,000)	6,079,000	20,921,000
Cash and cash equivalents, beginning of period	21,910,000	11,364,000	17,443,000
Cash and cash equivalents, end of period	$ 11,364,000	$ 17,443,000	$ 38,364,000

The accompanying notes are an integral part of these statements.

Back to Index

eResearchTechnology, Inc. and Subsidiaries
Notes To Consolidated Financial Statements

1. Background and Summary of Significant Accounting Policies:

Background

eResearchTechnology, Inc. (the Company), a Delaware corporation, is a provider of technology and services that enables the pharmaceutical, biotechnology and medical device industries to collect, interpret and distribute cardiac safety and clinical data more efficiently. The Company is a market leader in providing centralized electrocardiographic services (Cardiac Safety services or EXPeRT eECG services) and a leading provider of technology and services that streamline the clinical trials process by enabling its clients to evolve from traditional, paper-based methods to electronic processing using our Clinical Data Management products and services.

The Company was founded in 1977 to provide Cardiac Safety services used to evaluate the safety of new drugs. In February 1997, the Company completed an initial public offering of its common stock. In October 1997, the Company acquired the assets and business of a provider of clinical data management technology and consulting services to the pharmaceutical, biotechnology and medical device industries. In the second half of 1999, the Company closed its international Clinical Research Organization (CRO) operation, including clinical trial and data management services, and in December 1999 sold its domestic CRO operation to SCP Communications, Inc.

The Companys solutions improve the accuracy, timeliness and efficiency of trial set-up, data collection and interpretation and new drug, biologic and device application submission. The Company offers Cardiac Safety services, which are utilized by clinical trial sponsors and CROs during their conduct of clinical trials, including comprehensive Thorough Phase I ECG studies. Services may be provided through the Digital ECG Franchise program, which offers a unique approach designed to address the growing capacity demands for the Companys ECG services through partnerships with sponsors that desire dedicated resources within the Company to address specific levels of cardiac safety monitoring transactions. Additionally, the Company offers the licensing and/or hosting of its proprietary Clinical Data Management software products and the provision of maintenance and consulting services in support of its proprietary Clinical Data Management software products.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Reclassifications

The consolidated financial statements for prior periods have been reclassified to conform to the current periods presentation.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenues

The Companys license revenues consist of license fees for perpetual license sales and monthly and annual license sales. The Companys services revenues consist of Cardiac Safety services, technology consulting and training services and software maintenance services.

The Company recognizes software revenues in accordance with Statement of Position 97-2, Software Revenue Recognition, as amended by Statement of Position 98-9. Accordingly, the Company recognizes up-front license fee revenues under the residual method when a formal agreement exists, delivery of the software and related documentation has occurred, collectability is probable and the license fee is fixed or determinable. The Company recognizes monthly and annual license fee revenues over the term of the arrangement. Hosting service fees are recognized evenly over the term of service. Cardiac Safety services revenues consist of revenues that the Company provides on a fee for services basis as well as revenues from the rental of cardiac safety equipment. Such revenues are recognized as the services are performed or over the rental period. The Company recognizes revenues from software maintenance contracts on a straight-line basis over the term of the maintenance contract, which is typically twelve months. The Company provides consulting and training services on a time and materials basis and recognizes revenues as it performs the services.

For arrangements with multiple deliverables where the fair value of each element is known, the revenue is allocated to each component based on the relative fair values of each element. For arrangements with multiple deliverables where the fair value of the delivered element is not known, revenue is allocated to each component of the arrangement using the residual value method based on the fair value of the undelivered elements, which is specific to us. Fair values for undelivered elements are based primarily upon stated renewal rates for future products or services.

The Company has recorded reimbursements received for out-of-pocket expenses incurred as revenue in the accompanying consolidated financial statements for the years ended December 31, 2002 and 2003 in accordance with Emerging Issues Task Force (EITF) Issue No. 01-14, Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses. The Company has deemed reclassification for the year ended December 31, 2001 to be immaterial to the consolidated financial statements.

Cash and Cash Equivalents
The Company considers cash on deposit with financial institutions and all highly liquid investments with a purchased maturity of three months or less to be cash equivalents. At the balance sheet dates, cash equivalents consisted primarily of investments in money market funds, municipal securities and bonds of government sponsored agencies.

Short-Term Investments
At December 31, 2003, short-term investments consisted of municipal securities and bonds of government sponsored agencies with maturities of less than one year. Pursuant to Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities, available-for-sale securities are carried at fair value, based on quoted market prices, with unrealized gains and losses reported as a separate component of stockholders equity. The Company has classified all of its short-term investments at December 31, 2003 as available-for-sale. At December 31, 2002 and 2003, unrealized gains and losses were immaterial. Realized gains and losses during 2001, 2002 and 2003 were immaterial. For the purpose of determining realized gains and losses, the costs of the securities sold is based upon specific identification.

Marketable Securities
In March 2001, in accordance with SFAS No. 115, management determined the decline in the fair value of the common stock of Digital Angel Corporation (DAC), a publicly traded company, to be other than temporary, and as a result wrote down the cost basis to $2,029,000, which was the market value of the DAC common stock held on March 31, 2001. In connection with this write-down, an investment impairment charge of $3,746,000 was recorded during the quarter ended March 31, 2001. During the year ended December 31, 2002, the Company sold all of its investment in DAC at prices per share of between $2.30 and $6.88 and recorded a realized gain of $419,000.

Investments in Non-Marketable Securities
In July 1998, the Company paid $1,000,000 for a minority equity position in AmericasDoctor.com, Inc. This investment is accounted for under the cost method. In 1999, in connection with the merger of AmericasDoctor.com, Inc. with Affiliated Research Centers, Inc. (Affiliated Research), the Company invested an additional $1,500,000 in AmericasDoctor.com, Inc. During 2000, the carrying value of the Companys

Back to Index

investment was reduced by $200,000 as the result of proceeds received to buy out the Company's exclusive right to patient data under the original investment agreement. In 2001, in accordance with Accounting Principles Board (APB) Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," management determined that a decrease in the value of the investment occurred which was deemed to be other than temporary, and as a result wrote down the cost basis of the investment to $509,000. In connection with this write-down, an investment impairment charge of $1,790,000 was recorded during 2001.

The Company will continue to assess the fair value of this investment and whether or not any decline in fair value below the current cost basis is deemed to be other than temporary. If a decline in the fair value of this investment is judged to be other than temporary, the cost basis of this investment would be written down to fair value, and the amount of the write-down would be included in the Company's results. Given the current performance and general market conditions for technology related companies, additional write-downs of this investment may occur in the future.

In 2000, the Company made an investment in INNX, Inc. (INNX) of $150,000 for 2,706 shares of Series A preferred stock. In December 2001, in accordance with APB Opinion No. 18, management determined that a decrease in the value of the investment occurred that was deemed to be other than temporary, and as a result wrote off the entire cost basis of the investment. In connection with this write-off, an investment impairment charge of $150,000 was recorded during the quarter ended December 31, 2001.

Property and Equipment
Property and equipment are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the assets ranging from two to five years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the remaining lease term. Repair and maintenance costs are expensed as incurred. Improvements and betterments are capitalized. Pursuant to Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," the Company capitalizes costs associated with internally developed and/or purchased software systems for new products and enhancements to existing products that have reached application development stage and meet recoverability tests. These costs are included in property and equipment. Capitalized costs include external direct costs of materials and services utilized in developing or obtaining internal-use software, and payroll and payroll-related expenses for employees who are directly associated with and devote time to the internal-use software project. During the years ended December 31, 2001, 2002 and 2003, $2,356,000, $2,361,000 and $1,610,000, respectively, of these costs have been capitalized. As of December 31, 2003, $1,243,000 of capitalized costs have not yet been placed in service and are therefore not being amortized. The Company accelerated the amortization of certain internal use software costs due to an upgrade replacement that is scheduled to take place in 2005. The majority of these costs were to be amortized through August 2006. Amortization of capitalized software development costs was $0, $420,000 and $1,434,000 for the years ended December 31, 2001, 2002 and 2003, respectively, and is charged to cost of Cardiac Safety services. Gains or losses on the disposition of property and equipment are included in operations. Depreciation expense was $1,459,000, $2,264,000 and $3,876,000 for the years ended December 31, 2001, 2002 and 2003, respectively.

Goodwill
Effective January 1, 2002, the Company adopted the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 142 addresses the financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." Under SFAS No. 142, goodwill and other intangible assets with indefinite lives are not amortized but are subject to tests for impairment at least annually. In accordance with the provisions of SFAS No. 142, the Company ceased the amortization of goodwill effective January 1, 2002. Prior to the adoption of SFAS No. 142, the Company amortized goodwill over eight years. Amortization expense was $316,000 for the year ended December 31, 2001.

Back to Index

The following table provides reconciliations of reported and adjusted net income (loss) and basic and diluted net income (loss) per share as if SFAS No. 142 had been adopted as of January 1, 2001:

	Year Ended December 31,		
	2001	**2002**	**2003**
Reported net income (loss)	$ (3,774,000)	$ 6,150,000	$ 14,463,000
Add back goodwill amortization, net of tax	209,000	—	—
Adjusted net income (loss)	$ (3,565,000)	$ 6,150,000	$ 14,463,000
Income (loss) per share — basic:			
Reported net income (loss)	$ (0.12)	$ 0.20	$ 0.44
Add back goodwill amortization, net of tax	0.01	—	—
Adjusted net income (loss)	$ (0.11)	$ 0.20	$ 0.44
Income (loss) per share — diluted:			
Reported net income (loss)	$ (0.12)	$ 0.18	$ 0.40
Add back goodwill amortization, net of tax	0.01	—	—
Adjusted net income (loss)	$ (0.11)	$ 0.18	$ 0.40

In accordance with the provisions of SFAS No. 142, the Company was required to perform a transitional goodwill impairment test by June 30, 2002. In addition, SFAS No. 142 requires that the Company perform an impairment test annually or more frequently if events or circumstances indicate that the value of goodwill might be impaired. No goodwill impairments were recorded as a result of the SFAS No. 142 transitional impairment test or the annual impairment test completed during the fourth quarter of fiscal 2002 and 2003.

When it is determined that the carrying value of goodwill may not be recoverable based upon the existence of one or more indicators of impairment, measurement of any impairment will be based on a projected discounted cash flow method using a discount rate commensurate with the risk inherent in the current business model.

Long-lived Assets
The Company continually evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision or that the remaining balance of long-lived assets may not be recoverable. If factors indicate that long- lived assets should be evaluated for possible impairment, the Company would use an estimate of the related undiscounted cash flows in measuring whether long-lived assets should be written down to their fair value, in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Management believes that there has been no impairment of long-lived assets as of December 31, 2003.

Accrued Expenses
Included in accrued expenses at December 31, 2002 and 2003 was accrued compensation of $1,890,000 and $2,725,000, respectively.

Software Development Costs
Research and development expenditures are charged to operations as incurred. SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," requires the capitalization of certain software development costs subsequent to the establishment of technological feasibility. Since software development costs have not been significant after the establishment of technological feasibility, all such costs have been charged to expense as incurred.

Advertising Costs

The Company expenses advertising costs as incurred. Advertising expense for the years ended December 31, 2001, 2002 and 2003 was $916,000, $1,195,000 and $947,000, respectively.

Back to Index

Stock-Based Compensation

The Company applies APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations for stock options and other stock-based awards while disclosing pro forma net income (loss) and net income (loss) per share as if the fair value method had been applied in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation.," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure."

No stock-based employee compensation cost is reflected in net income (loss), as all options granted had an exercise price at least equal to the market value of the underlying common stock on the date of the grant. Had compensation cost for the Company's stock option plans been determined based upon the fair value of the options at the date of grant, as prescribed under SFAS No. 123, the Company's net income (loss) and basic and diluted net income (loss) per share would have been adjusted to the following pro forma amounts:

	Year Ended December 31,		
	2001	**2002**	**2003**
Net income (loss), as reported	$ (3,774,000)	$ 6,150,000	$ 14,463,000
Deduct: Net stock-based employee compensation expense determined under fair value based method, net of related tax effects	(2,271,000)	(1,203,000)	(1,985,000)
Pro forma net income (loss)	$ (6,045,000)	$ 4,947,000	$ 12,478,000
Earnings per share:			
Basic - as reported	$ (0.12)	$ 0.20	$ 0.44
Basic - pro forma	$ (0.19)	$ 0.16	$ 0.38
Diluted - as reported	$ (0.12)	$ 0.18	$ 0.40
Diluted - pro forma	$ (0.19)	$ 0.15	$ 0.35

The weighted average fair value per share of the Company's options granted during 2001, 2002 and 2003 was estimated as $0.88, $2.24, and $4.56, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2001	**2002**	**2003**
Risk-free interest rate	4.65%	3.19%	2.05%
Expected dividend yield	0.00%	0.00%	0.00%
Expected life	3 years	3 years	3 years
Expected volatility	93.68%	76.90%	69.21%

The effects of applying SFAS No. 123 in the pro forma disclosure may not be representative of future disclosures since the estimated fair value of stock options is amortized to expense over the vesting period and additional options may be granted in future years.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to the tax effects of operating loss and credit carryforwards and differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Other Income, Net

Other income, net consists primarily of earnings on cash, cash equivalents and short-term investments, net of interest expense related to capital lease obligations. Additionally, in 2002, the Company realized a net gain of $419,000 on the sale of marketable securities and $47,000 of interest income on the escrow account related to the sale of the domestic clinical research operation.

F-12

Back to Index

Supplemental Cash Flow Information
The Company paid $887,000, $1,052,000 and $1,139,000 for income taxes in the years ended December 31, 2001, 2002 and 2003, respectively.

During the years ended December 31, 2001, 2002 and 2003, the Company acquired $507,000, $1,336,000 and $0, respectively, of property and equipment through the execution of capital leases.

Concentration of Credit Risk and Significant Clients
Financial instruments that potentially subject the Company to concentration of credit risk consist primarily of trade accounts receivable from companies operating in the pharmaceutical, biotechnology and medical device industries. For the year ended December 31, 2001, one client accounted for 11.1% of net revenues, and for the year ended December 31, 2002, two clients accounted for 17.3% and 11.6% of net revenues, respectively. For the year ended December 31, 2003, one client accounted for 13.1% of net revenues. The loss of any such client could have a material adverse effect on the Company's operations. The Company maintains reserves for potential credit losses and such losses, in the aggregate, have not historically exceeded management's expectations.

Translation of Foreign Financial Statements
Assets and liabilities of the Company's UK subsidiary are translated at the exchange rate as of the end of each reporting period. The income statement is translated at the average exchange rate for the period. For the year ended December 31, 2002, the Company recorded accumulated foreign currency translation income of $410,000. For the year ended December 31, 2003, the Company recorded foreign currency translation income of $628,000, which increased the accumulated balance to $1,038,000.

Stock Split
On July 16, 2002, the Company effected a 3-for-2 split of its common stock. On May 29, 2003, the Company effected a 2-for-1 split of its common stock and on November 26, 2003, the Company effected a 3-for-2 split of its common stock. All share and per share data have been restated to reflect these splits of the Company's common stock as if the stock splits had occurred as of December 31, 2000.

Net Income (Loss) per Common Share
Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the year. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the year, adjusted for the dilutive effect of common stock equivalents, which consist of stock options, computed using the treasury stock method.

Back to Index

The table below sets forth the reconciliation of the numerators and denominators of the basic and diluted net income per share computations.

Year Ended December 31,	Net Income (Loss)	Shares	Per Share Amount
2001			
Basic net loss	$ (3,774,000)	31,254,000	$ (0.12)
Effect of dilutive shares			
Diluted net loss	$ (3,774,000)	31,254,000	$ (0.12)
2002			
Basic net income	$ 6,150,000	31,443,000	$ 0.20
Effect of dilutive shares		2,430,000	(0.02)
Diluted net income	$ 6,150,000	33,873,000	$ 0.18
2003			
Basic net income	$ 14,463,000	32,974,000	$ 0.44
Effect of dilutive shares		3,048,000	(0.04)
Diluted net income	$ 14,463,000	36,022,000	$ 0.40

In computing diluted net income (loss) per share, 3,745,275, 517,800 and 21,000 options to purchase shares of common stock were excluded from the computations for the years ended December 31, 2001, 2002 and 2003, respectively. The options were excluded from the 2001 computation because their effect would be anti-dilutive. The options were excluded from the 2002 and 2003 computations because the exercise prices of such options were greater than the average market price of the Company's common stock during the respective periods.

Comprehensive Income (Loss)

SFAS No. 130, "Reporting Comprehensive Income," requires companies to classify items of other comprehensive income (loss) by their nature in the financial statements and display the accumulated balance of other comprehensive income (loss) separately from retained earnings and additional paid-in-capital in the stockholders' equity section of the balance sheet. The Company's comprehensive income (loss) includes net income (loss) and unrealized gains and losses from foreign currency translation and marketable securities. For the year ended December 31, 2002, the Company recorded accumulated foreign currency translation income of $410,000. For the year ended December 31, 2003, the Company recorded a foreign currency translation adjustment of $628,000, which increased the accumulated balance to $1,038,000. The foreign currency translation adjustment was immaterial for the year ended December 31, 2001. For the year ended December 31, 2001, the Company recorded an impairment loss and adjusted the mark to market on its investment in marketable securities to an unrealized gain of $665,000. During the year ended December 31, 2002, the Company sold all of its investment in marketable securities and eliminated the unrealized gain of $665,000. The Company recognized a gain of $419,000 on the sale of its investment in marketable securities during 2002.

Recent Pronouncements

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities." The requirements for variable interest entities after January 31, 2003 were adopted on February 1, 2003. The Company's current results of operations and financial position have not been affected. In December 2003, a modification of FIN 46 was issued (FIN 46R) which delayed the effective date until no later than fiscal periods ending after March 31, 2004 and provided additional technical clarifications to implementation issues. The Company currently does not have any variable interest entities as defined in FIN 46R. The adoption of this statement is not expected to have any impact on the Company's consolidated financial statements.

Back to Index

In May 2003, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, (EITF 00-21). EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. It also addresses when and how an arrangement involving multiple deliverables should be divided into separate units of accounting. The guidance in EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of EITF Issue No. 00-21 did not have any impact on the Companys financial statements.

SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, was issued in May 2003. This Statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The Statement also includes required disclosures for financial instruments within its scope. For the Company, the Statement was effective for instruments entered into or modified after May 31, 2003 and otherwise will be effective as of January 1, 2004, except for mandatorily redeemable financial instruments. For certain mandatorily redeemable financial instruments, the Statement will be effective for the Company on January 1, 2005. The effective date has been deferred indefinitely for certain other types of mandatorily redeemable financial instruments. The Company currently does not have any financial instruments that are within the scope of this Statement.

In April 2002, SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections, was issued. SFAS No. 145 amends existing guidance on reporting gains and losses on the extinguishment of debt to prohibit the classification of the gain or loss as extraordinary, as the use of such extinguishments have become part of the risk management strategy of many companies. SFAS No. 145 also amends SFAS No. 13, Accounting for Leases, to require sale-leaseback accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. The provisions of SFAS No. 145 related to the rescission of SFAS No. 4, Reporting Gains and Losses from Extinguishment of Debt, were applied in fiscal years beginning after May 15, 2002. The provisions of SFAS No. 145 related to Statement 13 were effective for transactions occurring after May 15, 2002. The adoption of Statement 145 had no effect on the Companys financial statements.

In June 2002, SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, was issued. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity. The provisions of SFAS No. 146 were effective for exit or disposal activities initiated after December 31, 2002, with early application encouraged. The adoption of SFAS No. 146 did not have any impact on the Companys financial statements.

In November 2002, FASB Interpretation No. 45, Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, was issued. This Interpretation enhances the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees it has issued. The Interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation were applicable to guarantees issued or modified after December 31, 2002 and the disclosure requirements were effective for financial statements of interim or annual periods ending after December 15, 2002. The adoption of FASB Interpretation No. 45 did not have any impact on the Companys financial statements.

In December 2002, SFAS No. 148 was issued. SFAS No. 148 amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements. Disclosures required by this standard are included in the notes to these financial statements.

2. Sale of the Domestic CRO Operation

On December 31, 1999, the Company sold the business and certain of the assets of its domestic CRO operation (the Division), which consisted of clinical trial management and clinical data management operations. The Company received cash consideration of $1,000,000 on December 31, 1999 and $8,000,000 on

Back to Index

January 31, 2000, with additional consideration, if any, payable over time, subject to adjustments and earn-outs. In addition, certain specific liabilities of the Division were assumed by the buyer as part of the transaction. During the years ended December 31, 2001 and 2002, the Company recognized additional pre-tax gain of $1,422,000 and $35,000, respectively, related to the disposition. During the first quarter of 2002, the Company finalized the accounting for the disposition related to certain earn-outs. The escrow account that was established in connection with the transaction has been closed effective as of the last income distribution received by the Company during the first quarter of 2002.

3. Accounts Receivable

The components of accounts receivable are as follows:

	December 31,	
	2002	**2003**
Billed	$ 7,344,000	$ 14,074,000
Unbilled	49,000	240,000
Allowance for doubtful accounts	(439,000)	(367,000)
	$ 6,954,000	$ 13,947,000

4. Property and Equipment

The components of property and equipment are as follows:

	December 31,	
	2002	**2003**
Computer and other equipment	$ 12,855,000	$ 20,383,000
Furniture and fixtures	2,620,000	2,742,000
Leasehold improvements	1,491,000	1,543,000
System development costs	4,717,000	6,327,000
	21,683,000	30,995,000
Less-Accumulated depreciation	(9,096,000)	(14,579,000)
	$ 12,587,000	$ 16,416,000

5. Line of Credit

The Company has a line of credit with a bank, through June 30, 2004, that provides for borrowings up to $3,000,000 at an interest rate of prime minus 35 basis points. The line of credit agreement includes certain covenants, the most restrictive of which limit future indebtedness and require compliance with a liabilities-to-tangible net worth ratio. To date, the Company has not borrowed any amounts under its line of credit.

Back to Index

6. Income Taxes

The income tax provision (benefit) consists of the following:

	Year Ended December 31,		
	2001	**2002**	**2003**
Current provision (benefit):			
Federal	$ (133,000)	$ —	$ 8,752,000
State and local	—	182,000	900,000
Foreign	219,000	995,000	1,933,000
	86,000	1,177,000	11,585,000
Deferred provision (benefit):			
Federal	(198,000)	1,185,000	(3,166,000)
State and local	—	(932,000)	76,000
Foreign	—	166,000	322,000
	(198,000)	419,000	(2,768,000)
	$ (112,000)	$ 1,596,000	$ 8,817,000

Foreign income before income taxes was $730,000, $3,318,000 and $6,443,000 for the years ended December 31, 2001, 2002 and 2003, respectively.

The reconciliation between income taxes at the federal statutory rate and the amount recorded in the accompanying financial statements is as follows:

	Year Ended December 31,		
	2001	**2002**	**2003**
Tax at federal statutory rate	$ (1,282,000)	$ 2,634,000	$ 8,148,000
Increase (decrease) in valuation allowance	2,935,000	(1,074,000)	133,000
State and local taxes, net of federal	(1,002,000)	182,000	976,000
Change in effective rate for deferred assets	486,000	—	—
Federal tax credits	(807,000)	(172,000)	(587,000)
Foreign pre-tax income	(29,000)	33,000	—
Tax-free interest income	(75,000)	(24,000)	(18,000)
Other	(338,000)	17,000	165,000
	$ (112,000)	$ 1,596,000	$ 8,817,000

The components of the Company’s net deferred tax asset are as follows:

	December 31,	
	2002	**2003**
Goodwill amortization	$ 2,099,000	$ 1,982,000
Capitalized R&D expenses	—	3,200,000
Tax credit carryforwards	1,352,000	2,041,000
Net operating loss carryforwards	1,151,000	926,000
Investment impairment	1,791,000	1,845,000

Repatriation of UK earnings	(166,000)	(107,000)
Depreciation	(1,689,000)	(2,419,000)
Reserves and accruals	424,000	395,000
Deferred tax asset before valuation allowance	4,962,000	7,863,000
Valuation allowance	(2,145,000)	(2,278,000)
Net deferred tax asset	$ 2,817,000	$ 5,585,000

F-17

Back to Index

At December 31, 2003, the Company had net operating loss carryforwards for state and local tax purposes of approximately $15,500,000, which will begin to expire in 2004. A valuation allowance of $2,278,000 has been provided as of December 31, 2003 for the capital loss on the investment impairment as well as certain of the Company's state net operating loss carryforwards because of the uncertainty of their realization. At December 31, 2003, the Company had alternative minimum tax credit carryforwards of $188,000, which have no expiration date, and net research and development tax credits of $1,484,000, which begin to expire in 2018. The Company began recognizing a deferred tax liability for undistributed earnings of its UK subsidiary beginning in 2002.

Based on the Company's current and future estimates of pretax earnings, management believes the amount of gross deferred tax assets will more likely than not be realized through future taxable income; therefore, no valuation allowance is necessary with the exception of the capital loss and certain New Jersey state net operating loss carryforwards. New Jersey has suspended the use of net operating loss carryforwards through at least 2003 and management believes it is appropriate to maintain a valuation allowance on these items.

7. Employee Retirement Plan

The Company sponsors a 401(k) savings plan for all eligible employees of the Company. Generally, participants in this plan may contribute a portion of their compensation on either a before-tax basis, or on both a before-tax and after-tax basis. The plan also provides for mandatory and discretionary employer matching contributions at various rates. The cost of benefits under the savings plan totaled $245,000 in 2003, $200,000 in 2002 and $178,000 in 2001.

8. Related Party Transactions

The Company's Chairman, who is a stockholder, is a cardiologist who, in addition to his role as Chief Scientist of the Company, provided medical consulting services to the Company as an independent contractor through his wholly-owned professional corporation during 2001, 2002 and 2003 (see Note 10). Fees incurred under this consulting arrangement approximated $255,000, $389,000 and $394,000 for the years ended December 31, 2001, 2002 and 2003, respectively. At December 31, 2002 and 2003, $245,000 and $76,000, respectively, was owed to the professional corporation in connection with the consulting agreement. The Company amended its consulting agreement with the professional corporation in January 2003 and 2004 (see Note 10).

The Company recognized $180,000 of software maintenance service revenues associated with an agreement with DAC in the year ended December 31, 2001 which was included in the Company's consolidated services revenues.

A director of the Company is a partner of the law firm of Duane Morris LLP, which performs legal services for the Company. Fees paid by the Company for such services were $84,000, $61,000 and $75,000 for the years ended December 31, 2001, 2002 and 2003, respectively.

9. Stock Option Plans

In August 1993, the Company established a nonqualified stock option plan (the "1993 Plan") authorizing the grant of options to acquire up to 4,952,250 shares of the Company's common stock. The purpose of the 1993 Plan was to provide an incentive for key individuals to advance the success of the Company. The options cover the purchase of common stock of the Company at exercise prices determined by the Board of Directors, which were initially set at or above current fair value. Options granted under the 1993 Plan became fully vested 90 days after the Company's 1997 initial public offering and expired five years from the initial public offering date. The 1993 Plan expired in 2003 and no additional options were granted thereunder during 2003, prior to its termination.

In 1996, the Company adopted a stock option plan (the "1996 Plan") that authorized the grant of both incentive and non-qualified options to acquire up to 2,250,000 shares of the Company's common stock. The Company's Board of Directors determined the exercise price of the options under the 1996 Plan. The exercise price of incentive stock options were not below fair value on the grant date. Incentive stock options under the 1996 Plan expire ten years from the grant date and are exercisable in accordance with vesting provisions set by the Board, generally over three to five years. In May 1999, the stockholders approved an amendment to the 1996 Plan that increased the number of shares which could be granted under the 1996 Plan by 2,700,000 to 4,950,000

Back to Index

and provided for an annual option grant of 15,000 shares to each outside director. In April 2001, the stockholders approved an amendment to the 1996 Plan that increased the number of shares which could be granted under the 1996 Plan by 1,350,000 to 6,300,000. No additional options will be granted under this plan in 2004 and thereafter.

In May 2003, the stockholders approved a new stock option plan (the 2003 Plan) that authorized the grant of both incentive and non-qualified options to acquire up to 2,550,000 shares of the Companys common stock. The Compensation Committee of the Companys Board of Directors determines the exercise price of the options under the 2003 Plan. The exercise price of incentive stock options will not be below fair value on the grant date. Incentive stock options under the 2003 Plan expire ten years from the grant date, or at the end of such shorter period as may be designated by the Compensation Committee, and are exercisable in accordance with vesting provisions set by the Compensation Committee, generally over four years.

Information with respect to outstanding options under the Companys plans is as follows:

	Outstanding Shares	Option Price Per Share	Weighted Average Exercise Price
Balance, December 31, 2000	3,342,213	$ 0.51-3.96	$ 2.08
Granted	2,484,519	0.97-2.53	1.45
Exercised	(90,000)	1.33-2.23	1.87
Cancelled	(118,800)	0.97-3.96	2.66
Balance, December 31, 2001	5,617,932	0.51-3.61	1.79
Granted	883,875	3.56-6.32	4.34
Exercised	(678,575)	0.51-4.51	1.72
Cancelled	(452,772)	0.51-4.51	2.72
Balance, December 31, 2002	5,370,460	0.83-6.32	2.15
Granted	1,164,000	8.79-28.96	9.76
Exercised	(2,106,452)	0.83-4.51	1.85
Cancelled	(122,147)	0.97-9.43	5.00
Balance, December 31, 2003	4,305,861	0.83-28.96	4.27

As of December 31, 2003, 1,633,386 options with a weighted average exercise price of $2.91 per share were exercisable and 1,567,500 options were available for future grants under the 2003 Plan.

The following table summarizes information about stock options outstanding at December 31, 2003:

	Outstanding			Exercisable	
Range of Exercise Prices	Number of Options	Weighted Average Remaining Years of Contractual Life	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
$0.00 $2.89	2,541,575	6.8	$ 1.77	1,259,975	$ 1.96
$2.90 $5.79	532,786	7.7	4.05	199,036	3.59
$5.80 $8.69	97,500	8.8	6.32	24,375	6.32
$8.70 $11.58	1,101,000	9.3	9.34	150,000	9.43
$14.48 $17.38	12,000	9.6	16.24		
$26.06 $28.96	21,000	9.8	28.96		

	4,305,861	7.6	4.27	1,633,386	2.91

10. Commitments and Contingencies

Leases
The Company leases office space and certain equipment. While the majority of the leases are operating leases, certain Cardiac Safety equipment is leased under capital leases. Rent expense, net of sublease rentals, for

Back to Index

all operating leases for the years ended December 31, 2001, 2002 and 2003 was $1,687,000, $2,319,000 and $3,149,000, respectively.

The Company leases approximately 39,000 square feet of office space in Philadelphia, Pennsylvania, of which approximately 840 square feet is subleased to a third party. This lease expires in August 2008. The Company leases approximately 31,000 square feet of office space in Bridgewater, New Jersey, which expires in January 2011. The Company leases approximately 9,000 square feet of office space in Peterborough, United Kingdom, which expires in September 2009.

The Company entered into a lease for a facility in Bridgewater, New Jersey, which commenced on May 1, 1999 and expires on April 30, 2006. In 2000, the Company entered into a sublease agreement with a third party to lease this facility, which commenced on February 1, 2001 and expires on April 30, 2006.

Future minimum lease payments as of December 31, 2003 are as follows:

	Capital Leases	Gross Operating Leases	Sublease Income
2004	$ 691,000	$ 3,950,000	$ 328,000
2005	134,000	3,700,000	324,000
2006	—	2,853,000	104,000
2007	—	1,900,000	—
2008	—	1,497,000	—
2009 and thereafter	—	1,957,000	—
	$ 825,000	$ 15,857,000	$ 756,000
Less imputed interest	(50,000)		
Net present value of capital lease obligations	775,000		
Less current installments	(644,000)		
Long-term capital lease obligations, excluding current installments	$ 131,000		

Agreements with the Company’s Management
In addition to an employment agreement with the Company’s Chairman and Chief Scientist, the Company entered into a consulting agreement with his wholly-owned professional corporation commencing May 21, 2001. Either party may terminate the agreement at any time, with or without cause. The consulting agreement relates to the Chairman and Chief Scientist’s capacity as a medical doctor and cardiologist and, among other things, requires him to advise the Company on matters related to the successful operation, marketing and business development of its Cardiac Safety services operations. From inception to December 2002, compensation under the consulting agreement was $180,000 per year plus discretionary bonuses of $48,000 per year and other discretionary bonuses. The consulting agreement was amended effective January 1, 2003 to provide for compensation of $228,000 per year plus discretionary bonuses to be determined by the Compensation Committee of the Company’s Board of Directors. A discretionary bonus of $166,000 was awarded under the consulting agreement for the year ended December 31, 2003. The consulting agreement was further amended effective January 1, 2004 to provide for compensation of $240,000 per year plus discretionary bonuses to be determined by the Compensation Committee of the Company’s Board of Directors.

The Company has entered into an employment agreement with the Company’s Chief Executive Officer effective January 1, 2004. Under this agreement, his employment may be terminated with or without cause (as defined therein) by the Company at any time. In the event that the Company terminates Mr. Esposito’s employment other than for cause or in the event of Mr. Esposito’s death or disability (as defined therein), the Company is obligated to (i) pay Mr. Esposito, in lump sum, one year salary and bonus; (ii) to continue Mr. Esposito’s benefits (as defined therein) for one year; and (iii) accelerate the vesting of all of Mr. Esposito’s stock options, not otherwise vested, to purchase the Company□s Common Stock. The agreement provides that, upon a change of control (as defined therein) of the Company, Mr. Esposito may resign (i) if he is not offered a position

Back to Index

that includes comparable responsibilities, location or compensation or (ii) in Mr. Esposito's sole discretion, within one year after the first anniversary of accepting any position, regardless of the responsibilities, location or compensation of such position. The fact that Mr. Esposito may not be offered the position of Chief Executive Officer following any change of control will not conclusively determine whether the position offered does not include comparable responsibilities. If Mr. Esposito resigns under such circumstances, the Company will be obligated to provide the same benefits to Mr. Esposito as if he was terminated other than for cause. Pursuant to the agreement, Mr. Esposito has agreed, for a period of no less than one year after termination of employment, to refrain from (i) working with a company that directly competes with the Company; and (ii) interfering with the Company's business by soliciting customers or employees.

The Company has entered into employment agreements with each of the other executive officers. Under these agreements, their employment may be terminated with or without cause (as defined therein) by the Company at any time. In the event that the Company terminates an officer's employment other than for cause or in the event of the officer's death or disability (as defined therein), the Company is obligated to continue base salary payments and benefits for between six months and one year. These agreements provide that, upon a change of control (as defined therein) of the Company the officer may resign (i) if the officer is not offered a position that includes comparable responsibilities, authority, location or compensation or (ii) in the officer's sole discretion, within one year after accepting any position, regardless of the responsibilities, authority, location or compensation of such position. If the officer resigns under such circumstances, the Company will be obligated to provide up to one year's base salary and prorated bonus, in one lump sum payment. Pursuant to the agreement, each officer has agreed, for a period of no less than one year after termination of employment, to refrain from (i) working with a company that directly competes with the Company; and (ii) interfering with the Company's business by soliciting customers or employees.

Contingencies

The Company is involved in legal proceedings from time to time in the ordinary course of its business. The Company believes that none of these legal proceedings will have a material adverse effect on its financial condition or results of its operations.

11. Fair Value of Financial Instruments

The Company's financial instruments, including cash and cash equivalents, short-term investments, accounts receivable, accounts payable and capital leases are carried at cost, which approximates fair value due to the relatively short maturity of those instruments.

12. Operating Segments and Geographic Information

Commencing in 2003, the Company considers its operations to consist of one segment. The development of the one segment approach corresponds to the implementation of the Company's refinement in strategic focus in late 2002, and represents management's view of the Company's operations. Prior to 2003, the Company's reportable segments were Cardiac Safety and Clinical Research Technology and Services. All prior periods have been restated to conform to the current-year presentation.

The Company operates on a worldwide basis with two locations in the United States and one location in the United Kingdom, which is categorized below as North America and Europe, respectively.

Back to Index

Geographic information is as follows:

	Year Ended December 31, 2001		
	North America	Europe	Total
License revenues	$ 1,282,000	$ 90,000	$ 1,372,000
Service revenues	20,701,000	5,924,000	26,625,000
Net revenues from external customers	$ 21,983,000	$ 6,014,000	$ 27,997,000
Income (loss) from operations	$ (1,161,000)	$ 714,000	$ (447,000)
Identifiable assets	$ 39,201,000	$ 1,799,000	$ 41,000,000

	Year Ended December 31, 2002		
	North America	Europe	Total
License revenues	$ 2,022,000	$ 97,000	$ 2,119,000
Service revenues	29,608,000	9,799,000	39,407,000
Net revenues from external customers	$ 31,630,000	$ 9,896,000	$ 41,526,000
Income from operations	$ 3,542,000	$ 3,301,000	$ 6,843,000
Identifiable assets	$ 47,368,000	$ 6,024,000	$ 53,392,000

	Year Ended December 31, 2003		
	North America	Europe	Total
License revenues	$ 4,974,000	$ 764,000	$ 5,738,000
Service revenues	47,022,000	14,082,000	61,104,000
Net revenues from external customers	$ 51,996,000	$ 14,846,000	$ 66,842,000
Income from operations	$ 16,574,000	$ 6,396,000	$ 22,970,000
Identifiable assets	$ 83,834,000	$ 8,144,000	$ 91,978,000

13. Quarterly Financial Data (Unaudited)

The quarterly data below includes all adjustments (consisting only of normal recurring adjustments with the exception of those indicated below) that the Company considers necessary for a fair presentation (in thousands, except per share data).

	March 31,		June 30,		September 30,		December 31,	
	2002	2003	2002	2003	2002	2003	2002	2003
Net revenues	$ 8,361	$ 13,583	$ 10,104	$ 14,776	$ 10,924	$ 17,464	$ 12,137	$ 21,019
Gross margin	4,826	8,252	5,946	8,958	5,872	10,973	6,869	13,918
Operating income (a)	850	3,856	1,534	4,325	1,945	6,089	2,514	8,700
Net income (a) (b)	709	2,455	1,170	2,769	1,362	3,873	2,909	5,366
Basic net income per share	$ 0.02	$ 0.08	$ 0.04	$ 0.08	$ 0.04	$ 0.12	$ 0.09	$ 0.16
Diluted net income per share	$ 0.02	$ 0.07	$ 0.03	$ 0.08	$ 0.04	$ 0.11	$ 0.08	$ 0.15

(a) Includes gains on the sale of the Company's domestic CRO of $35 in the quarter ended March 31, 2002.

(b) Includes gain on the sale of marketable securities of $2, $73 and $344 in the quarters ended March 31, 2002, June 30, 2002 and December 31, 2002, respectively.

Back to Index

SCHEDULE II

eResearchTechnology, Inc. and Subsidiaries
VALUATION AND QUALIFYING ACCOUNTS
Allowance for Doubtful Accounts
(in thousands)

	Balance Beginning of Period	Charges to Expense	Deductions from Reserve	Balance End of Period
December 31, 2001	$ 833	—	$ 383	$ 450
December 31, 2002	$ 450	—	$ 11	$ 439
December 31, 2003	$ 439	—	$ 72	$ 367