KBR, INC.
Form 10-K
February 28, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2006

OR

¨ **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 1-33146

KBR, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**20-4536774**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

601 Jefferson Street

Suite 3400

Houston, Texas 77002

(Address of principal executive offices)

Telephone Number - Area code (713) 753-3011

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

Title of each class	Name of each Exchange on which registered
Common Stock par value $0.001 per share	**New York Stock Exchange**

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

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

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

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

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

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 ¨	Accelerated filer ¨	Non-accelerated filer x

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

As of December 29, 2006, the last business day of the first fiscal quarter in which the registrant s Common Stock was listed for trading, the aggregate market value of Common Stock held by nonaffiliates was approximately $837,536,000, determined using the closing price of the Common Stock on the New York Stock Exchange on that date of $26.16 per share.

As of February 22, 2006, there were 167,643,000 shares of KBR, Inc. Common Stock, $0.001 par value per share, outstanding.

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I

Item 1. Business

General

KBR, Inc. (KBR) was incorporated in Delaware on March 21, 2006 as an indirect wholly owned subsidiary of Halliburton Company (Halliburton). KBR was formed to own and operate KBR Holdings, LLC (KBR Holdings), which was contributed to KBR by Halliburton in November 2006. KBR had no operations from the date of its formation to the date of the contribution of KBR Holdings. KBR is a leading global engineering, construction and services company supporting the energy, petrochemicals, government services and civil infrastructure sectors.

We offer our wide range of services through two business segments, Energy and Chemicals (E&C) and Government and Infrastructure (G&I). Although we provide a wide range of services, our business in both our E&C segment and our G&I segment is heavily focused on major projects. At any given time, a relatively few number of projects and joint ventures represent a substantial part of our operations. See Note 9 to the consolidated financial statements for financial information about business segments.

In November 2006, KBR completed an initial public offering of 32,016,000 shares of its common stock (the Offering) at an initial public offering price of $17.00 per share. KBR received net proceeds of $511 million from the offering after underwriting discounts and commissions of which $450 million was used to repay indebtedness owed to subsidiaries of Halliburton under subordinated intercompany notes. Halliburton currently owns 135,627,000 shares, or 81%, of the outstanding common stock of KBR.

On February 26, 2007, Halliburton s board of directors approved a plan under which Halliburton will dispose of its remaining interest in KBR through a tax-free exchange with Halliburton s stockholders pursuant to an exchange offer and, following the completion or termination of the exchange offer, a special pro-rata dividend distribution of any and all of Halliburton s remaining KBR, Inc. shares. In connection with the anticipated exchange offer, KBR will file with the Securities and Exchange Commission (SEC) a registration statement on Form S-4 with respect to the terms and conditions of the exchange offer, and Halliburton will file with the SEC a Schedule TO. The exchange offer will be conditioned on a minimum number of shares being tendered. Any exchange of KBR stock for outstanding shares of Halliburton stock, pursuant to the exchange offer will be registered under the Securities Act of 1933, and such shares of common stock will only be offered and sold by means of a prospectus. The exchange offer and any subsequent spin-off will complete the separation of KBR from Halliburton and will result in two independent companies.

Our Business Segments

Energy and Chemicals. Our E&C segment designs and constructs energy and petrochemical projects, including large, technically complex projects in remote locations around the world. Our expertise includes onshore oil and gas production facilities, offshore oil and gas production facilities, including platforms, floating production and subsea facilities (which we refer to collectively as our offshore projects), onshore and offshore pipelines, liquified natural gas (LNG) and gas-to-liquids (GTL) gas monetization facilities (which we refer to collectively as our gas monetization projects), refineries, petrochemical plants (such as ethylene and propylene) and Syngas, primarily for fertilizer-related facilities. We provide a wide range of Engineering Procurement Construction Commissioning Start-up (EPC-CS) services, as well as program and project management, consulting and technology services.

Government and Infrastructure. Our G&I segment delivers on-demand support services across the full military mission cycle from contingency logistics and field support to operations and maintenance on military bases. In the civil infrastructure market, we operate in diverse sectors, including transportation, waste and water treatment, and facilities maintenance. We provide program and project management, contingency logistics, operations and maintenance, construction management, engineering, and other services to military and civilian branches of governments and private customers worldwide. We currently provide these services in the Middle East to support one of the largest U.S. military deployments since World War II, as well as in other global

Table of Contents

locations where military personnel are stationed. A significant portion of our G&I segment s current operations relate to the support of United States government operations in the Middle East, which we refer to as our Middle East operations.

See Note 9 to the consolidated financial statements for financial information about our business segments.

Our Business Strategy

Our strategy is to create stockholder value by leveraging our competitive strengths and focusing on the many opportunities in the growing end-markets we serve. Key features of our strategy include:

- *Capitalize on leadership positions in growth markets*. We intend to leverage our leading positions in the energy, petrochemicals and government services sectors to grow our market share.

- *Leverage technology portfolio for continued growth*. We intend to capitalize on our E&C segment s portfolio of process and design technologies and experience in the commercial application of these technologies to strengthen and differentiate our service offerings, enhance our competitiveness and increase our profitability.

- *Selectively pursue new projects to enhance profitability and mitigate risk*. We intend to focus our resources on projects and services where we believe we have competitive strengths as part of our efforts to increase our profitability and reduce our execution risk.

- *Maintain a balanced and diversified portfolio*. We seek to maintain a balanced and diversified portfolio of projects across end-markets, services and contract types in order to increase our operating flexibility and reduce our exposure to any particular end-market.

- *Provide global execution on a cost-effective basis*. In order to meet the demands of our global customers, we have developed expertise in positioning our expatriate employees around the world and hiring and training a local workforce. These capabilities benefit virtually all of our programs and projects. We seek to leverage these capabilities to allow us to meet the technical project requirements of a job at a lower cost.

Competition and Scope of Global Operations

Our services are sold in highly competitive markets throughout the world. The principal methods of competition with respect to sales of our services include:

- price;

- service delivery, including the ability to deliver personnel, processes, systems and technology on an as needed, where needed, when needed basis with the required local content and presence;

- health, safety, and environmental standards and practices;

- financial strength;

- service quality;
- warranty;
- breadth of technology and technical sophistication; and
- customer relationships.

We conduct business in over 45 countries. Based on the location of services provided, our operations in countries other than the United States accounted for 86% of our consolidated revenue during 2006, 87% of our consolidated revenue during 2005 and 90% of our consolidated revenue during 2004. Revenue from our operations in Iraq, primarily related to our work for the U.S. government was 45% of our consolidated revenue in

Table of Contents

2006, 50% of our consolidated revenue in 2005 and 45% in 2004. Also, 12% of our consolidated revenue during 2006 and 11% of our consolidated revenue during 2005 was from the United Kingdom. In 2004, no other one geographic location generated greater than 10% of consolidated revenues.

We market substantially all of our services through our servicing and sales organizations. We serve highly competitive industries and we have many substantial competitors. Some of our competitors have greater financial and other resources and access to capital than we do, which may enable them to compete more effectively for large-scale project awards. Since the markets for our services are vast and cross numerous geographic lines, we cannot make a meaningful estimate of the total number of our competitors.

Our operations in some countries may be adversely affected by unsettled political conditions, acts of terrorism, civil unrest, force majeure, war or other armed conflict, expropriation or other governmental actions, inflation, exchange controls and currency fluctuations.

Please read Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Instruments Market Risk and Note 19 to our consolidated financial statements for information regarding our exposures to foreign currency fluctuations, risk concentration, and financial instruments used to minimize our risks.

Significant E&C Projects

The following table summarizes several representative E&C projects currently in progress or recently completed within each of our primary end-markets.

Oil and Gas Production

Project Name	Customer Name	Location	Contract Type	Description
Azeri-Chirag-Gunashli	AIOC	Azerbaijan	Cost-reimbursable	Engineering and procurement services for six offshore platforms, subsea facilities, 600 kilometers of offshore pipeline and onshore terminal upgrades.
In Amenas Gas Development	British Petroleum / Sonatrach	Algeria	Fixed-price	EPC-CS services for gas processing facility, associated pipeline and infrastructure; joint venture with JGC.
Block 18 -Greater Plutonio	British Petroleum Angola	Angola	Cost-reimbursable	EPCm services for a floating production storage and offloading unit and subsea facilities.

3

LNG

Project Name	Customer Name	Location	Contract Type	Description
Tangguh LNG	BP Berau Ltd.	Indonesia	Fixed-price	EPC-CS services for two LNG liquefaction trains; joint venture with JGC and PT Pertafenikki Engineering of Indonesia.
Yemen LNG	Yemen LNG Company Ltd.	Yemen	Fixed-price	EPC-CS services for two LNG liquefaction trains; joint venture with JGC and Technip.
NLNG Trains 4, 5 and 6	Nigeria LNG Ltd.	Nigeria	Fixed-price	EPC-CS services for three LNG liquefaction trains; working through TSKJ joint venture.

GTL

Project Name	Customer Name	Location	Contract Type	Description
Escravos GTL	Chevron Nigeria Ltd. & Nigeria National Petroleum Corp.	Nigeria	Fixed-price	EPC-CS services for a GTL plant producing diesel, naphtha and liquefied petroleum gas; joint venture with JGC and Snamprogetti.
Pearl GTL	Qatar Shell GTL Ltd	Qatar	Cost-reimbursable	Front-end engineering design work and project management for the overall complex and EPCm for the GTL synthesis and utilities portions of the complex; joint venture with JGC.

Petrochemicals

Project Name	Customer Name	Location	Contract Type	Description
Sasol Superflex	Sasol Limited	South Africa	Cost-reimbursable	EPCm and facility commissioning and start-up services for propylene plant using KBR s SUPERFLEX technology.
JUPC ethylene	Jubail United Petrochemicals Corporation	Saudi Arabia	Fixed-price	EPCm for ethylene plant construction and capacity expansion project.
Ethylene/Olefins Facility	Saudi Kayan Petrochemical Company	Saudi Arabia	Fixed-price	Basic process design and EPCm services for a new ethylene facility using SCORE technology

Table of Contents

Refining

Project Name	Customer Name	Location	Contract Type	Description
UE-1 Upgrader Expansion Project	Syncrude Canada Ltd.	Canada	Cost-reimbursable	Recently completed EPCm revamp and greenfield refinery project for the production of Syncrude Sweet Blend.
Jamnagar Refinery Expansion	ExxonMobil	India	Multiple fixed-price contracts	Licensing and basic engineering packages for clean fuels and alkylation units.
Greenfield Refinery Project	Saudi Aramco/ ConocoPhillips	Saudi Arabia	Cost-reimbursable	Program management services including front end engineering development for a new 400,000 barrels per day greenfield refinery

Synthesis Gas / Fertilizer

Project Name	Customer Name	Location	Contract Type	Description
Egypt Ammonia Plant	Egypt Basic Industries Corporation	Egypt	Fixed-price	EPC-CS services for an ammonia plant based on KBR Advanced Ammonia Process technology.

Emerging Markets

Project Name	Customer Name	Location	Contract Type	Description
Orlando Power Project	Southern Company/U.S. Department of Energy	Florida	Cost-reimbursable	Engineering for a power plant 50% funded by the U.S. Department of Energy that will utilize KBR s Transport Gasifier technology.
In Salah Gas	BP	Algeria	Fixed-price	EPC-CS services for a gas field CO_2 sequestration development project.

Significant G&I Projects

The following table summarizes several significant contracts under which our G&I segment is currently providing or has recently provided services.

Contingency Logistics

Project Name	Customer Name	Location	Contract Type	Description
LogCAP III	U.S. Army	Worldwide	Cost-reimbursable	Contingency support services.
PCO Oil South	U.S. Army	Iraq	Cost-reimbursable	Restoration of Iraqi oil fields (southern region).
Restore Iraqi Oil (RIO)	U.S. Army	Iraq	Cost-reimbursable	Restoration of Iraqi oil fields.
AFCAP	U.S. Air Force	Worldwide	Cost-reimbursable	Contingency support services.
TDA	U.K. Ministry of Defence	Worldwide	Fixed-price	Battlefield infrastructure support.
Contingency			Cost-reimbursable	

Support Project	U.S. Department of Homeland Security	United States	Indefinite delivery/indefinite quantity contingency support services.

5

Table of Contents

Operations and Maintenance

Project Name	Customer Name	Location	Contract Type	Description
Balkan Support	U.S. Army	Balkans region	Cost-reimbursable	Theater-level logistics and base operating support services.
Los Alamos National Laboratory	University of California for the U.S. Department of Energy	New Mexico	Cost-reimbursable	Site support services.
Fort Knox	U.S. Air Force	Kentucky	Cost-reimbursable	Base support services.

Construction Management and Engineering

Project Name	Customer Name	Location	Contract Type	Description
CONCAP III	U.S. Navy	Worldwide	Cost-reimbursable	Emergency construction services.
CENTCOM	U.S. Army	Middle East	Combination of fixed-price and cost-reimbursable	Construction of military infrastructure and support facilities.
U.S. Embassy Macedonia	U.S. Department of State	Macedonia	Fixed-price	Design and construction of embassy.
Scottish Water	Scottish Water	Scotland	Cost-reimbursable	Program management of water assets renewal.
Hope Downs DES	Rio Tinto for Hope Downs joint venture	Australia	Cost-reimbursable	EPCm services supporting mine development.

Submarine and Warship Maintenance

Project Name	Customer Name	Location	Contract Type	Description
DML Victorious LOP(R)	U.K. Ministry of Defence	U.K.	Fixed-price	Submarine refuel, refit and maintenance.
DML WSMI (Warship Modernization Initiative)	U.K. Ministry of Defence	U.K.	Cost-reimbursable	Range of engineering, logistics and facilities management tasks mostly at DML s main dockyard site.
CVF (Future Aircraft Carrier)	U.K. Ministry of Defence	U.K.	Cost-reimbursable	Program management of future aircraft carriers.

Table of Contents

Management Consulting and Training

Project Name	Customer Name	Location	Contract Type	Description
Air 87	Australian Aerospace for the Australian Army	Australia	Fixed-price	Helicopter training services throughout the equipment lifecycle.
Air 9000	Australian Aerospace for the Australian Army	Australia	Fixed-price	Helicopter training services to support the acquisition of a new helicopter.

Privately Financed Projects

Project Name	Customer Name	Location	Contract Type	Description
FreightLink Alice Springs-Darwin Railway	Various	Australia	Fixed-price and market rates	Design, build, own, finance and operate railway/freight services.
Heavy Equipment Transporter	U.K. Ministry of Defence	Worldwide	Combination of fixed-price and cost-reimbursable	Own, finance, operate and service battle tank transporter fleet.
Aspire Defence Allenby & Connaught	U.K. Ministry of Defence	U.K.	Combination of fixed-price and cost-reimbursable	Own, finance, upgrade and service army facilities.

Joint Ventures and Alliances

We enter into joint ventures and alliances with other industry participants in order to reduce and diversify risk, increase the number of opportunities that can be pursued, capitalize on the strengths of each party, the relationships of each party with different potential customers, and allow for greater flexibility in choosing the preferred location for our services based on the greatest cost and geographical efficiency. Several examples of these joint ventures and alliances are described below. All joint venture ownership percentages presented are as of December 31, 2006.

We began working with JGC Corporation in 1978 to pursue an LNG project in Malaysia. This relationship was formalized into a gas alliance agreement in 1999, which was renewed in 2005. Under the alliance, KBR and JGC have agreed to jointly promote and market their capabilities in the natural gas industry. Our ownership interest in current projects with JGC varies between 25% and 55% depending on the number of parties involved. The alliance expires in August 2008, but contains a provision contemplating renewals as agreed by the parties. In the last 27 years, the majority of our LNG and GTL projects have been pursued jointly with JGC. KBR and JGC have been awarded twenty-one front-end engineering design and/or EPC-CS contracts for LNG and GTL facilities, and have completed over 30 million metric tons per annum of LNG capacity between 2000 and 2005. We operate this alliance through global hubs in Houston, Yokohama and London. Pursuant to the terms of our gas alliance agreement, if and when the distribution of our common stock by Halliburton to its stockholders occurs the alliance may be terminated by either party. We do not believe any termination of the alliance would result in a material impact to our ability to win LNG or GTL projects, to pursue such projects jointly with JGC in the future, or have a material adverse impact to our financial position or results of operations.

7

In 2002, we entered into a cooperative agreement with ExxonMobil Research and Engineering Company for licensing fluid catalytic cracking technology that was an extension of a previous agreement with Mobil Oil Corporation. Under this alliance, we offer to the industry certain fluid catalytic cracking technology that is available from both parties. We lead the marketing effort under this collaboration, and we co-develop certain new fluid catalytic cracking technology.

M.W. Kellogg Limited (MWKL) is a London-based joint venture that provides full EPC-CS contractor services for LNG, GTL and onshore oil and gas projects. MWKL is owned 55% by us and 45% by JGC. MWKL supports both of its parent companies, on a stand-alone basis or through our gas alliance with JGC, and also provides services to other third party customers. We consolidate MWKL for financial accounting purposes.

TKJ Group is a joint venture consortium consisting of several private limited liability companies registered in Dubai, UAE. The TKJ Group was created for the purpose of trading equipment and the performance of services required for the realization, construction, and modification of maintenance of oil, gas, chemical, or other installations in the Middle East. KBR holds a 33.3% interest in the TKJ Group companies.

TSKJ is a joint venture formed to design and construct large-scale projects in Nigeria. TSKJ s members are Technip, SA of France, Snamprogetti Netherlands B.V., which is a subsidiary of Saipem SpA of Italy, JGC and us, each of which has a 25% interest. TSKJ has completed five LNG production facilities on Bonny Island, Nigeria and is currently working on a sixth such facility. We account for this investment using the equity method of accounting.

Brown & Root-Condor Spa (BRC), a joint venture with Sonatrach and another Algerian company, enhances our ability to operate in Algeria by providing access to local resources. BRC executes work for Algerian and international customers, including Sonatrach. BRC has built oil and gas production facilities and civil infrastructure projects, including hospitals and office buildings. We have a 49% interest in the joint venture. We account for this investment using the equity method of accounting. We have recently been notified by a joint venture partner in BRC that it wishes to dissolve the joint venture. We do not believe that a dissolution of BRC would have a material adverse impact to our financial position or results of operations.

Devonport Management Limited (DML) owns and operates the Devonport Royal Dockyard located in Plymouth, England. We own 51% of DML, Balfour Beatty and Weir Group own the remaining interests. DML provides several services to the United Kingdom Ministry of Defence (MoD), including sole-source contracting for nuclear refitting and refueling of the MoD s nuclear submarine fleet, surface ship maintenance and upgrading, naval base management and operational services. We consolidate DML for financial accounting purposes. We are engaging in discussions with the MoD regarding KBR s ownership in DML and the possibility of reducing or disposing of our interest. Although no decision has been made with respect to a disposition or reduction of our interest in DML, we are supporting a process to identify potential bidders that may have an interest in acquiring our interest in DML. We do not know at this time if the process will result in a disposition or reduction of our interest in DML. Please read *Forward-Looking Information and Risk Factors Risks Related to Our Customers and Contracts Our G&I segment is directly affected by spending and capital expenditures by our customers and our ability to contract with our customers Our separation from Halliburton may adversely affect or result in the loss of our DML joint venture s interest in the operation of the Devonport Royal Dockyard in exchange for the fair value of the interest and the loss of our interest in DML in exchange for the lower of net asset value or fair market value, which could have a material adverse effect on our future prospects, business, results of operations and cash flow and Forward-Looking Information and Risk Factors Risks Related to Our Customers and Contracts Our results of operations depend on the award of new contracts and the timing of the performance of these contracts Our customers and prospective customers will need assurances that our financial stability on a stand-alone basis is sufficient to satisfy their requirements for doing or continuing to do business with them.*

KSL is a joint venture with Shaw Group and Los Alamos Technical, formed to provide support services to the Los Alamos National Laboratory in New Mexico. We are a 55% owner and the managing partner of KSL.

Table of Contents

The joint venture serves as subcontractor to the University of California, which in December 2005 won a rebid for laboratory operatorship. As part of the rebid, the University of California system is required to continue using KSL for support services. This contract has five one-year extension options beginning in 2008. We consolidate KSL for financial accounting purposes.

FreightLink The Alice Springs-Darwin railroad is a privately financed project initiated in 2001 to build, own and operate the transcontinental railroad from Alice Springs to Darwin, Australia and has been granted a 50-year concession period by the Australian government. We provided EPC services and are the largest equity holder in the project with a 36.7% interest, with the remaining equity held by eleven other participants. We account for this investment using the equity method of accounting.

Aspire Defence Allenby-Connaught is a joint venture between us, Mowlem Plc. and a financial investor formed to contract with the MoD to upgrade and provide a range of services to the British Army s garrisons at Aldershot and around the Salisbury Plain in the United Kingdom. We indirectly own a 45% interest in Aspire Defence. In addition, we own a 50% interest in each of the two joint ventures that provide the construction and related support services to Aspire Defence. We account for this investment using the equity method of accounting.

Backlog

Backlog represents the dollar amount of revenue we expect to realize in the future as a result of performing work under multi-period contracts that have been awarded to us. Backlog is not a measure defined by generally accepted accounting principles, and our methodology for determining backlog may not be comparable to the methodology used by other companies in determining their backlog. Backlog may not be indicative of future operating results. Not all of our revenue is recorded in backlog for a variety of reasons, including the fact that some projects begin and end within a short-term period. Many contracts do not provide for a fixed amount of work to be performed and are subject to modification or termination by the customer. The termination or modification of any one or more sizeable contracts or the addition of other contracts may have a substantial and immediate effect on backlog.

We generally include total expected revenue in backlog when a contract is awarded and/or the scope is definitized. For our projects related to unconsolidated joint ventures, we have included in the table below our percentage ownership of the joint venture s backlog. However, because these projects are accounted for under the equity method, only our share of future earnings from these projects will be recorded in our revenue. Our backlog for projects related to unconsolidated joint ventures in our continuing operations totaled $4.4 billion and $2.9 billion at December 31, 2006 and 2005, respectively. We also consolidate joint ventures which are majority-owned and controlled or are variable interest entities in which we are the primary beneficiary. Our backlog included in the table below for projects related to consolidated joint ventures with minority interest includes 100% of the backlog associated with those joint ventures and totaled $3.9 billion at December 31, 2006 and $3.6 billion at December 31, 2005.

For long-term contracts, the amount included in backlog is limited to five years. In many instances, arrangements included in backlog are complex, nonrepetitive in nature, and may fluctuate depending on expected revenue and timing. Where contract duration is indefinite, projects included in backlog are limited to the estimated amount of expected revenue within the following twelve months. Certain contracts provide maximum dollar limits, with actual authorization to perform work under the contract being agreed upon on a periodic basis with the customer. In these arrangements, only the amounts authorized are included in backlog. For projects where we act solely in a project management capacity, we only include our management fee revenue of each project in backlog.

Table of Contents

Backlog(1)(2)

(in millions)	December 31, 2006	December 31, 2005
G&I Middle East Operations	$ 3,066	$ 2,139
G&I DML Shipyard Operations	1,079	1,305
G&I Other	3,658	1,708
E&C Gas Monetization	3,883	3,651
E&C Offshore Projects	130	275
E&C Other	1,700	1,511
Total backlog for continuing operations	$ 13,516	$ 10,589

(1) Our backlog for continuing operations does not include backlog associated with our E&C segment s Production Services group, which we sold in May 2006 and which was accounted for as discontinued operations. Backlog for the Production Services group was $1.2 billion as of December 31, 2005.

(2) Our G&I segment s total backlog from continuing operations attributable to firm orders was $5.7 billion and $3.4 billion as of December 31, 2006 and 2005, respectively. Our G&I segment s total backlog from continuing operations attributable to unfunded orders was $2.1 billion and $1.8 billion as of December 31, 2006 and 2005, respectively.

We estimate that as of December 31, 2006, 52% of our E&C segment backlog and 64% of our G&I segment backlog will be complete within one year. As of December 31, 2006, 43% of our backlog for continuing operations was attributable to fixed-price contracts and 57% was attributable to cost-reimbursable contracts. For contracts that contain both fixed-price and cost-reimbursable components, we characterize the entire contract based on the predominant component. In August 2006, we were awarded a task order for approximately $3.5 billion for our continued services in Iraq through September 2007 under the LogCAP III contract. As of December 31, 2006, our backlog under the LogCAP III contract was $3.0 billion.

Contracts

Our contracts can be broadly categorized as either cost-reimbursable or fixed-price, sometimes referred to as lump-sum. Some contracts can involve both fixed-price and cost-reimbursable elements.

Fixed-price contracts are for a fixed sum to cover all costs and any profit element for a defined scope of work. Fixed-price contracts entail more risk to us because they require us to predetermine both the quantities of work to be performed and the costs associated with executing the work. Although fixed-price contracts involve greater risk than cost-reimbursable contracts, they also are potentially more profitable since the owner/customer pays a premium to transfer many risks to us.

Cost-reimbursable contracts include contracts where the price is variable based upon our actual costs incurred for time and materials, or for variable quantities of work priced at defined unit rates, including reimbursable labor hour contracts. Profit on cost-reimbursable contracts may be based upon a percentage of costs incurred and/or a fixed amount. Cost reimbursable contracts are generally less risky than fixed-price contracts because the owner/customer retains many of the risks.

Our G&I segment provides substantial work under government contracts with the Department of Defense (DoD) and the MoD and other governmental agencies. These contracts include our LogCAP contract and contracts to rebuild Iraq s petroleum industry such as the PCO Oil South contract. If our customer or a government auditor finds that we improperly charged any costs to a contract, these costs are not reimbursable or, if already reimbursed, the costs must be refunded to the customer. If performance issues arise under any of our

Table of Contents

government contracts, the government retains the right to pursue remedies, which could include threatened termination or termination under any affected contract. Furthermore, the government has the contractual right to terminate or reduce the amount of work under certain of our contracts at any time.

Customers

We provide services to a diverse customer base, including international and national oil and gas companies, independent refiners, petrochemical producers, fertilizer producers and domestic and foreign governments. Revenue from the U.S. government, resulting primarily from work performed in the Middle East by our G&I segment, represented 61% of our 2006 consolidated revenue, 65% of our 2005 consolidated revenue, and 67% of our 2004 consolidated revenue. Revenue from the government of the United Kingdom totaled 11% and 9% of consolidated revenue for the years ended December 31, 2006 and 2005, respectively. No other customer represented more than 10% of consolidated revenue in any of these periods.

Raw Materials

Equipment and materials essential to our business are available from worldwide sources. Current market conditions have triggered constraints in the supply chain of certain equipment and materials. We are proactively seeking ways to ensure the availability of equipment and materials as well as manage rising costs. Our procurement department is actively leveraging our size and buying power through several programs designed to ensure that we have access to key equipment and materials at the best possible prices and delivery schedule. Please read, *Forward-Looking Information and Risk Factors Risks Related to Our Customers and Contracts Difficulties in engaging third party subcontractors, equipment manufacturers or materials suppliers or failures by third party subcontractors, equipment manufacturers or materials suppliers to perform could result in project delays and cause us to incur additional costs.*

Intellectual Property

We have developed or otherwise have the right to license leading technologies, including technologies held under license from third parties, used for the production of a variety of petrochemicals and chemicals and in the areas of olefins, refining, fertilizers and semi-submersible technology. Our petrochemical technologies include SCORE and SUPERFLEX. SCORE is a process for the production of ethylene which includes technology developed with ExxonMobil. SUPERFLEX is a flexible proprietary technology for the production of high yields of propylene using low value chemicals. We also license a variety of technologies for the transformation of raw materials into commodity chemicals such as phenol and aniline used in the production of consumer end-products. Our Residuum Oil Supercritical Extraction (ROSE) heavy oil technology is designed to maximize the refinery production yield from each barrel of crude oil. The by-products from this technology, known as asphaltines, can be used as a low-cost alternative fuel. We are also a licensor of ammonia process technologies and have the right to license ammonia processes used in the conversion of Syngas to ammonia. KAAPplus, our ammonia process which combines the best features of the KBR Advanced Ammonia Process, the KBR Reforming Exchanger System and the KBR Purifier technology, offers ammonia producers reduced capital cost, lower energy consumption and higher reliability. We believe our technology portfolio and experience in the commercial application of these technologies and related know-how differentiates us from other contractors, enhances our margins and encourages customers to utilize our broad range of EPC-CS services.

Our rights to make use of technologies licensed to us are governed by written agreements of varying durations, including some with fixed terms that are subject to renewal based on mutual agreement. For example, our SCORE license runs until 2028 while our rights to SUPERFLEX currently expire in 2013. Both may be further extended and we have historically been able to renew existing agreements as they expire. We expect these and other similar agreements to be extended so long as it is mutually advantageous to both parties at the time of renewal. For technologies we own, we protect our rights through patents and confidentiality agreements to protect our know-how and trade secrets. Our ammonia process technology is protected through twenty-two active patents, the last of which expires in 2022.

Table of Contents

Technology Development

We own and operate a technology center that actively works with our customers to develop new technologies and improve existing ones. We license these technologies to our customers for the design, engineering and construction of oil and gas and petrochemical facilities. We are also working to identify new technologically driven opportunities in emerging markets, including coal gasification technologies to promote more environmentally friendly uses of abundant coal resources and CO_2 sequestration to reduce CO_2 emissions by capturing and injecting them underground. Our expenditures for research and development activities were $2 million in 2006, $2 million in 2005 and $6 million in 2004, which are classified as a component of general and administrative expenses in our consolidated statements of operations. We make additional technology expenditures in connection with our technology center, our licenses and for new technologies developed jointly with our customers. As an example, we make expenditures in connection with the development or use of technology with respect to our projects that are charged to the particular projects and are not included as part of our research and development expenditures.

Seasonality

On an overall basis, our operations are not generally affected by seasonality. Weather and natural phenomena can temporarily affect the performance of our services, but the widespread geographic scope of our operations mitigates those effects.

Employees

As of December 31, 2006, we had over 56,000 employees in our continuing operations, of which approximately 1.7% were subject to collective bargaining agreements. Based upon the geographic diversification of our employees, we believe any risk of loss from employee strikes or other collective actions would not be material to the conduct of our operations taken as a whole. We believe that our employee relations are good.

Health and Safety

We are subject to numerous health and safety laws and regulations. In the United States, these laws and regulations include: the Federal Occupation Safety and Health Act and comparable state legislation, the Mine Safety and Health Administration laws, and safety requirements of the Departments of State, Defense, Energy and Transportation. We are also subject to similar requirements in other countries in which we have extensive operations, including the United Kingdom where we are subject to the various regulations enacted by the Health and Safety Act of 1974.

These regulations are frequently changing, and it is impossible to predict the effect of such laws and regulations on us in the future. We actively seek to maintain a safe, healthy and environmentally friendly work place for all of our employees and those who work with us. However, we provide some of our services in high-risk locations and, as a result, we may incur substantial costs to maintain the safety of our personnel.

Environmental Regulation

We are subject to numerous environmental, legal, and regulatory requirements related to our operations worldwide. In the United States, these laws and regulations include, among others:

- the Comprehensive Environmental Response, Compensation and Liability Act;
- the Resources Conservation and Recovery Act;
- the Clean Air Act;
- the Federal Water Pollution Control Act; and

the Toxic Substances Control Act.

Table of Contents

In addition to federal laws and regulations, states and other countries where we do business often have numerous environmental, legal, and regulatory requirements by which we must abide. We evaluate and address the environmental impact of our operations by assessing and remediating contaminated properties in order to avoid future liabilities and comply with environmental, legal, and regulatory requirements. On occasion, we are involved in specific environmental litigation and claims, including the remediation of properties we own or have operated, as well as efforts to meet or correct compliance-related matters.

We do not expect costs related to these remediation requirements to have a material adverse effect on our consolidated financial position or our results of operations.

Website Access

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act of 1934 are made available free of charge on our internet website at www.kbr.com as soon as reasonably practicable after we have electronically filed the material with, or furnished it to, the SEC. The public may read and copy any materials we have filed with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains our reports, proxy and information statements, and our other SEC filings. The address of that site is www.sec.gov. We have posted on our website our Code of Business Conduct, which applies to all of our employees and Directors and serves as a code of ethics for our principal executive officer, principal financial officer, principal accounting officer, and other persons performing similar functions. Any amendments to our Code of Business Conduct or any waivers from provisions of our Code of Business Conduct granted to the specified officers above are disclosed on our website within four business days after the date of any amendment or waiver pertaining to these officers.

Item 1A. Risk Factors

Information relating to risk factors is described in Management s Discussion and Analysis of Financial Condition and Results of Operations under Forward-Looking Information and Risk Factors.

Item 1B. Unresolved Staff Comments

None

Table of Contents

Item 2. Properties

We own or lease properties in domestic and foreign locations. The following locations represent our major facilities.

Location	Owned/Leased	Description	Business
Houston, Texas	Leased[1]	High-rise office facility	E&C and Corporate
Arlington, Virginia	Leased	High-rise office facility	G&I
Houston, Texas	Owned	Campus facility	G&I, E&C and Corporate
Leatherhead, United Kingdom	Owned	Campus facility	G&I and E&C
Greenford, Middlesex United Kingdom	Owned[2]	High-rise office facility	E&C
Devonport, Plymouth United Kingdom	Owned[3]	Shipyard facility	G&I

(1) At December 31, 2006, we had a 50% interest in a joint venture which owns this office facility.
(2) At December 31, 2006, we had a 55% interest in a joint venture which owns this office facility.
(3) At December 31, 2006, we had a 51% interest in a joint venture which owns this shipyard facility.

We also own or lease numerous small facilities that include our technology center, sales offices and project offices throughout the world. We own or lease marine fabrication facilities covering approximately 535 acres in England (primarily related to DML) and Scotland. Our marine facilities located in Scotland are currently for sale. All of our owned properties are unencumbered and we believe all properties that we currently occupy are suitable for their intended use.

Item 3. Legal Proceedings

Information relating to various commitments and contingencies is described in Management s Discussion and Analysis of Financial Condition and Results of Operations in Forward-Looking Information and Risk Factors and in Notes 7, 12, and 14 to our consolidated financial statements.

Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of security holders during the fourth quarter of 2006.

Table of Contents

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

KBR common stock is traded on the New York Stock Exchange. Information relating to the high and low market prices of common stock and quarterly dividend payments is included under the caption Quarterly Data and Market Price Information on page 140 of this annual report. No cash dividends were paid on common stock for 2006. Our Board of Directors does not intend to pay dividends on the outstanding shares of our common stock in the foreseeable future. However, the declaration and payment of future dividends will be at the discretion of the Board of Directors and will depend upon, among other things, future earnings, general financial condition and liquidity, success in business activities, capital requirements, and general business conditions.

At February 22, 2007, there were 13 shareholders of record. In calculating the number of shareholders, we consider clearing agencies and security position listings as one shareholder for each agency or listing.

The chart below compares the cumulative total shareholder return on our common shares from November 16, 2006 (the date of our initial public offering) to the end of the year with the cumulative total return on the Dow Jones Heavy Construction Industry Index and the Russell 1000 Index for the same period. The comparison assumes the investment of $100 on November 16, 2006, and reinvestment of all dividends. The shareholder return is not necessarily indicative of future performance.

	11/16/2006	11/27/2006	12/5/2006	12/13/2006	12/21/2006	12/29/2006
KBR	$ 100.00	$ 105.78	$ 103.86	$ 109.40	$ 125.30	$ 126.07
Dow Jones Heavy Construction	100.00	100.35	105.67	103.05	103.14	103.62
Russell 1000	100.00	98.79	101.25	101.05	101.29	101.31

Table of Contents

Item 6. Selected Financial Data

The selected financial data of KBR as of December 31, 2006 and 2005 and for each of the three years in the period ended December 31, 2006 has been derived from the audited consolidated financial statements of KBR included elsewhere herein. The selected financial data as of December 31, 2004 and 2003, and for the years ended December 31, 2003 has been derived from consolidated financial statements of KBR not included herein. The selected financial data as of December 31, 2002 and for the year then ended has been derived from unaudited consolidated financial statements of KBR not included herein. The following data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the audited consolidated financial statements and the notes thereto included herein.

KBR was formed on March 21, 2006 as an indirect wholly owned subsidiary of Halliburton. At inception, KBR issued 1,000 shares to Halliburton. On October 27, 2006, KBR effected a 135,627-for-one split of its common stock. All of the share and per share data of KBR for all periods presented herein has been adjusted to reflect the stock split.

KBR was formed to own and operate KBR Holdings. Prior to October 30, 2006, the existing ownership interest of the member of KBR Holdings was represented by 100 shares. On October 30, 2006, the sole member of KBR Holdings effected a 1,356,270-for-one split of its outstanding shares.

In November 2006, KBR completed an initial public offering of 32,016,000 shares of its common stock. Halliburton currently owns 135,627,000 shares, or 81%, of the outstanding common stock of KBR. In connection with the initial public offering, Halliburton contributed 100% of the common stock of KBR Holdings to KBR. KBR had no operations from the date of formation (March 21, 2006) to the date of the contribution of KBR Holdings.

Table of Contents

You should read the following information in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and the related notes to the consolidated financial statements.

	Years Ended December 31, 2002	2003	2004	2005	2006
	(In millions, except for per share amounts)				
Statement of Operations Data:					
Total revenue	$ 5,125	$ 8,863	$ 11,906	$ 10,146	$ 9,633
Operating costs and expenses:					
Cost of services	5,218	8,849	12,171	9,716	9,285
General and administrative	89	82	92	85	108
Gain on sale of assets, net		(4)		(110)	(6)
Operating income (loss)	(182)	(64)	(357)	455	246
Interest expense and other	1	(41)	(28)	(22)	(26)
Income (loss) from continuing operations before income taxes and minority interest	(181)	(105)	(385)	433	220
Benefit (provision) for income taxes	98	(11)	96	(182)	(129)
Minority interest in net income of consolidated subsidiaries	(45)	(26)	(25)	(41)	(10)
Income (loss) from continuing operations	(128)	(142)	(314)	210	81
Income from discontinued operations, net of tax provisions	15	9	11	30	87
Cumulative effect of change in accounting principle, net	21				
Net income (loss)	$ (92)	$ (133)	$ (303)	$ 240	$ 168
Basic and diluted income (loss) per share:					
Continuing operations	$ (0.94)	$ (1.04)	$ (2.31)	$ 1.54	$ 0.58
Discontinued operations	0.11	0.06	0.08	0.22	0.62
Cumulative effect of change in accounting principle	0.15				
Basic and diluted net income (loss) per share	$ (0.68)	$ (0.98)	$ (2.23)	$ 1.76	$ 1.20
Weighted average shares outstanding	136	136	136	136	140
Other Financial Data:					
Capital expenditures	$ 161	$ 63	$ 74	$ 76	$ 57
Depreciation and amortization expense	29	51	52	56	47

	At December 31, 2002	2003	2004	2005	2006
	(In millions)				
Balance Sheet Data:					
Cash and equivalents	$ 858	$ 439	$ 234	$ 394	$ 1,461
Net working capital	913	882	765	944	915
Property, plant and equipment, net	411	431	467	444	492
Total assets	4,031	5,532	5,487	5,182	5,407
Total debt (including due to and notes payable to parent)	756	1,242	1,248	808	172
Shareholders equity	1,133	944	812	1,256	1,787

Table of Contents

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Executive Overview

E&C revenue increased from $2.0 billion in 2005 to $2.4 billion in 2006, or approximately 19%. The increase was largely due to a $594 million increase in revenue from our gas monetization projects offset by a decrease of $241 million from a crude oil project in Canada. Operating income decreased from $123 million in 2005 to $45 million in 2006 primarily due to a $157 million charge related to the Escravos GTL project in Nigeria which was partially offset by an aggregate $65 million increase in operating income from an ammonia project in Egypt and other gas monetization projects.

G&I produced revenue of $7.2 billion in 2006 compared to $8.1 billion in 2005, an 11% decrease. The decrease is largely due to a $698 million decrease in our military support activities in Iraq. Operating income for G&I decreased from $332 million in 2005 to $201 million in 2006 as a result of the decreases in Iraq-related activity as well as impairment charges on a railroad project in Australia and a road project in the United Kingdom.

In August 2006, we were awarded a $3.5 billion task order under our LogCAP III contract for additional work through 2007. Backlog related to the LogCAP III contract at December 31, 2006 was $3.0 billion. In 2006, Iraq-related work contributed $4.7 billion to consolidated revenue and $166 million to consolidated operating income, resulting in a 3.5% margin before corporate costs and taxes. We were awarded $120 million in LogCAP award fees during 2006 as a result of our performance rating. During the almost five-year period we have worked under the LogCAP III contract, we have been awarded 64 excellent ratings out of 76 total ratings. We expect to complete all open task orders under our LogCAP III contract during the third quarter of 2007.

In August 2006, the DoD issued a request for proposals on a new competitively bid, multiple service provider LogCAP IV contract to replace the current LogCAP III contract. We are currently the sole service provider under our LogCAP III contract, and in October 2006, we submitted the final portion of our bid on the LogCAP IV contract. We expect that the contract will be awarded during the second quarter of 2007. Despite the award of the August 2006 task order under our LogCAP III contract and the possibility of being awarded a portion of the LogCAP IV contract, we expect our overall volume of work to decline as our customer scales back the amount of services we provide. However, as a result of the recently announced surge of additional troops in Iraq, we expect the decline to occur more slowly than previously expected. Please read *Forward-Looking Information and Risk Factors-Risks Related to Our Customers and Contracts A decrease in the magnitude of work we perform for the U.S. government in Iraq and for the MoD through our DML joint venture or other decreases in governmental spending and outsourcing for military and logistical support of the type that we provide could have a material adverse effect on our business, results of operations and cash flow and The DoD awards its contracts through a rigorous competitive process and our efforts to obtain future contract awards from the DoD, including the LogCAP IV contract, may be unsuccessful, and the DoD has recently favored multiple award task order contracts.*

With regard to our E&C projects, worldwide resource constraints, escalating material and equipment prices, and ongoing supply chain pricing pressures are causing delays in awards of and, in some cases, cancellations of major gas monetization and upstream prospects. Of the eight very large scale (each defined for these purposes as having approximately $2 billion or more in estimated revenue to us or other parties (or total installed cost to the client) over the course of the project) natural gas projects that we have been pursuing for new awards, three have either been cancelled or awarded to competitors and we believe the awards of two others may also be significantly delayed or cancelled. Although two additional very large scale natural gas projects have subsequently been added to our pursuit list, due to the lengthy nature of the bidding process, we do not expect awards for these projects to be made in the near term. These developments may negatively and materially impact 2007 and 2008 results (excluding consideration of potential offsets such as the slower than expected decline in LogCAP III activity, or work in other areas and overhead reductions that may or may not be realized). It is generally very difficult to predict whether or when we will receive such awards as these contracts frequently

Table of Contents

involve a lengthy and complex bidding and selection process which is affected by a number of factors, such as market conditions, financing arrangements, governmental approvals and environmental matters. See *Forward-Looking Information and Risk Factors-Risks Related to Our Customers and Contracts Our results of operations depend on the award of new contracts and the timing of the performance of these contracts.*

In the second quarter of 2006, we identified a $148 million charge, before income taxes and minority interest, related to our consolidated 50%-owned GTL project in Escravos, Nigeria. This charge was primarily attributable to increases in the overall estimated cost to complete the project. The project experienced delays related to civil unrest and security on the Escravos River near the project site, with additional delays resulting from scope changes and engineering and construction modifications. As of September 30, 2006, we had approximately $269 million in unapproved change orders related to this project. In the fourth quarter of 2006, we reached agreement with the project owner to settle $264 million of these change orders. We recorded an additional $9 million loss in the fourth quarter of 2006 related to non-billable engineering services for the Escravos joint venture. As of December 31, 2006, we have recorded $43 million of unapproved change orders which primarily relates to additional cost increases on this project.

In May 2006, we completed the sale of the Production Services group, which was part of our E&C segment. In connection with the sale, we received net proceeds of $265 million and recorded a pre-tax gain of $120 million, net of post-closing adjustments. The results of operations and net assets of the Production Services group for the current and prior periods have been reported as discontinued operations. See Note 26 to our consolidated financial statements.

On April 1, 2006, Halliburton contributed to us its interests in three joint ventures, which are accounted for using the equity method of accounting. These joint ventures own and operate offshore vessels equipped to provide various services, including accommodations, catering and other services to sea-based oil and gas platforms and rigs off the coast of Mexico. At March 31, 2006, the contributed interests in the three joint ventures had a book value of $26 million.

In 2006, we recorded $58 million of impairment charges related to an investment in a railway joint venture in Australia. This joint venture has sustained losses since the railway commenced operations in early 2004 and incurred an event of default under its loan agreements by failing to make an interest and principal payment in October 2006. The write-down of our investment in this joint venture in the first and third quarters of 2006 resulted from lower than anticipated freight volume, a slowdown in the planned expansion of the Port of Darwin and the joint venture s unsuccessful efforts to raise additional equity from third parties.

In April 2006, KBR, Petrobras, and the project lenders agreed to technical and operational acceptance of the completed Barracuda and Caratinga production vessels. In March 2006, Petrobras submitted to arbitration a $220 million claim related to the Barracuda-Caratinga project. The submission claimed that certain subsea flowline bolts failed and that the replacement of these bolts was our responsibility. We disagree with the Petrobras claim since the bolts met Petrobras design specification, and we do not believe there is any basis for the amount claimed by Petrobras. We have examined possible solutions to the problem and determined the cost would not exceed $140 million. We are defending ourselves in the arbitration process and will pursue recovery of our costs associated with this defense.

Separation from Halliburton

In November 2006, we completed our initial public offering of 32,016,000 shares of our common stock for aggregate net proceeds of $511 million. Halliburton intends to complete the separation by means of a tax-free exchange offer and a subsequent spin-off distribution of any remaining shares. In connection with our initial public offering, Halliburton and KBR entered into various agreements relating to the separation of our business from Halliburton, including, among others, a master separation agreement, a registration rights agreement, employee matters agreement, transition services agreements and a tax sharing agreement. For a description of these agreements, as amended, and other agreements that we entered into with Halliburton, please read Certain Relationships and Related Transactions, and Director Independence.

In 2007, we anticipate incurring approximately $12 million of additional cost of services and approximately $23 million of additional general and administrative expense associated with being a separate publicly traded company, including approximately $8 million of expense for stock-based compensation. These public company expenses include anticipated compensation and benefit expenses of our executive management and directors (including stock-based compensation), costs associated with our long-term incentive plan, expenses associated with the preparation of annual and quarterly reports, proxy statements and other filings with the SEC, independent auditor fees, investor relations activities, registrar and transfer agent fees, incremental director and officer liability insurance costs and higher insurance costs due to the unavailability of Halliburton s umbrella insurance coverage. We expect to incur additional one-time system costs of approximately $10 million to replace certain human resources and payroll-related IT systems that we currently share with Halliburton and that are not included in the scope of our current SAP implementation process.

In connection with KBR s initial public offering, we granted stock options, restricted stock and restricted stock units to our executive officers and a number of our employees as described under Executive Compensation. We also intend to make annual grants of restricted stock units to our outside directors as described under Director Compensation. Any amounts recorded related to stock-based compensation would include the fair value of awards of stock options, restricted stock and/or restricted stock units to our outside directors, executive officers and other employees. The estimated fair value of these grants have been determined using the Black-Scholes pricing model in accordance with Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)). Once Halliburton s ownership interest in KBR is 20% or less, outstanding awards to KBR employees of options to purchase Halliburton stock and unvested Halliburton restricted stock under the Halliburton 1993 Stock and Incentive Plan (Halliburton 1993 Plan) will be converted into similar KBR awards under a new Transitional Stock Adjustment Plan, with the intention of preserving approximately the equivalent value of the previous awards under the Halliburton 1993 Plan.

Other Corporate Matters

At December 31, 2006, we adopted Statement of Financial Accounting Standards No. 158 (SFAS No. 158), Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R). The adoption of SFAS No. 158 impacted our balance sheet at December 31, 2006 as follows: a decrease to total assets of $156 million, an increase to total liabilities of $93 million, a decrease to minority interest of $97 million, and a decrease to shareholders equity of $152 million.

In January 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)) and began expensing the cost of our employee stock option awards and our employee stock purchase plan. On a pretax basis, these costs totaled approximately $7 million in 2006 and are in addition to $5 million in costs we have historically expensed related to other equity based compensation and $6 million of incremental compensation cost related to modifications of previously granted stock-based awards retained when certain employees left the company. All expense related to stock compensation awards were charged to the segments to which each affected employee is assigned.

In the fourth quarter of 2006, we committed to a restructuring plan that included broad based headcount reductions deemed necessary to reduce overhead and better position our company for the future. In connection with this reorganization, the company recorded restructuring charges totaling $5 million for severance, incentives, and other employee benefit costs for personnel whose employment was involuntarily terminated. Of this amount, $3 million relates to our E&C segment and $2 million relates to our G&I segment. The entire $5 million was included in General and administrative in the statements of operations as of December 31, 2006. These termination benefits were offered to approximately 139 personnel, with 66 receiving enhanced termination benefits who were located in the United States and United Kingdom. As of December 31, 2006, the $5 million is included in Accounts payable on the consolidated balance sheets for the restructuring plan.

Table of Contents

Material weakness in financial controls. During the second quarter of 2006, we discovered a large increase in our estimated costs on the Escravos project as a result of our completing a first check estimate in June 2006. A first check estimate is a detailed process by which the project s schedule and cost is re-estimated through its completion. We perform a first check estimate once sufficient engineering work has been completed to allow for a detailed cost re-estimate based on actual engineering drawings. The large increase in estimated costs identified on the Escravos project included the estimated costs for the plant scope changes resulting from the front-end engineering design validation, the impact of inflation on procurement costs due to schedule delays, and the costs of additional security needed due to the continued deterioration of civil conditions in Nigeria that had occurred.

As a result of the significant increase in estimated costs identified in our first check estimate, we performed a review to determine why these costs were not previously estimated and communicated. From this review, we learned that even though most of the cost increases could not be identified until the rescheduling and recosting exercise of the first check estimate, there were some cost increases that should have been recognized by existing procedures related to project deviations/changes which had been identified prior to March 31, 2006 but not included in the project cost estimate as of that date. Our policies require that all estimated costs attributed to project deviations/changes be included in the project cost estimate in the period in which they are identified. Since our policy was not followed on this project, we concluded that a material weakness in internal controls existed in our Escravos project estimating process.

During the second quarter of 2006, we performed an additional review of our other significant fixed-price projects and found that the control policies and procedures which had not been followed on the Escravos project were being followed on these projects, providing us assurance that the control deficiency was isolated to the Escravos project. Further, we believe the first check estimate we performed in the second quarter of 2006 mitigated the risk of any material errors in the Escravos project as of December 31, 2006.

We have taken appropriate actions to upgrade project control personnel on the Escravos project and we have provided additional training to these new individuals concerning our company policies relating to project deviations/changes. We have also initiated control enhancements on the Escravos project, which are expected to help identify any similar control deficiencies on a more timely basis in the future. These include expanded monthly project reviews by segment management for all significant projects with increased focus on project deviations/changes.

During the fourth quarter of 2006, we completed the first check estimate on the Yemen project, which was the only major E&C project underway for which a first check estimate had not previously been completed at that point. In addition, during the fourth quarter of 2006, we have continued our assessment of the Escravos controls and other control changes implemented following the second quarter of 2006, and have concluded that these controls are operating effectively. We believe that this material weakness has been remediated as of December 31, 2006.

Correction of prior period results. In connection with a review of our consolidated 50%-owned GTL project in Escravos, Nigeria, which is part of our E&C segment, we identified increases in the overall estimated cost to complete the project. As a result, during the second quarter of 2006, we identified a $148 million charge, before income taxes and minority interest. We determined that $16 million of the $148 million charge was based on information available to us but not reported as of March 31, 2006. Of the $16 million related to the prior periods, $9 million was related to the quarter ended March 31, 2006 and $7 million was related to the quarter ended December 31, 2005. We have restated our financial statements for the quarter ended March 31, 2006 to include the $9 million charge ($2.9 million after minority interest and tax) as well as for other unrelated, individually insignificant adjustments that subsequently became known to us. The $9 million adjustment related to Escravos had the effect of reducing income (loss) from continuing operations before income taxes and minority interest by $9 million, increasing benefit (provision) for income taxes by $1.6 million, increasing minority interest in net income of subsidiaries by $2.9 million (net of tax of $1.6 million), and reducing net income by $2.9 million for the quarter ended March 31, 2006. These other adjustments had the effect of reducing pretax income and net income by $2 million and $5 million for the quarter ended March 31, 2006, respectively. We recorded the remaining $7 million charge ($2.3 million after minority interest and income taxes) in the quarter ended June 30, 2006, since the amounts were not material to 2005 or 2006 based on our 2006 projections.

Table of Contents

In addition to the above, we adjusted our member s equity and other balance sheet accounts as of January 1, 2003 to reflect a correction to DML s initial purchase price allocation from a 1997 acquisition. DML s original purchase price allocation did not adequately record the prepaid pension asset that existed at the acquisition date. The corrected allocation of purchase price to the pension asset also had the effect of increasing negative goodwill. The resulting negative goodwill would have been reversed in 2002 upon the adoption of SFAS 141, Business Combinations , and reflected in cumulative effect of change in an accounting principle, net . Accordingly, our January 1, 2003 consolidated balance sheet has been adjusted to increase member s equity by $34 million, to increase prepaid pension asset by $72 million, to decrease property, plant, and equipment by $2 million, to decrease deferred taxes by $12 million and to increase minority interest by $24 million. Currency translation adjustments on the above resulted in increased equity at December 31, 2005, 2004 and 2003 of $9 million, $17 million and $8 million, respectively. We do not believe these adjustments have a material impact on balances previously reported.

Liquidity and Capital Resources

At December 31, 2006 and 2005, cash and equivalents totaled $1.5 billion and $394 million, respectively. These balances include cash and cash from advanced payments related to contracts in progress held by ourselves or our joint ventures that we consolidate for accounting purposes and which totaled $527 million at December 31, 2006 and $223 million at December 31, 2005. The use of these cash balances is limited to the specific projects or joint venture activities and are not available for other projects, general cash needs or distribution to us without approval of the board of directors of the respective joint venture or subsidiary.

Historically, our primary sources of liquidity were cash flows from operations, including cash advance payments from our customers, and borrowings from our parent, Halliburton. In addition, at times during 2004 and 2005, we sold receivables under our U.S. government accounts receivable facility. Effective December 16, 2005, we entered into a bank syndicated unsecured $850 million five-year revolving credit facility (Revolving Credit Facility), which extends through 2010 and is available for cash advances and letters of credit. In connection therewith, the U.S. government accounts receivable facility was terminated and an intercompany payable to Halliburton of $774 million was converted into Subordinated Intercompany Notes. We expect that our future liquidity will be provided by cash flows from operations, including advance cash payments from our customers, and borrowings under the Revolving Credit Facility.

As mentioned above, we previously utilized borrowings from Halliburton as a primary source of liquidity. In October 2005, Halliburton capitalized $300 million of the outstanding intercompany balance to equity through a capital contribution. On December 1, 2005, our remaining intercompany balance was converted into Subordinated Intercompany Notes to Halliburton. At December 31, 2005, the outstanding principal balance of the Subordinated Intercompany Notes was $774 million. In October 2006, we repaid $324 million in aggregate principal amount of the $774 million of indebtedness we owed under the Subordinated Intercompany Notes. In November 2006, we repaid the remaining $450 million in aggregate principal amount of the Subordinated Intercompany Notes with proceeds from our initial public offering. Amounts owed under the Subordinated Intercompany Notes are reflected in our consolidated financial statements at December 31, 2005 as Notes payable to related party.

Our Revolving Credit Facility is available for cash advances required for working capital and letters of credit to support our operations. Amounts drawn under the Revolving Credit Facility bear interest at variable rates based on a base rate (equal to the higher of Citibank s publicly announced base rate, the Federal Funds rate plus 0.5% or a calculated rate based on the certificate of deposit rate) or the Eurodollar Rate, plus, in each case, the applicable margin. The applicable margin will vary based on our utilization spread. At December 31, 2006 and December 31, 2005, we had $0 of cash draws and $55 million and $25 million, respectively, in letters of credit issued and outstanding, which reduced the availability under the Revolving Credit Facility to $795 million and $825 million, respectively. In addition, we pay a commitment fee on any unused portion of the credit line under the Revolving Credit Facility. Further, the Revolving Credit Facility limits the amount of new letters of credit and other debt we can incur outside of the credit facility to $250 million, which could adversely affect our ability to bid or bid competitively on future projects if the credit facility is not amended or replaced.

Table of Contents

Letters of credit, bonds and financial and performance guarantees. In connection with certain projects, we are required to provide letters of credit, surety bonds or other financial and performance guarantees to our customers. As of December 31, 2006, we had $676 million in letters of credit and financial guarantees outstanding, of which $55 million were issued under our Revolving Credit Facility. Over $597 million of the remaining $621 million were issued under various Halliburton facilities and are irrevocably and unconditionally guaranteed by Halliburton. Of the total outstanding, $516 million relate to our joint venture operations, including $159 million issued in connection with our Allenby & Connaught project. The remaining $160 million of outstanding letters of credit relate to various other projects. At December 31, 2006, $248 million of the $676 million in outstanding letters of credit had triggering events that would entitle a bank to require cash collateralization. In addition, Halliburton has guaranteed surety bonds and provided direct guarantees primarily related to our performance. We expect to cancel these letters of credit, surety bonds and other guarantees as we complete the underlying projects. We have limited stand-alone bonding capacity without Halliburton, and Halliburton is no longer obligated to provide credit support for our letters of credit, surety bonds and other guarantees, except to the limited extent it has agreed to do so under the terms of the master separation agreement entered into in connection with our initial public offering. We have obtained a limited amount of stand-alone surety capacity and are engaged in discussions with surety companies to obtain additional stand-alone capacity.

We and Halliburton have agreed that the existing surety bonds, letters of credit, performance guarantees, financial guarantees and other credit support instruments guaranteed by Halliburton will remain in full force and effect following the separation of our companies. In addition, we and Halliburton have agreed that until December 31, 2009, Halliburton will issue additional guarantees, indemnification and reimbursement commitments for our benefit in connection with (a) letters of credit necessary to comply with our EBIC contract, our Allenby & Connaught project and all other contracts that were in place as of December 15, 2005; (b) surety bonds issued to support new task orders pursuant to the Allenby & Connaught project, two job order contracts for our G&I segment and all other contracts that were in place as of December 15, 2005; and (c) performance guarantees in support of these contracts. Each credit support instrument outstanding at the time of our initial public offering and any additional guarantees, indemnification and reimbursement commitments will remain in effect until the earlier of: (1) the termination of the underlying project contract or our obligations thereunder or (2) the expiration of the relevant credit support instrument in accordance with its terms or release of such instrument by our customer. In addition, we have agreed to use our reasonable best efforts to attempt to release or replace Halliburton s liability under the outstanding credit support instruments and any additional credit support instruments relating to our business for which Halliburton may become obligated for which such release or replacement is reasonably available. For so long as Halliburton or its affiliates remain liable with respect to any credit support instrument, we have agreed to pay the underlying obligation as and when it becomes due. Furthermore, we agreed to pay to Halliburton a quarterly carry charge for its guarantees of our outstanding letters of credit and surety bonds and agreed to indemnify Halliburton for all losses in connection with the outstanding credit support instruments and any new credit support instruments relating to our business for which Halliburton may become obligated following our initial public offering. Please read Certain Relationships and Related Transactions, and Director Independence.

As the need arises, future projects will be supported by letters of credit issued under our Revolving Credit Facility or arranged on a unilateral basis. In connection with the issuance of letters of credit under the Revolving Credit Facility, we are charged an issuance fee and a quarterly fee on outstanding letters of credit based on an annual rate.

Debt covenants. The Revolving Credit Facility contains a number of covenants restricting, among other things, our ability to incur additional indebtedness and liens, sales of our assets and payment of dividends, as well as limiting the amount of investments we can make. We are limited in the amount of additional letters of credit and other debt we can incur outside of the Revolving Credit Facility. Also, under the current provisions of the Revolving Credit Facility, it is an event of default if any person or two or more persons acting in concert, other than Halliburton or us, directly or indirectly acquire 25% or more of the combined voting power of all outstanding equity interests ordinarily entitled to vote in the election of directors of KBR Holdings, LLC, the borrower under the facility and a wholly owned subsidiary of KBR.

Table of Contents

The Revolving Credit Facility also requires us to maintain certain financial ratios, as defined by the Revolving Credit Facility agreement, including a debt-to-capitalization ratio that does not exceed 55% until June 30, 2007 and 50% thereafter; a leverage ratio that does not exceed 3.5; and a fixed charge coverage ratio of at least 3.0. At December 31, 2006 and 2005, we were in compliance with these ratios and other covenants.

	Years Ended December 31,		
Cash flow activities	**2006**	**2005**	**2004**
		(In millions)	
Cash flows provided by (used in) operating activities	$ 931	$ 527	$ (61)
Cash flows provided by (used in) investing activities	225	20	(85)
Cash flows provided by (used in) financing activities	(139)	(375)	(83)
Effect of exchange rate changes on cash	50	(12)	24
Increase (decrease) in cash and equivalents	$ 1,067	$ 160	$ (205)

Operating activities. Cash provided by operations was $931 million for the year ended December 31, 2006 compared to cash provided by operations of $527 million the year ended December 31, 2005. In 2006, we received $304 million of advanced billings on several consolidated joint venture projects including our Escravos project. This cash advance is only available for use on the Escravos project and is not available to us for other purposes. In addition, our working capital for our Iraq-related work, excluding cash and equivalents, decreased $247 million from $495 million at December 31, 2005 to $248 million at December 31, 2006. These cash increases were partially offset by increases of $86 million in working capital related to new projects initiated in 2006, including the EBIC and Allenby & Connaught projects. We also contributed $129 million to fund our pension plans in 2006 and experienced higher payroll and related payments due to the timing of our payroll payments.

Cash provided by operations were $527 million in 2005. The increase in cash provided by operations in 2005 compared to 2004 was primarily due to better operating results and a reduction in working capital required in support of the U.S. government s activities in Iraq. Net income increased to $240 million in 2005, compared to a net loss of $303 million in 2004. Our working capital requirements for our Iraq-related work, excluding cash and equivalents, decreased from $700 million at December 31, 2004 to $495 million at December 31, 2005. The working capital of $700 million at December 31, 2004 excluded $263 million of receivables sold under our U.S. government accounts receivable facility, which was terminated in December 2005. The working capital decrease was mainly due to the settlement of dining facilities-related issues and fuel issues and resolution of RIO project issues. These increases in cash flow were partially offset by cash outlays required to fund losses on the Barracuda-Caratinga project totaling $169 million in 2005.

Investing activities. Cash provided by investing activities for the year ended December 31, 2006 totaled $225 million compared to cash provided by investing activities of $20 million for the year ended December 31, 2005. Capital expenditures in 2006 were $57 million as compared to $76 million in 2005. Capital spending in 2006 was down primarily due to the deferral of certain capital improvement projects at our DML shipyard. In the second quarter of 2006, we completed the sale of our Production Services group, which was part of our E&C segment. In connection with the sale, we received net proceeds of $265 million. During 2005 we received $96 million in cash from the sale of and one-time cash distribution from our interest in the Dulles Greenway toll road in Virginia.

Cash provided by investing activities totaled $20 million in 2005 compared to cash flows used in investing activities of $85 million in 2004. The increase in cash flow from investing activities was primarily due to the sale of and one-time cash distribution from our interest in the Dulles Greenway toll road in 2005, which provided $96 million of net cash inflows. Capital expenditures of $76 million in 2005 were consistent with 2004. Capital spending in 2005 was primarily directed to our implementation of an enterprise system, SAP, offset by lower spending in 2005 at our DML shipyard.

Financing activities. Cash used in financing activities for the year ended December 31, 2006 totaled $139 million, compared to cash flows used in financing activities of $375 million in 2005 and is primarily related to repayment of our borrowings under the Halliburton Cash Management Note previously discussed. In addition, in November 2006, we completed an initial public offering of less than 20% of the common stock of KBR resulting in net proceeds of $511 million. Cash flows used in or provided by financing activities in 2006, 2005 and 2004 are primarily related to payments from or payments to Halliburton in order to obtain funds to support our operations or to repay borrowings from Halliburton with excess funds from operations.

Historically, our daily cash needs have been funded through intercompany borrowings from our parent, Halliburton, while our surplus cash was invested with Halliburton on a daily basis. Effective December 1, 2005, we entered into Subordinated Intercompany Notes with Halliburton whereby our $774 million intercompany payable balance was converted into Subordinated Intercompany Notes payable due in December 2010 that each had an annual interest rate of 7.5%. In October 2006, we repaid $324 million and in November 2006, we repaid the remaining $450 million in aggregate principal amount of the Subordinated Intercompany Notes with proceeds from our initial public offering.

Prior to December 2006, Halliburton provided daily cash management services to us. As part of this arrangement, we invested surplus cash with Halliburton on a daily basis, which could be returned as needed for operations. Halliburton executed a demand note payable (Halliburton Cash Management Note) for amounts outstanding under these arrangements. Annual interest on the Halliburton Cash Management Note was based on the closing rate of overnight Federal Funds rate determined on the first business day of each month. Similarly, we could, from time to time, borrow funds from Halliburton, subject to limitations provided under the Revolving Credit Facility, on a daily basis pursuant to a note payable (KBR Cash Management Note). Annual interest on the KBR Cash Management Note was based on the six-month Eurodollar Rate plus 1.00%. This cash management arrangement was terminated in December 2006 and amounts owed under the Halliburton Cash Management Note and the KBR Cash Management Note were settled in December 2006.

On November 29, 2002, DML entered into a credit facility denominated in British pounds with Bank of Scotland, HSBC Bank and The Royal Bank of Scotland totaling $157 million. The U.S. dollar amounts presented were converted using published exchange rates for the applicable periods. This facility, which is non-recourse to us, matures in September 2009, provides for a $137 million term loan facility and a $20 million revolving credit facility. The interest rate for both the term loan and revolving credit facility is variable based on an adjusted LIBOR rate and DML must maintain certain financial covenants. At December 31, 2006 and 2005, there was $18 million and $31 million, respectively, outstanding under this term loan facility, which is payable in quarterly installments through September 2009. At December 31, 2006 there was no outstanding balance under the revolving credit facility. In addition, DML had $2 million and $3 million of other long-term debt outstanding at December 31, 2006 and December 31, 2005, respectively. The interest rate on this debt is variable and payments are due quarterly through October 2008. DML also has a $29 million overdraft facility for which there was no outstanding balance at December 31, 2006.

On June 6, 2005, our 55%-owned subsidiary, M.W. Kellogg Limited, entered into a credit facility with Barclays Bank totaling $29 million. The U.S. dollar amounts presented were converted using published exchange rates for the applicable period. This facility, which is non-recourse to us is primarily used for bonding, guarantee, and other indemnity purposes. Fees are assessed monthly in the amount of 0.25% per annum of the average outstanding balance. Amounts outstanding under the facility are payable upon demand and the lender may require cash collateral for any amounts outstanding under the facility. At December 31, 2006 and December 31, 2005, there was $2 million of bank guarantees outstanding under the facility.

Future sources of cash. Future sources of cash include cash flows from operations, including cash advance payments from our customers, and borrowings under our Revolving Credit Facility. The Revolving Credit Facility is available for cash advances required for working capital and letters of credit to support our operations. However, to meet our short- and long-term liquidity requirements, we will primarily look to cash generated from operating activities. As such, we will be required to consider the working capital requirements of future projects.

Table of Contents

Future uses of cash. Future uses of cash will primarily relate to working capital requirements for our operations. For a discussion of risks related to our working capital requirements and sources of liquidity following our separation from Halliburton, please read *Forward-Looking Information and Risk Factors Other Risks Related to Our Business We experience increased working capital requirements from time to time associated with our business, and such an increased demand for working capital could adversely affect our ability to meet our liquidity needs.* In addition, we will use cash to fund capital expenditures, pension obligations, operating leases, long-term debt repayment and various other obligations, including the commitments discussed in the table below, as they arise. In October 2006, we repaid $324 million in aggregate principal amount of the indebtedness we owed under the Subordinated Intercompany Notes and in November 2006 we repaid the remaining $450 million with net proceeds from our initial public offering.

Capital expenditures. Capital spending in 2006 was approximately $57 million. The capital expenditures budget for 2007 is approximately $99 million, and includes a $19 million increase in spending related to our DML shipyard for certain capital improvement projects deferred in 2006.

Commitments and other contractual obligations. The following table summarizes our significant contractual obligations and other long-term liabilities as of December 31, 2006:

	Payments Due						
	2007	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**
				(In millions)			
Long-term debt(a)	18	2					20
Operating leases	48	50	42	39	39	41	259
Purchase obligations(b)	15	13	4	3	2	2	39
Pension funding obligation	57						57
Barracuda-Caratinga	10						10
Total	148	65	46	42	41	43	385

(a) DML revolving credit facility and associated interest based on adjusted LIBOR rate.
(b) The purchase obligations disclosed above do not include purchase obligations that we enter into with vendors in the normal course of business that support existing contracting arrangements with our customers. The purchase obligations with our vendors can span several years depending on the duration of the projects. In general, the costs associated with the purchase obligations are expensed to correspond with the revenue earned on the related projects.

In addition to the commitments above, we had commitments of $156 million at December 31, 2006 to provide funds to related companies, including $119 million at December 31, 2006 to fund our privately financed projects. These commitments arose primarily during the start-up of these entities or due to losses incurred by them. We expect approximately $13 million of the commitments to be paid during 2007. In addition, we funded $37 million on the Barracuda-Caratinga project, net of revenue received, during 2006.

Off balance sheet arrangements and other factors affecting liquidity

We participate, generally through an equity investment in a joint venture, partnership or other entity, in privately financed projects that enable our government customers to finance large-scale projects, such as railroads, and major military equipment purchases. We evaluate the entities that are created to execute these projects following the guidelines of Financial Accounting Standards Board (FASB) Interpretation No. 46R (see Note 20 Equity Method Investments and Variable Interest Entities in the notes to our consolidated financial statements for a description of our significant unconsolidated subsidiaries that are accounted for using the equity method of accounting). These projects typically include the facilitation of non-recourse financing, the design and construction of facilities, and the provision of operations and maintenance services for an agreed to period after the facilities have been completed. The carrying value of our investments in privately financed project entities totaled $3 million and $145 million at December 31, 2006 and 2005, respectively. Our equity in earnings (losses) from privately financed project entities totaled $(77) million, $18 million and $(12) million for the years ended December 31, 2006, 2005 and 2004, respectively. See Note 9 to our consolidated financial statements.

In May 2004, we entered into an agreement to sell, assign, and transfer our entire title and interest in specified U.S. government accounts receivable to a third party. The total amount of receivables outstanding under this agreement as of December 31, 2004 was $263 million. At December 31, 2005, these receivables were collected, the balance was retired, and the facility was terminated.

As of December 31, 2006, we had incurred $159 million of costs under the LogCAP III contract that could not be billed to the government due to lack of appropriate funding on various task orders. These amounts were associated with task orders that had sufficient funding in total, but the funding was not appropriately allocated within the task order. We are in the process of preparing a request for a reallocation of funding to be submitted to the U.S. Army for negotiation. We believe the negotiations will result in an appropriate distribution of funding by the U.S. Army and collection of the full amounts due.

Halliburton has agreed to indemnify us and our greater than 50%-owned subsidiaries for fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of claims made or assessed against us by U.S. and certain foreign governmental authorities or a settlement thereof relating to certain FCPA matters. If we incur losses as a result of or relating to certain FCPA matters, or as a result of violations of U.S. antitrust laws arising out of ongoing bidding practices investigations, for which the Halliburton indemnity will not apply, we may not have the liquidity or funds to address those losses. Please read Certain Relationships and Related Transactions, and Director Independence.

In certain circumstances, Halliburton has also agreed to indemnify us for out-of-pocket cash costs and expenses, or cash settlement or cash arbitration awards in lieu thereof, we may incur as a result of the replacement of certain subsea flow-line bolts installed in connection with the Barracuda-Caratinga project. If we incur losses relating to the Barracuda-Caratinga project for which the Halliburton indemnity will not apply, we may not have the liquidity or funds to address those losses.

We may take or fail to take actions that could result in our indemnification from Halliburton with respect to FCPA Matters or matters relating to the Barracuda-Caratinga project no longer being available, and the Halliburton indemnities do not apply to all potential losses. For additional information regarding these indemnification agreements and related risks, please read Related Party Transactions and Forward-Looking Information and Risk Factors.

Halliburton has incurred $14 million, $9 million and $8 million for the years ended December 31, 2006, 2005 and 2004, respectively, for expenses relating to the FCPA and bidding practices investigations. In 2004, $1.5 million of the $8 million incurred was charged to us. Except for this $1.5 million, Halliburton has not charged these costs to us. These expenses were incurred for the benefit of both Halliburton and us, and we and Halliburton have no reasonable basis for allocating these costs between Halliburton and us.

Security. In February 2007, we received a letter from the Department of the Army informing us of their intent to adjust payments under the LogCAP III contract associated with the cost incurred by the subcontractors to provide security to their employees. Based on this letter, the DCAA withheld the Army s initial assessment of $20 million. The Army based its assessment on one subcontract wherein, based on communications with the subcontractor, the Army estimated 6% of the total subcontract cost related to the private security costs. The Army indicated that not all task orders and subcontracts have been reviewed and that they may make additional adjustments. The Army indicated that, within 60 days, they intend to begin making further adjustments equal to 6% of prior and current subcontractor costs unless we can provide timely information sufficient to show that such action is not necessary to protect the government s interest. We are working with the Army to provide the additional information they have requested.

The Army indicated that they believe our LogCAP III contract prohibits us from billing costs of privately acquired security. We believe that, while LogCAP III contract anticipates that the Army will provide force protection to KBR employees, it does not prohibit any of our subcontractors from using private security services to provide force protection to subcontractor personnel. In addition, a significant portion of our subcontracts are competitively bid lump sum or fixed price subcontracts. As a result, we do not receive details of the subcontractors cost estimate nor are we legally entitled to it. Accordingly, we believe that we are entitled to reimbursement by the Army for the cost of services provided by our subcontractors, even if they incurred costs for private force protection services. Therefore, we believe that the Army s position that such costs are unallowable and that they are entitled to withhold amounts incurred for such costs is wrong as a matter of law.

If we are unable to demonstrate that such action by the Army is not necessary, a 6% suspension of all subcontractor costs incurred to date could result in suspended costs of approximately $400 million. The Army has asked us to provide information that addresses the use of armed security either directly or indirectly charged to LogCAP III. The actual costs associated with these activities cannot be accurately estimated at this time, but we believe that they should be less than 6% of the total subcontractor costs. As of December 31, 2006, no amounts have been accrued for suspended security billings. Please read *Forward-Looking Information and Risk Factors Risks Related to Our Customers and Contracts Our government contracts work is regularly reviewed and audited by our customer and government auditors, and these reviews can lead to withholding or delay of payments to us, non-receipt of award fees and other remedies against us* for further discussion.

Business Environment and Results of Operations

Business Environment

We are a leading global engineering, construction and services company supporting the energy, petrochemicals, government services and civil infrastructure sectors. We are a leader in many of the growing end-markets that we serve, particularly gas monetization, having designed and constructed, alone or with joint venture partners, more than half of the world s operating LNG production capacity over the past 30 years. In addition, we are one to the ten largest government defense contractors worldwide according to a Defense News ranking based on fiscal 2005 revenue and, accordingly, we believe we are the world s largest government defense services provider. For fiscal year 2005, we were the sixth largest contractor for the DoD based on its prime contract awards.

We offer our wide range of services through two business segments, E&C and G&I. Although we provide a wide range of services, our business in both our E&C segment and our G&I segment is heavily focused on major projects. At any given time, a relatively few number of projects and joint ventures represent a substantial part of our operations. Our projects are generally long term in nature and are impacted by factors including local economic cycles, introduction of new governmental regulation, and governmental outsourcing of services. Demand for our services depends primarily on our customers capital expenditures and budgets for construction and defense services. We have benefitted from increased capital expenditures by our petroleum and petrochemical customers driven by high crude oil and natural gas prices and general global economic expansion. Additionally, the heightened focus on global security and major military force realignments, particularly in the Middle East, as well as a global expansion in government outsourcing, have all contributed to increased demand for the type of services that we provide.

Our operations in some countries may be adversely affected by unsettled political conditions, acts of terrorism, civil unrest, force majeure, war or other armed conflict, expropriation or other governmental actions, inflation, exchange controls, or currency fluctuations.

E&C Segment Activity

Our E&C segment designs and constructs energy and petrochemical projects, including large, technically complex projects in remote locations around the world. Our expertise includes onshore oil and gas production facilities, offshore oil and gas production facilities, including platforms, floating production and subsea facilities

Table of Contents

(which we refer to collectively as our offshore projects), onshore and offshore pipelines, LNG and GTL gas monetization facilities (which we refer to collectively as our gas monetization projects), refineries, petrochemical plants (such as ethylene and propylene) and Syngas, primarily for fertilizer-related facilities. We provide a wide range of Engineering Procurement Construction Commissioning Start-up (EPC-CS) services, as well as program and project management, consulting and technology services.

In order to meet growing energy demands, oil and gas companies are increasing their exploration, production, and transportation spending to increase production capacity and supply. We are currently targeting reimbursable EPC and engineering, procurement, and construction management opportunities in northern and western Africa, the Middle East, the Caspian area, Asia Pacific, Latin America, and the North Sea.

Outsourcing of operations and maintenance work by industrial and energy companies has been increasing worldwide. Opportunities in this area are anticipated as the aging infrastructure in United States refineries and chemical plants requires more maintenance and repairs to minimize production downtime. More stringent industry safety standards and environmental regulations also lead to higher maintenance standards and costs.

In the first quarter of 2006, we signed a $400 million contract to build and operate the Egypt Basic Industries Corporation (EBIC) ammonia plant in Ain Sokna, Egypt. In connection with this project, we are performing the engineering, procurement and construction work for the project and operation and maintenance services for the facility. In August 2006, the lenders providing the construction financing notified EBIC that it was in default of the terms of its debt agreement, which effectively prevented the project from making additional borrowings until such time as certain security interests in the ammonia plant assets related to the export facilities could be perfected. Indebtedness under the debt agreement is non-recourse to us. This default was cured on December 8, 2006 subject to EBIC s submission and the lender s acceptance of the remaining documents by March 2007. No event of default has occurred pursuant to our EPC contract and we have been paid all amounts due from EBIC. In September 2006, we were instructed by EBIC to cease work on one location of the project on which the ammonia storage tanks were originally planned to be constructed due to a decision to relocate the tanks. The new location has been selected and the client and its lenders have agreed to compensate us for approximately $6 million in costs resulting from the relocation of the storage tanks. We resumed work on the ammonia tanks in February 2007.

In July 2006, we were awarded, through a 50%-owned consolidated joint venture, a $997 million contract with Qatar Shell GTL Limited to provide project management and cost-reimbursable engineering, procurement and construction management services for the Pearl GTL project in Ras Laffan, Qatar. The project, which is expected to be completed by 2011, consists of gas production facilities and a GTL plant.

Also in July 2006, we were awarded a $194 million fixed-price EPCm contract by Saudi Kayan Petrochemical Company for a 1.35 million ton per year ethylene plant in Jubail City, Saudi Arabia.

Escravos project. In the second quarter of 2006, we identified a $148 million charge, before income taxes and minority interest, related to our consolidated 50%-owned GTL project in Escravos, Nigeria. This charge was primarily attributable to increases in the overall estimated cost to complete the project. The project, which was awarded in April 2005, has experienced delays relating to civil unrest and security on the Escravos River, near the project site. Further delays have resulted from scope changes, engineering and construction modifications due to necessary front-end engineering design changes and increases in procurement costs due to project delays. As of September 30, 2006, we had approximately $269 million in unapproved change orders related to this project. In the fourth quarter of 2006, we reached agreement with the project owner to settle these change orders. As a result, portions of the remaining work now have a lower risk profile, particularly with respect to security and logistics. Since we completed our first check estimate in the second quarter of 2006, the project has continued to estimate significant additional cost increases. We currently expect to recover these recently identified cost increases through change orders. As of December 31, 2006, we have recorded $43 million of unapproved change orders primarily relates to these cost increases. Because of the civil unrest and security issues that currently exist in Nigeria, uncertainty regarding soil conditions at the property site, and other matters, we could experience substantial additional cost increases on the Escravos project in the future. We believe that future cost increases attributed to civil unrest, security and potential differences in actual rather than anticipated soil conditions should ultimately be recoverable through future change orders pursuant to the terms of our contract as amended in 2006. However, should this occur, there could be timing differences between the recognition of cost and recognition of offsetting potential recoveries from our client, if any. We recorded an additional $9 million loss in the fourth quarter of 2006 related to non-billable engineering services for the Escravos joint venture. These services were in excess of the contractual limit of total engineering costs each partner can bill to the joint venture. As of December 31, 2006, the project was approximately 45% complete.

Barracuda-Caratinga and Belanak projects. In June 2000, we entered into a contract with Barracuda & Caratinga Leasing Company B.V., the project owner, to develop the Barracuda and Caratinga crude oilfields, which are located off the coast of Brazil. We have recorded losses on the project of $19 million, $8 million and $407 million for the years ended December 31, 2006, 2005 and 2004, respectively. We have been in negotiations with the project owner since 2003 to settle the various issues that have arisen and have entered into several agreements to resolve those issues. As part of these settlements, we paid $22 million in liquidated damages. We funded $37 million in cash shortfalls, net of revenue received, during 2006.

The Barracuda-Caratinga vessels are both fully operational. In April 2006, we executed an agreement with Petrobras that enabled us to achieve conclusion of the lenders reliability test and final acceptance of the FPSOs. These acceptances eliminated any further risk of liquidated damages being assessed. Our remaining obligation under the April 2006 agreement is primarily for warranty on the two vessels. At Petrobras direction, we have replaced certain bolts located on the subsea flowlines that have failed through mid-November 2005, and we understand that additional bolts have failed thereafter, which have been replaced by Petrobras. These failed bolts were identified by Petrobras when it conducted inspections of the bolts. The original design specification for the bolts was issued by Petrobras, and as such, we believe the cost resulting from any replacement is not our responsibility. In March 2006, Petrobras submitted this matter to arbitration claiming $220 million plus interest for the cost of monitoring and replacing the defective stud bolts and, in addition, all of the costs and expenses of the arbitration including the cost of attorneys fees. We disagree with Petrobras claim since the bolts met Petrobras design specifications, and we do not believe there is any basis for the amount claimed by Petrobras. We intend to vigorously defend this matter and pursue recovery of the costs we have incurred to date through the arbitration process. Under the master separation agreement we entered into with Halliburton in connection with our initial public offering, Halliburton agreed, subject to certain conditions, to indemnify us and hold us harmless from all cash costs and expenses incurred as a result of the replacement of the subsea bolts. As of December 31, 2006 and 2005, we have not accrued any amounts related to this arbitration.

We have completed construction on another offshore FPSO named Belanak, which is currently in production. Our work on Belanak was pursuant to a fixed-price contract on which we incurred $29 million of losses in 2004. As a result of losses sustained on the Barracuda-Caratinga and other projects, we announced in 2002 that we would no longer pursue bidding on high risk fixed-price EPC-CS contracts for offshore production facilities primarily due to the fact that the risk/reward equation for these types of projects had become unacceptable to us. We believe these projects involve a disproportionate risk and require using a large share of bonding and letter of credit capacity relative to the profit contribution provided by these types of projects. In contrast to risks involved in large onshore, fixed-price EPC-CS contracts, risks involved in these projects include lack of front-end definition of scope, lack of uniform approach to project execution, disproportionate risks allocated to contractors, increase in risk profile as projects shift into deepwater frontiers, unpredictable weather and ocean current conditions and unpredictable local manufacturing conditions and capacity.

G&I Segment Activity

Our G&I segment delivers on-demand support services across the full military mission cycle from contingency logistics and field support to operations and maintenance on military bases. In the civil infrastructure market, we operate in diverse sectors, including transportation, waste and water treatment, and facilities maintenance. We provide program and project management, contingency logistics, operations and maintenance, construction management, engineering, and other services to military and civilian branches of governments and private customers worldwide. We currently provide these services in the Middle East to support one of the largest U.S. military deployments since World War II, as well as in other global locations where military personnel are stationed. A significant portion of our G&I segment s current operations relate to the support of United States government operations in the Middle East, which we refer to as our Middle East operations.

In July 2006, we resumed work under the U.S. Army Europe Support Contract, which was originally awarded in 2005. Under this contract, we will continue to provide support services to U.S. forces deployed in the Balkans. In addition, we will provide camp operations and maintenance, and transportation and maintenance services in support of troops throughout the U.S. Army Europe s area of responsibility, which includes over 90 countries.

In addition, in January 2006, we were awarded a competitively bid indefinite delivery/indefinite quantity contract to support the Department of Homeland Security s U.S. Immigration and Customs Enforcement facilities in the event of an emergency. With a maximum total value of $385 million, this contract has a five-year term, consisting of a one-year base period and four one-year renewal options.

We provide substantial work under our government contracts to the DoD and other governmental agencies. Most of the services provided to the U.S. government are under cost- reimbursable contracts where we have the opportunity to earn an award fee based on our customer s evaluation of the quality of our performance. These award fees are evaluated and granted by our customer periodically. For contracts entered into prior to June 30, 2003, all award fees are recognized during the term of the contract based on our estimate of amounts to be awarded. In 2005, our customer for the LogCAP III contract definitized and granted award fees allocated to a significant amount of cost incurred to date, many of which related to costs incurred and services provided in earlier years. Accordingly, award fees totaling $53 million in excess of amounts previously accrued were recognized in 2005. In addition, based on the award fee scores, which determined the fees awarded during 2005, we increased our award fee accrual rate on the LogCAP III contract from 50% to 72%, which resulted in an additional $14 million of award fees being recorded in 2005. We continue to receive a performance rating of excellent for our work under the LogCAP III contract. This rating translated to an average award fee of 90%. Based on this rating, our historical experience and our assessment of our performance, we increased our award fee accrual percentage from 72% to 84% in 2006.

In April 2006, Aspire Defence, a joint venture between us, Mowlem Plc. and a financial investor, was awarded a privately financed project contract, the Allenby & Connaught project, by the MoD to upgrade and provide a range of services to the British Army s garrisons at Aldershot and around Salisbury Plain in the United Kingdom. In addition to a package of ongoing services to be delivered over 35 years, the project includes a nine year construction program to improve soldiers single living, technical and administrative accommodations, along with leisure and recreational facilities. Aspire Defence will manage the existing properties and will be responsible for design, refurbishment, construction and integration of new and modernized facilities. At December 31, 2006, we indirectly owned a 45% interest in Aspire Defence, the project company that is the holder of the 35-year concession contract. In addition, at December 31, 2006, we owned a 50% interest in each of two joint ventures that provide the construction and the related support services to Aspire Defence. As of December 31, 2006, our performance through the construction phase is supported by $159 million in letters of credit and surety bonds totaling $209 million, both of which have been guaranteed by Halliburton. Furthermore, our financial and performance guarantees are joint and several, subject to certain limitations, with our joint venture partners. The project is funded through equity and subordinated debt provided by the project sponsors, including us, and the issuance of publicly held senior bonds.

Table of Contents

We are also the majority owner of DML, the owner and operator of one of Western Europe s largest naval dockyard complexes. Our DML shipyard operations are primarily engaged in refueling nuclear submarines and performing maintenance on surface vessels for the MoD as well as limited commercial projects. We are engaging in discussions with the MoD regarding KBR s ownership in DML and the possibility of reducing or disposing of our interest. Although no decision has been made with respect to a disposition of our interest in DML, we are supporting a process to identify potential bidders that may have an interest in acquiring our interest in DML. We do not know at this time if the process will result in a disposition of our interest in DML.

We also expect the volume of our work under our DML joint venture s contract to refit the MoD s nuclear submarine fleet to decline in 2009 and 2010 as we complete this round of refueling of the current fleet. As a result, we are focused on diversifying our G&I segment s project portfolio and capitalizing on the positive government outsourcing trends with work on other MoD projects and for the U.S. Air Force under the AFCAP contract.

With respect to the Alice Springs-Darwin railroad project, we own a 36.7% interest in a joint venture that is the holder of a 50-year concession contract with the Australian government to operate and maintain the railway. We account for this investment using the equity method of accounting. This joint venture has sustained losses since commencing operations due to lower than anticipated freight volume and a slowdown in the planned expansion of the Port of Darwin. At the end of the first quarter of 2006, the joint venture s revised financial forecast led us to record a $26 million impairment charge. In October 2006, the joint venture incurred an event of default under its loan agreement by failing to make an interest and principal payment. These loans are non-recourse to us. In light of the default, the joint venture s need for additional financing and the realization that the joint venture efforts to raise additional equity from third parties was not successful, we recorded an additional $32 million impairment charge in the third quarter of 2006. We will receive no tax benefit as this impairment charge is not deductible for Australian tax purposes. In December 2006, the senior lenders agreed to waive existing defaults and concede certain rights under the existing indenture. Among these were a reduction in the joint venture s debt service reserve and the relinquishment of the right to receive principal payments for 27 months, through March 2009. In exchange for these concessions, the shareholders of the joint venture committed approximately $12 million of new subordinated financing, of which $6 million was committed by us. At December 31, 2006, our investment in this joint venture was $6 million. The $6 million additional funding commitment was still outstanding.

We are involved in four privately financed projects, executed through joint ventures, to design, build, operate, and maintain roadways for certain government agencies in the United Kingdom. We have a 25% ownership interest in these joint ventures and account for them using the equity method of accounting. With respect to one of these roadways, we received a revised financial forecast during the second quarter of 2006, which takes into account sustained projected losses due to lower than anticipated long vehicle traffic and higher than forecasted lane availability deductions, which reduces project revenues. Because of this new information, we recorded an impairment charge of $10 million during the second quarter of 2006. As of December 31, 2006, the carrying value of our investment in this joint venture and the related company that performed the construction of the road was $0, and we had no additional funding commitments.

In the civil infrastructure sector, there has been a general trend of historic under-investment. In particular, infrastructure related to the quality of water, wastewater, roads and transit, airports, and educational facilities has declined while demand for expanded and improved infrastructure continues to outpace funding. As a result, we expect increased opportunities for our engineering and construction services and for our privately financed project activities as our financing structures make us an attractive partner for state and local governments undertaking important infrastructure projects.

Table of Contents

Contract structure. Engineering and construction contracts can be broadly categorized as either cost-reimbursable or fixed-price, sometimes referred to as lump sum. Some contracts can involve both fixed-price and cost-reimbursable elements. Fixed-price contracts are for a fixed sum to cover all costs and any profit element for a defined scope of work. Fixed-price contracts entail more risk to us as we must predetermine both the quantities of work to be performed and the costs associated with executing the work. While fixed-price contracts involve greater risk, they also are potentially more profitable for the contractor, since the owner/customer pays a premium to transfer many risks to the contractor. Cost-reimbursable contracts include contracts where the price is variable based upon our actual costs incurred for time and materials, or for variable quantities of work priced at defined unit rates. Profit on cost-reimbursable contracts may be based upon a percentage of costs incurred and/or a fixed amount. Cost-reimbursable contracts are generally less risky, since the owner/customer retains many of the risks. We are continuing with our strategy to move away from offshore fixed-price EPIC contracts within our E&C segment. We have only two remaining major fixed-price EPIC offshore projects. As of December 31, 2006, they were substantially complete.

Results of Operations

	Years Ended December 31,		
	2006	2005	2004
	(In millions of dollars)		
Revenue: (1)			
G&I Middle East Operations	$ 5,262	$ 5,966	$ 7,454
G&I DML Shipyard Operations	850	863	738
G&I Other	1,137	1,307	1,217
Total Government and Infrastructure	7,249	8,136	9,409
E&C Gas Monetization Projects	898	304	223
E&C Offshore Projects	316	463	656
E&C Other	1,170	1,243	1,618
Total Energy and Chemicals	2,384	2,010	2,497
Total revenue	$ 9,633	$ 10,146	$ 11,906
Operating Income (loss):			
G&I Middle East Operations	$ 159	$ 167	$ 25
G&I DML Shipyard Operations	86	62	48
G&I Other	(44)	103	9
Total Government and Infrastructure	201	332	82
E&C Gas Monetization Projects	(106)	13	22
E&C Offshore Projects	21	30	(454)
E&C Other	130	80	(7)
Total Energy and Chemicals	45	123	(439)
Total operating income (loss)	$ 246	$ 455	$ (357)

(1) Our revenue includes both equity in the earnings of unconsolidated affiliates as well as revenue from the sales of services into the joint ventures. We often participate on larger projects as a joint venture partner and also provide services to the venture as a subcontractor. The amount included in our revenue represents our share of total project revenue, including equity in the earnings from joint ventures and revenue from services provided to joint ventures.

33

Table of Contents

Year ended December 31, 2006 compared to year ended December 31, 2005

Revenue. G&I revenue decreased $887 million to $7.2 billion in 2006 compared to $8.1 billion in 2005. This decrease is primarily due to a $698 million decrease in revenue from Iraq-related activities and a $151 million decrease in revenue associated with hurricane repair efforts for U.S. naval facilities under our CONCAP contract.

G&I revenue from our Middle East operations, which includes Iraq-related activities for 2006 was $5.3 billion compared to $6.0 billion for 2005. This $704 million decrease was primarily due to lower activity on our LogCAP III contract as our customer continued to scale back the construction and procurement related to military sites in Iraq.

G&I revenue from our DML shipyard operations for 2006 was $850 million compared to $863 million for 2005. This decrease reflects lower spending by the MoD. DML shipyard operations revenue and operating results generally vary with the level of service provided on military vessels in a period. In addition, DML has experienced a decrease in activity on commercial shipbuilding as certain projects near completion.

E&C revenue increased $374 million to $2.4 billion for 2006 compared to $2.0 billion for 2005. This increase in revenue was primarily due to a $594 million increase in revenue from our gas monetization projects. These increases were partially offset by a $241 million decrease in revenue from a crude oil project in Canada.

E&C revenue from our gas monetization projects for 2006 was $898 million compared to $304 million for 2005. This increase is primarily due to the start-up of several projects awarded in 2005 or early 2006, including the work performed by us on the Pearl project and revenue earned on the Escravos GTL project. Revenue related to these two projects and our work on the Yemen and Skikda projects increased an aggregate of $561 million in 2006 compared to 2005.

E&C revenue from our offshore projects for 2006 was $316 million compared to $463 million for 2005. This decrease in revenue is primarily due to reduced activity on our lump-sum EPIC projects, Barracuda-Caratinga and Belanak. In April of 2006, we received acceptance of the FPSOs on the Barracuda-Carratinga project. These decreases were partially offset by increased revenues from several other reimbursable offshore projects. Our current offshore work is primarily related to work we are performing in the Caspian Sea.

Operating income. G&I operating income decreased $131 million to $201 million for 2006 compared to $332 million for 2005. This decrease is primarily related to $58 million of impairment charges recorded on our equity investment in the Alice Springs-Darwin railroad operations and a $10 million impairment charge recorded on an equity investment in a joint venture road project in the United Kingdom. In addition, we recorded a $96 million gain from the sale of and one-time cash distribution from our interest in a U.S. toll road in 2005, which contributed to the negative variance.

G&I operating income from our Middle East operations was $159 million for 2006 compared to $167 million in 2005. The decrease in operating income was largely due to the favorable resolution of fuel and other issues in 2005.

G&I operating income from our DML shipyard operations in 2006 increased to $86 million compared to $62 million for 2005. This increase is primarily due to the resolution of several items with our government and private customers in addition to increased performance incentives.

E&C operating income for 2006 was $45 million compared to operating income of $123 million in 2005. The $78 million decrease was primarily due to a $157 ($148 million and $9 million in the second and fourth quarters of 2006, respectively) million charge related to the Escravos GTL project in Nigeria, which is included in our gas monetization projects. This decrease was partially offset by an aggregate $60 million increase in operating income in other projects including an ammonia project in Egypt and other gas monetization projects.

E&C operating loss from gas monetization for 2006 was $106 million compared to operating income of $13 million for 2005. We recorded charges totaling $157 million in the second and fourth quarter of 2006, before income taxes and minority interests, related to our Escravos GTL project in Nigeria. This charge was primarily attributable to increases in the overall estimated cost to complete the project and an increase in our engineering hours in excess of amounts billable to the joint venture. The project has experienced delays relating to civil unrest and security on the Escravos River, near the project site, and further delays have resulted from scope changes and engineering and construction modifications. This charge was partially offset by an increase in operating income from more recently awarded projects such as our Yemen LNG project and work performed on our Pearl GTL project.

E&C operating income from our offshore projects for 2006 was $21 million compared to $30 million for 2005. Operating income decreased primarily due to $15 million of additional charges for our Barracuda-Carratinga project recorded in the first quarter of 2006 and a decrease in operating income related to our Belanak project. These decreases were partially offset by increases in operating income related to work we are performing in the Caspian Sea.

Non-operating items. Related party interest expense increased to $36 million for 2006 compared to $24 million for 2005 primarily due to the conversion of the non-interest bearing portion of our intercompany payable to Halliburton into $774 million interest bearing subordinated intercompany notes to subsidiaries of Halliburton, which occurred in December 2005. This increase was partially offset as a result of the subordinated intercompany notes being paid in full during the fourth quarter of 2006.

Net interest income increased $30 million to $26 million for 2006 compared to net interest expense of $4 million for 2005. The increase in net interest income is primarily due to additional interest earned on cash advances from our customers and proceeds from our initial public offering in the fourth quarter of 2006.

Provision for income taxes from continuing operations in 2006 was $129 million compared to $182 million in 2005. Our effective tax rate in 2006 was 59%, which exceeded our statutory rate of 35% due to not receiving a tax benefit for the impairment charge on our investment in the Alice-Springs Darwin railroad in Australia, return to accrual adjustments recorded in 2006, and foreign tax credit displacement resulting from the domestic net operating losses created by the asbestos settlement with Halliburton. Our effective tax rate in 2005 was 42%, which is higher than the statutory rate of 35% primarily due to foreign tax credit displacement resulting from the domestic net operating losses from the asbestos settlement with Halliburton.

Minority interest in net (income) losses of subsidiaries decreased from $41 million in 2005 to $10 million in 2006 primarily due to $74 million from our 50% partners share of the losses recorded on the Escravos project, which was partially offset by increased earnings from our other less than 100%-owned consolidated subsidiaries.

Income from discontinued operations, net of tax provision, all of which is related to the operations of our Production Services Group, was $87 million in 2006 which included a pre-tax gain of $120 million from the sale that occurred in April 2006.

Foreign currency gains (losses), net. Foreign currency losses increased by $20 million in 2006 compared to 2005. This increase is primarily attributable to foreign currency losses on the proceeds from the sale of our Production Services group. These proceeds were received in U.S. dollars and held by our U.K. subsidiary with a British pound functional currency through July 2006. The British Pound strengthened against the U.S. dollar during the period, resulting in a net loss.

Year ended December 31, 2005 compared to year ended December 31, 2004

Revenue. G&I revenue decreased $1.3 billion to $8.1 billion in 2005 compared to $9.4 billion in 2004. This decrease is primarily related to decreases in our Middle East operations, which was partially offset by increased revenue from DML shipyard operations and a $230 million increase in revenue associated with hurricane repair efforts for U.S. naval facilities under our CONCAP contract.

Revenue from our Middle East operations in 2005 was $6.0 billion compared to $7.5 billion in 2004. This $1.5 billion decrease is primarily due to the completion of our Restore Iraqi Oil (RIO) contract in 2004, which contributed $1.0 billion to the decrease, and $345 million in lower revenue from our LogCAP III contract. In addition, revenue from our PCO Oil South contract was $98 million lower in 2005 compared to 2004.

Revenue from our DML shipyard operations in 2005 was $863 million compared to $738 million in 2004. The increase was primarily attributed to an increase in commercial shipbuilding revenue associated with three new projects. DML also increased its involvement with naval support contracts in communications, weapons and spares. DML also experienced increased work associated with the MoD, DML s largest customer.

E&C revenue decreased $487 million to $2.0 billion in 2005 compared to $2.5 billion in 2004. Revenue from our offshore projects decreased $193 million and revenue from oil and gas projects in Africa decreased $240 million. These decreases were partially offset by an $81 million increase in revenue from our gas monetization projects.

Revenue from our gas monetization projects in 2005 was $304 million compared to $223 million in 2004. This increase was primarily due to the start-up of several projects awarded in late 2004 or 2005, including the front-end engineering and design work performed on our Pearl project, and the Escravos GTL project. Revenue related to these two projects increased $95 million in 2005 compared to 2004. In addition, revenue from our Tangguh, Yemen, Gorgon and Skikda LNG projects as well as Train 6 of our Nigeria LNG project increased an aggregate $137 million of revenue in 2005 compared to 2004. These increases were partially offset by a $137 million of decreased revenue related to our Segas LNG project in Egypt and Trains 4 and 5 of our Nigeria LNG project, which were nearing completion in 2005 and early 2006.

Revenue from our offshore projects in 2005 was $463 million compared to $656 million in 2004, a decrease of $193 million. This decrease was attributable to decreased revenue from our Barracuda-Caratinga project in Brazil and Belanak project in Indonesia, which decreased an aggregate of $149 million. These two projects were either completed or were nearing completion in 2005. In addition, revenue from our PEMEX project in Mexico decreased $26 million. These decreases were partially offset by a combined $45 million increase related to our project in the Caspian Sea.

Operating income. G&I operating income increased $250 million to $332 million in 2005 compared to $82 million in 2004. Operating income from our Middle East operations and DML shipyard operations for 2005 increased $142 million and $14 million, respectively, compared to 2004. Hurricane repair efforts for U.S. Naval facilities on the Gulf Coast under the CONCAP construction contingency contract also contributed to the increase. Operating income in 2005 also included $96 million from the sale of and one-time cash distribution from our interest in the Dulles Greenway toll road joint venture. In addition, G&I segment results in 2004 included restructuring charges of $12 million.

Operating income from our Middle East operations in 2005 was $167 million compared to $25 million in 2004. Operating income on our LogCAP III contract increased $153 million in 2005 compared to 2004, primarily due to $43 million of additional income from award fees on definitized LogCAP III task orders, $10 million from the settlement of dining facilities-related issues, $14 million from the increase of our award fee accrual rate from 50% to 72% (due to the definitization of a substantial amount of task orders in the first six months of 2005), and $11 million as a result of resolving fuel and other issues with the customer. In addition, we incurred approximately $11 million in charges associated with potentially disallowed costs, primarily related to Iraq activities, in 2005 compared to $83 million in 2004. These increases were partially offset by a decrease in operating income as we completed the RIO contract in 2004.

Operating income from our DML shipyard operations in 2005 was $62 million compared to $48 million in 2004. The increase was primarily attributable to three new commercial projects and an increase in the level of activity with the MoD, which is DML s largest customer.

Table of Contents

E&C operating income increased $562 million to $123 million in 2005 compared to a loss of $439 million in 2004. This increase in operating income was primarily due to losses, incurred in 2004, on our offshore projects. Operating income in 2005 also benefited from $21 million of gains on sales of assets. These increases were partially offset by a $9 million decrease in operating income from our gas monetization projects.

Operating income from our gas monetization projects in 2005 was $13 million compared to operating income of $22 million in 2004. Operating income on our Tangguh and Gorgon projects, as well as Train 6 of our Nigeria LNG project contributed $51 million in 2005. This increase was partially offset by reduced earnings due to the completion of our Segas and other projects.

Operating income from our offshore projects in 2005 was $30 million compared to an operating loss of $454 million in 2004. This increase was primarily due to losses incurred in 2004, which did not recur in 2005. These losses include a $407 million loss on the Barracuda-Caratinga project and a $29 million loss on the Belanak project.

Non-operating items. Related party interest expense increased $9 million to $24 million in 2005 compared to $15 million in 2004. This increase was primarily due to an overall increase in variable interest rates associated with our intercompany debt and interest expense charged on $774 million of intercompany notes with Halliburton, which were executed in December 2005. Prior to the execution of these notes, portions of our intercompany debt were non-interest bearing.

Provision for income taxes on income from continuing operations in 2005 of $182 million resulted in an effective tax rate of 42% compared to an effective tax rate of 25% on losses incurred in 2004. Our 2005 tax rate is higher than our statutory rate of 35% primarily due to foreign tax credit displacement resulting from the domestic net operating losses from the asbestos settlement by Halliburton. The 2004 effective rate is lower than our statutory rate of 35% due to unfavorable effect of the valuation allowance recorded on foreign tax credit carryforwards.

Minority interest in net income of subsidiaries increased $16 million to $41 million in 2005 compared to $25 million in 2004. This increase is primarily due to earnings growth from the DML shipyard and earnings from a consolidated joint venture formed in 2005 for a GTL project in Nigeria.

Income from discontinued operations, net of tax, increased $19 million to $30 million in 2005 compared to $11 million in 2004 and relates to the Production Services group that was sold in May 2006.

Critical Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to select appropriate accounting policies and to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Our critical accounting policies are described below to provide a better understanding of how we develop our assumptions and judgments about future events and related estimations and how they can impact our financial statements. A critical accounting estimate is one that requires our most difficult, subjective, or complex estimates and assessments and is fundamental to our results of operations.

We base our estimates on historical experience and on various other assumptions we believe to be reasonable according to the current facts and circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. We believe the following are the critical accounting policies used in the preparation of our consolidated financial statements in accordance with accounting principles generally accepted in the United States, as well as the significant estimates and judgments affecting the application of these policies. This discussion and analysis should be read in conjunction with our consolidated financial statements and related notes.

Percentage of completion. Revenue from long-term contracts to provide construction, engineering, design or similar services are reported on the percentage-of-completion method of accounting. This method of accounting requires us to calculate job profit to be recognized in each reporting period for each job based upon our projections of future outcomes, which include estimates of the total cost to complete the project; estimates of the project schedule and completion date; estimates of the extent of progress toward completion; and amounts of any probable unapproved claims and change orders included in revenue. Progress is generally based upon physical progress, man-hours or costs incurred depending on the type of job. Physical progress is determined as a combination of input and output measures as deemed appropriate by the circumstances.

At the outset of each contract, we prepare a detailed analysis of our estimated cost to complete the project. Risks relating to service delivery, usage, productivity, and other factors are considered in the estimation process. Our project personnel periodically evaluate the estimated costs, claims, change orders, and percentage of completion at the project level. The recording of profits and losses on long-term contracts requires an estimate of the total profit or loss over the life of each contract. This estimate requires consideration of total contract value, change orders, and claims, less costs incurred and estimated costs to complete. Anticipated losses on contracts are recorded in full in the period in which they become evident. Profits are recorded based upon the product of estimated contract profit times the current percentage-complete for the contract.

When calculating the amount of total profit or loss on a long-term contract, we include unapproved claims in contract value when the collection is deemed probable based upon the four criteria for recognizing unapproved claims under the American Institute of Certified Public Accountants Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Including probable unapproved claims in this calculation increases the operating income (or reduces the operating loss) that would otherwise be recorded without consideration of the probable unapproved claims. Probable unapproved claims are recorded to the extent of costs incurred and include no profit element. In all cases, the probable unapproved claims included in determining contract profit or loss are less than the actual claim that will be or has been presented to the customer. We are actively engaged in claims negotiations with our customers, and the success of claims negotiations has a direct impact on the profit or loss recorded for any related long-term contract. Unsuccessful claims negotiations could result in decreases in estimated contract profits or additional contract losses, and successful claims negotiations could result in increases in estimated contract profits or recovery of previously recorded contract losses.

At least quarterly, significant projects are reviewed in detail by senior management. We have a long history of working with multiple types of projects and in preparing cost estimates. However, there are many factors that impact future costs, including but not limited to weather, inflation, labor and community disruptions, timely availability of materials, productivity, and other factors as outlined in our Forward-Looking Information and Risk Factors. These factors can affect the accuracy of our estimates and materially impact our future reported earnings. In the past, we have incurred substantial losses on projects that were not initially projected, including our Barracuda-Caratinga project (see Barracuda-Caratinga Project in Note 7 of our consolidated financial statements for further discussion).

Accounting for government contracts. Most of the services provided to the United States government are governed by cost-reimbursable contracts. Services under our LogCAP, PCO Oil South, and Balkans support contracts are examples of these types of arrangements. Generally, these contracts contain both a base fee (a fixed profit percentage applied to our actual costs to complete the work) and an award fee (a variable profit percentage applied to definitized costs, which is subject to our customer s discretion and tied to the specific performance measures defined in the contract, such as adherence to schedule, health and safety, quality of work, responsiveness, cost performance, and business management).

Revenue is recorded at the time services are performed, and such revenues include base fees, actual direct project costs incurred and an allocation of indirect costs. Indirect costs are applied using rates approved by our government customers. The general, administrative, and overhead cost reimbursement rates are estimated periodically in accordance with government contract accounting regulations and may change based on actual costs incurred or based upon the volume of work performed. Revenue is reduced for our estimate of costs that

Table of Contents

either are in dispute with our customer or have been identified as potentially unallowable per the terms of the contract or the federal acquisition regulations.

Award fees are generally evaluated and granted periodically by our customer. For contracts entered into prior to June 30, 2003, award fees are recognized during the term of the contract based on our estimate of amounts to be awarded. Once award fees are granted and task orders underlying the work are definitized, we adjust our estimate of award fees to actual amounts earned. Our estimates are often based on our past award experience for similar types of work. We have been receiving award fees on the Balkans project since 1995, and our estimates for award fees for this project have generally been accurate in the periods presented. During 2005, we began to receive LogCAP award fee scores and, based on these actual amounts, we adjusted our accrual rate for future awards. The controversial nature of this contract may cause actual awards to vary significantly from past experience.

For contracts containing multiple deliverables entered into subsequent to June 30, 2003 (such as PCO Oil South), we analyze each activity within the contract to ensure that we adhere to the separation guidelines of Emerging Issues Task Force Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, and the revenue recognition guidelines of Staff Accounting Bulletin No. 104 Revenue Recognition. For service-only contracts and service elements of multiple deliverable arrangements, award fees are recognized only when definitized and awarded by the customer. The LogCAP IV contract would be an example of a contract in which award fees would be recognized only when definitized and awarded by the customer. Award fees on government construction contracts are recognized during the term of the contract based on our estimate of the amount of fees to be awarded.

Similar to many cost-reimbursable contracts, these government contracts are typically subject to audit and adjustment by our customer. Each contract is unique; therefore, the level of confidence in our estimates for audit adjustments varies depending on how much historical data we have with a particular contract. Further, the significant size and controversial nature of our contracts may cause actual awards to vary significantly from past experience.

Income tax accounting. We are currently included in the consolidated U.S. federal income tax return of Halliburton. Additionally, many of our subsidiaries are subject to consolidation, group relief or similar provisions of tax law in foreign jurisdictions that allow for sharing of tax attributes with other Halliburton affiliates. Our income tax expense is calculated on a pro rata basis. Additionally, intercompany settlements attributable to utilization of tax attributes are dictated by a tax sharing agreement. Our tax sharing agreement with Halliburton provides for settlement of tax attributes utilized by Halliburton on a consolidated basis. Therefore, intercompany settlements due to utilized attributes are only established to the extent that the attributes decreased the tax liability of another affiliate in any given jurisdiction. The adjustment to reflect the difference between the tax provision/benefit calculated as described above and the amount settled with Halliburton pursuant to the tax sharing agreement is recorded as a contribution or distribution to member s equity. For purposes of determining income tax expense, it is assumed that we will continue to file on this consolidated basis until the separation from Halliburton is completed.

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been recognized in the financial statements or tax returns. We apply the following basic principles in accounting for our income taxes: a current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year; a deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards; the measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law, and the effects of potential future changes in tax laws or rates are not considered; and the value of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will not be realized. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment.

Our methodology for recording income taxes requires a significant amount of judgment in the use of assumptions and estimates. Additionally, we use forecasts of certain tax elements such as taxable income and foreign tax credit utilization, as well as evaluate the feasibility of implementing tax planning strategies. Given the inherent uncertainty involved with the use of such variables, there can be significant variation between anticipated and actual results. Unforeseen events may significantly impact these variables, and changes to these variables could have a material impact on our income tax accounts related to both continuing and discontinued operations.

We have operations in a number of countries other than the United States. Consequently, we are subject to the jurisdiction of a significant number of taxing authorities. The income earned in these various jurisdictions is taxed on differing bases, including income actually earned, income deemed earned, and revenue-based tax withholding. The final determination of our tax liabilities involves the interpretation of local tax laws, tax treaties, and related authorities in each jurisdiction. Changes in the operating environment, including changes in tax law and currency/repatriation controls, could impact the determination of our tax liabilities for a tax year.

Tax filings of our subsidiaries, unconsolidated affiliates, and related entities are routinely examined in the normal course of business by tax authorities. These examinations may result in assessments of additional taxes, which we work to resolve with the tax authorities and through the judicial process. Predicting the outcome of disputed assessments involves some uncertainty. Factors such as the availability of settlement procedures, willingness of tax authorities to negotiate, and the operation and impartiality of judicial systems vary across the different tax jurisdictions and may significantly influence the ultimate outcome. We review the facts for each assessment, and then utilize assumptions and estimates to determine the most likely outcome and provide taxes, interest, and penalties as needed based on this outcome.

Legal and Investigation Matters. As discussed in Notes 14 and 15 of our consolidated financial statements, as of December 31, 2006 and December 31, 2005, we have accrued an estimate of the probable and estimable costs for the resolution of some of these matters. For other matters for which the liability is not probable and reasonably estimable, we have not accrued any amounts. Attorneys in our legal department monitor and manage all claims filed against us and review all pending investigations. Generally, the estimate of probable costs related to these matters is developed in consultation with internal and outside legal counsel representing us. Our estimates are based upon an analysis of potential results, assuming a combination of litigation and settlement strategies. The precision of these estimates is impacted by the amount of due diligence we have been able to perform. We attempt to resolve these matters through settlements, mediation, and arbitration proceedings when possible. If the actual settlement costs, final judgments, or fines, after appeals, differ from our estimates, our future financial results may be materially and adversely affected. We have in the past recorded significant adjustments to our initial estimates of these types of contingencies.

Pensions. Our pension benefit obligations and expenses are calculated using actuarial models and methods, in accordance with Statement of Financial Accounting Standards No. 158 (SFAS No. 158), Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 123(R). Two of the more critical assumptions and estimates used in the actuarial calculations are the discount rate for determining the current value of plan benefits and the expected rate of return on plan assets. Other critical assumptions and estimates used in determining benefit obligations and plan expenses, including demographic factors such as retirement age, mortality, and turnover, are also evaluated periodically and updated accordingly to reflect our actual experience.

Discount rates are determined annually and are based on rates of return of high-quality fixed income investments currently available and expected to be available during the period to maturity of the pension benefits. Expected long-term rates of return on plan assets are determined annually and are based on an evaluation of our plan assets, historical trends, and experience, taking into account current and expected market conditions. Plan assets are comprised primarily of equity and debt securities. As we have both domestic and international plans, these assumptions differ based on varying factors specific to each particular country or economic environment.

The discount rate utilized to determine the projected benefit obligation at the measurement date for our U.S. pension plans remained flat at 5.75% at December 31, 2006 and 2005. The discount rate utilized to determine the projected benefit obligation at the measurement date for our U.K. pension plans, which constitutes all of our international plans and 99% of all plans, remained flat at 5.00% at December 31, 2006 and 2005. An additional future decrease in the discount rate of 25 basis points for our U.K. pension plans would increase our projected benefit obligation by an estimated $150 million, while a similar increase in the discount rate would reduce our projected benefit obligation by an estimated $144 million.

Our defined benefit plans reduced pretax earnings by $39 million, $48 million and $58 million for the years ended December 31, 2006, 2005 and 2004, respectively. Included in the amounts were earnings from our expected pension returns of $180 million, $161 million and $150 million for the years ended December 31, 2006, 2005 and 2004, respectively. Unrecognized actuarial gains and losses are being recognized over a period of 11 to 15 years, which represents the expected remaining service life of the employee group. Our unrecognized actuarial gains and losses arise from several factors, including experience and assumptions changes in the obligations and the difference between expected returns and actual returns on plan assets. Actual returns were $254 million, $470 million and $220 million for the years ended December 31, 2006, 2005 and 2004, respectively. The difference between actual and expected returns is deferred as an unrecognized actuarial gain or loss and is recognized as future pension expense. Our unrecognized actuarial loss at December 31, 2006 was $633 million, of which $29 million will be recognized as a component of our expected 2007 pension expense. During 2006, we made contributions to fund our defined benefit plans of $129 million, which included $74 million contributed in order to mitigate a portion of the projected underfunding of our UK Plans. We currently expect to make contributions in 2007 of approximately $57 million.

The actuarial assumptions used in determining our pension benefits may differ materially from actual results due to changing market and economic conditions, higher or lower withdrawal rates, and longer or shorter life spans of participants. While we believe that the assumptions used are appropriate, differences in actual experience or changes in assumptions may materially affect our financial position or results of operations.

Financial Instruments Market Risk

Foreign currency risk. We have foreign currency exchange rate risk resulting from international operations. We do not comprehensively hedge the exposure to currency rate changes; however, we selectively manage these exposures through the use of derivative instruments to mitigate our market risk from these exposures. The objective of our risk management program is to protect our cash flow related to sales or purchases of goods or services from market fluctuations in currency rates. We do not use derivative instruments for trading purposes. We used a Monte Carlo simulation model to analyze our year-end 2006 derivative instruments used to hedge our foreign currency exposure noting the value at risk was immaterial.

Interest rate risk. The following table represents principal amounts of our long-term debt at December 31, 2006 and related weighted average interest rates on the payment amounts by year of maturity for our long-term debt.

	2007	2008	2009	2010	2011	Thereafter	Total
			(millions of dollars)				
Variable-rate debt:							
Repayment amount ($US)	18	2					20
Weighted average interest rate on repaid amount	5.7%	6.0%					5.7%

Environmental Matters

We are subject to numerous environmental, legal, and regulatory requirements related to our operations worldwide. In the United States, these laws and regulations include, among others: the Comprehensive Environmental Response, Compensation, and Liability Act; the Resources Conservation and Recovery Act; the Clean Air Act; the Federal Water Pollution Control Act; and the Toxic Substances Control Act.

In addition to the federal laws and regulations, states and other countries where we do business often have numerous environmental, legal, and regulatory requirements by which we must abide. We evaluate and address the environmental impact of our operations by assessing and remediating contaminated properties in order to avoid future liabilities and comply with environmental, legal, and regulatory requirements. On occasion, we are involved in specific environmental litigation and claims, including the remediation of properties we own or have operated, as well as efforts to meet or correct compliance-related matters. Our Health, Safety and Environment group has several programs in place to maintain environmental leadership and to prevent the occurrence of environmental contamination. We do not expect costs related to environmental matters to have a material adverse effect on our consolidated financial position or our results of operations.

Related Party Transactions

Historically, all transactions between Halliburton and KBR were recorded as an intercompany payable or receivable. At December 31, 2004, KBR had an outstanding intercompany payable to Halliburton of $1.2 billion. In October 2005, Halliburton contributed $300 million of the intercompany balance to KBR equity in the form of a capital contribution. On December 1, 2005, the remaining intercompany balance was converted to two long-term notes payable to Halliburton subsidiaries (Subordinated Intercompany Notes). At December 31, 2005, the outstanding aggregate principal balance of the Subordinated Intercompany Notes was $774 million and was to be paid on or before December 31, 2010. Interest on both notes, which accrued at 7.5% per annum, was payable semi-annually beginning June 30, 2006. The notes were subordinated to the Revolving Credit Facility. At December 31, 2005, the amount of $774 million is shown in the Consolidated Financial Statements as Notes Payable to Related Party. During the fourth quarter of 2006, we paid in full the $774 million of Subordinated Intercompany Notes.

In addition, Halliburton, through the date of our initial public offering in November 2006, continued to provide daily cash management services. Accordingly, we invested surplus cash with Halliburton on a daily basis, which will be returned as needed for operations. A Halliburton subsidiary executed a demand note payable (Halliburton Cash Management Note) for amounts outstanding under these arrangements. Annual interest on the Halliburton Cash Management Note has been based on the closing rate of overnight Federal Funds rate determined on the first business day of each month. Similarly, from time to time, we borrowed funds from Halliburton, subject to limitations provided under the Revolving Credit Facility, on a daily basis pursuant to a note payable (KBR Cash Management Note). Annual interest on the KBR Cash Management Note is based on the six-month Eurodollar Rate plus 1.00%. In connection with our initial public offering in November of 2006, Halliburton repaid to us the $387 million balance in the Halliburton Cash Management Note. At December 31, 2006, KBR has a $152 million balance payable to Halliburton which consists of amounts KBR owes Halliburton for estimated current year outstanding income taxes, amounts owed pursuant to our transition services agreement and other amounts.

We conduct business with other Halliburton entities on a commercial basis, and we recognize revenues as services are rendered and costs as they are incurred. Amounts billed to us by Halliburton were primarily for services provided by Halliburton s Energy Services Group on projects in the Middle East and were $0, $0 and $18 million for the years ended December 31, 2006, 2005 and 2004, respectively, and are included in cost of services in the consolidated statements of operations. Amounts we billed to Halliburton s Energy Services Group were $2 million, $1 million and $4 million for the years ended December 31, 2006, 2005 and 2004, respectively.

In addition to the transactions described above, Halliburton and certain of its subsidiaries provide various support services to KBR, including information technology, legal and internal audit. Costs for information

Table of Contents

technology, including payroll processing services, which totaled $11 million , $20 million and $19 million for the years ended December 31, 2006, 2005 and 2004, respectively, are allocated to KBR based on a combination of factors of Halliburton and KBR, including relative revenues, assets and payroll, and negotiation of the reasonableness of the charge. Costs for other services allocated to us were $23 million, $20 million and $20 million for the years ended December 31, 2006, 2005 and 2004, respectively. Costs for these other services, including legal services and audit services, are primarily charged to us based on direct usage of the service. Costs allocated to KBR using a method other than direct usage are not significant individually or in the aggregate. We believe the allocation methods are reasonable. In addition, KBR leases office space to Halliburton at its Leatherhead, U.K. location.

Historically, Halliburton has centrally developed, negotiated and administered our risk management process. This insurance program has included broad, all-risk coverage of worldwide property locations, excess worker s compensation, general, automobile and employer liability, director s and officer s and fiduciary liability, global cargo coverage and other standard business coverages. Net expenses of $17 million, $17 million and $20 million, representing our share of these risk management coverages and related administrative costs, have been allocated to us for the years ended December 31, 2006, 2005 and 2004, respectively. These expenses are included in cost of services in the consolidated statements of operations. Historically, we have been self insured, or have participated in a Halliburton self-insured plan, for certain insurable risks, such as general liability, property damage and workers compensation. However, subject to specific limitations, Halliburton has had umbrella insurance coverage for some of these risk exposures. In anticipation of our complete separation from Halliburton, we are developing our own stand-alone insurance and risk management policies that will provide substantially the same coverage. In connection with our initial public offering we obtained a stand-alone director and officer liability insurance policy. The insurance policies covering primary liability and marine cargo were separated between us and Halliburton in 2007. At the time of our complete separation from Halliburton certain other policies will be separated. We are also in the process of obtaining certain stand-alone insurance policies, including property coverage. Our property coverage will differ from prior coverage as appropriate to reflect the nature of our properties, as compared to Halliburton s properties.

The balances for the related party transactions described above are reflected in the consolidated financial statements as due from parent or due to parent, as appropriate. The average intercompany balance for 2006 was $348 million. For 2005 and 2004, the average intercompany balance was $921 million and $1.2 billion respectively.

In connection with certain projects, we are required to provide letters of credit and guarantees to our customers. As of December 31, 2006, in addition to the $55 million of letters of credit outstanding under our revolving credit facility, we had additional letters of credit and financial guarantees totaled approximately $621 million, of which, approximately $516 million related to our joint venture operations, including $159 million issued in connection with the Allenby & Connaught project. The remaining $160 million of outstanding letters of credit relate to various other projects. Of the $676 million in letters of credit outstanding at December 31, 2006, $597 million are irrevocably and unconditionally guaranteed by Halliburton. In addition, Halliburton has guaranteed surety bonds and provided direct guarantees primarily related to our performance. Under certain reimbursement agreements, if we were unable to reimburse a bank under a paid letter of credit and the amount due is paid by Halliburton, we would be required to reimburse Halliburton for any amounts drawn on those letters of credit or guarantees in the future. We expect to cancel these letters of credit, surety bonds and other guarantees as we complete the underlying projects. (See Note 15.)

All of the charges described above have been included as costs of our operation in these consolidated financial statements. It is possible that the terms of these transactions may differ from those that would result from transactions among third parties.

Halliburton has incurred $14 million, $9 million and $8 million for the years ended December 31, 2006, 2005 and 2004, respectively, for expenses relating to the FCPA and bidding practices investigations described in Note 14. In 2004, $1.5 million of the $8 million incurred was charged to us. Except for this $1.5 million,

Table of Contents

Halliburton has not charged these costs to us. These expenses were incurred for the benefit of both Halliburton and us, and we and Halliburton have no reasonable basis for allocating these costs between Halliburton and us.

In connection with our initial public offering in November 2006, we entered into various agreements to complete the separation of our business from Halliburton, including, among others, a master separation agreement, transition services agreements and a tax sharing agreement. The master separation agreement provides for, among other things, our responsibility for liabilities relating to our business and the responsibility of Halliburton for liabilities unrelated to our business. Pursuant to our master separation agreement, we agreed to indemnify Halliburton for, among other matters, all past, present and future liabilities related to our business and operations. We agreed to indemnify Halliburton for liabilities under various outstanding and certain additional credit support instruments relating to our businesses and for liabilities under litigation matters related to our business. Halliburton agreed to indemnify us for, among other things, liabilities unrelated to our business, for certain other agreed matters relating to the FCPA investigations and the Barracuda-Caratinga project and for other litigation matters related to Halliburton s business. In connection with Halliburton s anticipated exchange offer, at Halliburton s request KBR and Halliburton amended the tax sharing agreement to clarify that the terms of the tax sharing agreement are applicable to the anticipated exchange offer and amended the registration rights agreement to contemplate that KBR will file an S-4 registration statement with the SEC relating to the anticipated exchange offer sooner than 180 days after the completion of KBR s initial public offering and other agreed changes. KBR s board of directors appointed a special committee, consisting of KBR s independent directors, which reviewed and approved these amendments. The special committee retained an independent financial advisor and independent legal counsel to assist it in connection with its review.

Under the transition services agreements, Halliburton is expected to continue providing various interim corporate support services to us and we will continue to provide various interim corporate support services to Halliburton. The tax sharing agreement provides for certain allocations of U.S. income tax liabilities and other agreements between us and Halliburton with respect to tax matters. The services provided under the transition services agreement between Halliburton and KBR are substantially the same as the services historically provided. Similarly, the related costs of such services will be substantially the same as the costs incurred and recorded in our historical financial statements. Further, the tax sharing agreement contains substantially the same tax sharing provisions as included in our previous tax sharing agreements.

On April 1, 2006, Halliburton contributed to us its interest in three joint ventures, which are accounted for using the equity method of accounting. These joint ventures own and operate offshore vessels equipped to provide various services, including accommodations, catering and other services to sea-based oil and gas platforms and rigs off the coast of Mexico. At March 31, 2006, the contributed interest in the three joint ventures had a book value of approximately $26 million.

We perform many of our projects through incorporated and unincorporated joint ventures. In addition to participating as a joint venture partner, we often provide engineering, procurement, construction, operations or maintenance services to the joint venture as a subcontractor. Where we provide services to a joint venture that we control and therefore consolidate for financial reporting purposes, we eliminate intercompany revenues and expenses on such transactions. In situations where we account for our interest in the joint venture under the equity method of accounting, we do not eliminate any portion of our revenues or expenses. We recognize the profit on our services provided to joint ventures that we consolidate and joint ventures that we record under the equity method of accounting primarily using the percentage-of-completion method. Total revenue from services provided to our unconsolidated joint ventures recorded in our consolidated statements of operations were $450 million, $249 million and $519 million for the years ended December 31, 2006, 2005 and 2004, respectively. Profit on transactions with our joint ventures recognized in our consolidated statements of operations were $62 million, $21 million and $50 million for the years ended December 31, 2006, 2005 and 2004, respectively.

Recent Accounting Pronouncements

We adopted the provisions of SFAS No. 123(R) Share-Based Payment on January 1, 2006 using the modified prospective application. Certain of our key employees participate in both the Halliburton and KBR

Table of Contents

stock-based employee compensation plans. Accordingly, we recognized compensation expense for all newly granted awards and awards modified, repurchased, or cancelled after January 1, 2006. Compensation expense for the unvested portion of awards that were outstanding as of January 1, 2006 will be recognized ratably over the remaining vesting period based on the fair value at date of grant as calculated under the Black-Scholes option pricing model. This treatment is consistent with our prior year pro forma disclosure under SFAS No. 123. We recognized compensation expense using the Black-Scholes pricing model for the ESPP beginning with the January 1, 2006 purchase period.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. The interpretation prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. We did not elect early adoption of this interpretation and have adopted the provisions of FIN 48 beginning January 1, 2007. We have completed an initial evaluation of the impact of the January 1, 2007, adoption of FIN 48 and determined that such adoption is not expected to have a significant impact on our financial position or results from operations. We expect that any adjustment to reduce retained earnings as of January 1, 2007 will not exceed $15 million.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires an employer to:

- recognize on its balance sheet the funded status (measured as the difference between the fair value of plan assets and the projected benefit obligation) of pension and other postretirement benefit plans;
- recognize, through comprehensive income, certain changes in the funded status of a defined benefit and postretirement plan in the year in which the changes occur;
- measure plans assets and benefit obligations as of the end of the employer s fiscal year, and;
- disclose additional information.

The requirement to recognize the funded status of a benefit plan and the additional disclosure requirements are effective for fiscal years ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end is effective for fiscal years ending after December 15, 2008 and we will elect to adopt the requirements at that time. See Note 22 to our consolidated financial statements for further discussion of the impact on our financial statements of adopting this standard.

During September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statement . SAB 108 provides guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. This interpretation was effective for the first fiscal year ending after November 15, 2006. The adoption of this interpretation did not have an impact on our financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to measure eligible assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We will adopt SFAS 159 on January 1, 2008, and have not yet determined the impact, if any, on our consolidated financial statements.

Table of Contents

Legal Proceedings

DCAA Audit Issues

Our operations under U.S. government contracts are regularly reviewed and audited by the Defense Contract Audit Agency (DCAA) and other governmental agencies. The DCAA serves in an advisory role to our customer. When issues are found during the governmental agency audit process, these issues are typically discussed and reviewed with us. The DCAA then issues an audit report with its recommendations to our customer s contracting officer. In the case of management systems and other contract administrative issues, the contracting officer is generally with the Defense Contract Management Agency (DCMA). We then work with our customer to resolve the issues noted in the audit report. If our customer or a government auditor finds that we improperly charged any costs to a contract, these costs are not reimbursable, or, if already reimbursed, the costs must be refunded to the customer. Our revenue recorded for government contract work is reduced for our estimate of costs that may be categorized as in dispute with our customer or identified as potentially unallowable as a result of cost overruns or the audit process.

Dining facilities. In September 2005, Eurest Support Services (Cyprus) International Limited, or ESS, filed suit against us alleging various claims associated with its performance as a subcontractor in conjunction with our LogCAP III contract in Iraq. The case was settled during the first quarter of 2006 without material impact to us.

In the third quarter of 2006, the DCAA raised questions regarding $95 million of costs related to dining facilities in Iraq. We have responded to the DCAA that our costs are reasonable.

Security. In February 2007, we received a letter from the Department of the Army informing us of their intent to adjust payments under the LogCAP III contract associated with the cost incurred by the subcontractors to provide security to their employees. Based on this letter, the DCAA withheld the Army s initial assessment of $20 million. The Army based its assessment on one subcontract wherein, based on communications with the subcontractor, the Army estimated 6% of the total subcontract cost related to the private security costs. The Army indicated that not all task orders and subcontracts have been reviewed and that they may make additional adjustments. The Army indicated that, within 60 days, they intend to begin making further adjustments equal to 6% of prior and current subcontractor costs unless we can provide timely information sufficient to show that such action is not necessary to protect the government s interest. We are working with the Army to provide the additional information they have requested.

The Army indicated that they believe our LogCAP III contract prohibits us from billing costs of privately acquired security. We believe that, while LogCAP III contract anticipates that the Army will provide force protection to KBR employees, it does not prohibit any of our subcontractors from using private security services to provide force protection to subcontractor personnel. In addition, a significant portion of our subcontracts are competitively bid lump sum or fixed price subcontracts. As a result, we do not receive details of the subcontractors cost estimate nor are we legally entitled to it. Accordingly, we believe that we are entitled to reimbursement by the Army for the cost of services provided by our subcontractors, even if they incurred costs for private force protection services. Therefore, we believe that the Army s position that such costs are unallowable and that they are entitled to withhold amounts incurred for such costs is wrong as a matter of law.

If we are unable to demonstrate that such action by the Army is not necessary, a 6% suspension of all subcontractor costs incurred to date could result in suspended costs of approximately $400 million. The Army has asked us to provide information that addresses the use of armed security either directly or indirectly charged to LogCAP III. The actual costs associated with these activities cannot be accurately estimated at this time but we believe that they should be less than 6% of the total subcontractor costs. As of December 31, 2006, no amounts have been accrued for suspended security billings.

Fuel. In December 2003, the DCAA issued a preliminary audit report that alleged that we may have overcharged the Department of Defense by $61 million in importing fuel into Iraq. The DCAA questioned costs associated with fuel purchases made in Kuwait that were more expensive than buying and transporting fuel from

Turkey. We responded that we had maintained close coordination of the fuel mission with the Army Corps of Engineers, or COE, which was our customer and oversaw the project throughout the life of the task orders and that the COE had directed us to use the Kuwait sources. After a review, the COE concluded that we obtained a fair price for the fuel. However, DoD officials referred the matter to the agency s inspector general, which we understand commenced an investigation. We intend to cooperate fully if and when contacted by the inspector general.

Containers. In June 2005, the DCAA recommended withholding certain costs associated with providing containerized housing for soldiers and supporting civilian personnel in Iraq. The DCAA recommended that the costs be withheld pending receipt of additional explanation or documentation to support the subcontract costs. Approximately $55 million has been withheld as of December 31, 2006, of which $17 million was withheld from our subcontractor. During 2006, we favorably resolved approximately $25 million of the withheld amounts with our contracting officer which was received in the first quarter of 2007. We will continue working with the government and our subcontractors to resolve the remaining amounts.

Other issues. The DCAA is continuously performing audits of costs incurred for the foregoing and other services provided by us under our government contracts. During these audits, there have been questions raised by the DCAA about the reasonableness or allowability of certain costs or the quality or quantity of supporting documentation. The DCAA might recommend withholding some portion of the questioned costs while the issues are being resolved with our customer. Because of the intense scrutiny involving our government contracts operations, issues raised by the DCAA may be more difficult to resolve. We do not believe any potential withholding will have a significant or sustained impact on our liquidity.

McBride Qui Tam suit

In September 2006, we became aware of a *qui tam* action filed against us by a former employee alleging various wrongdoings in the form of overbillings of our customer on the LogCAP III contract. This case was originally filed pending the government s decision whether or not to participate in the suit. In June 2006, the government formally declined to participate. The principal allegations are that our compensation for the provision of Morale, Welfare and Recreation (MWR) facilities under LogCAP III is based on the volume of usage of those facilities and that we deliberately overstated that usage. In accordance with the contract, we charged our customer based on actual cost, not based on the number of users. It was also alleged that, during the period from November 2004 into mid-December 2004, we continued to bill the customer for lunches, although the dining facility was closed and not serving lunches. There are also allegations regarding housing containers and our provision of services to our employees and contractors. Our investigation is ongoing. However, we believe the allegations to be without merit, and we intend to vigorously defend this action. As of December 31, 2006, we had not accrued any amounts in connection with this matter.

Wilson and Warren Qui Tam Suit

During November 2006, we became aware of a *qui tam* action filed against us alleging that we overcharged the military $30 million by failing to adequately maintain trucks used to move supplies in convoys and by sending empty trucks in convoys. It was alleged that the purpose of these acts was to cause the trucks to break down more frequently than they would if properly maintained and to unnecessarily expose them to the risk of insurgent attacks, both for the purpose of necessitating their replacement thus increasing our revenue. The suit also alleges that in order to silence the plaintiffs, who allegedly were attempting to report those allegations and other alleged wrongdoing, we unlawfully terminated them. On February 6, 2007, the court granted our motion to dismiss the plaintiffs *qui tam* claims as legally insufficient and ordered the plaintiffs to arbitrate their claims that they were unlawfully discharged. As of December 31, 2006, we had not accrued any amounts in connection with this matter.

Investigations Relating to Iraq, Kuwait and Afghanistan

In October 2004, we reported to the DoD Inspector General s office that two former employees in Kuwait may have had inappropriate contacts with individuals employed by or affiliated with two third party subcontractors prior to the award of the subcontracts. The Inspector General s office may investigate whether these two employees may have solicited and/or accepted payments from those third party subcontractors while they were employed by us.

We also provided information to the DoD Inspector General s office in February 2004 about other contacts between former employees and our subcontractors and, in March 2006, one of these former employees pled guilty to taking money in exchange for awarding work to a Saudi Arabian subcontractor. The Inspector General s investigation of these matters may continue.

In October 2004, a civilian contracting official in the COE asked for a review of the process used by the COE for awarding some of the contracts to us. We understand that the DoD Inspector General s office may review the issues involved.

We understand that the Department of Justice (DOJ), an Assistant U.S. Attorney based in Illinois, and others are investigating these and other individually immaterial matters we have reported relating to our government contract work in Iraq. If criminal wrongdoing were found, criminal penalties could range up to the greater of $500,000 in fines per count for a corporation or twice the gross pecuniary gain or loss. We also understand that certain of our current and former employees have received subpoenas and have given or may give grand jury testimony related to some of these matters.

We have reported to the U.S. Department of State and Department of Commerce that exports of materials, including personal protection equipment such as helmets, goggles, body armor and chemical protective suits, in connection with personnel deployed to Iraq and Afghanistan may not have been in accordance with current licenses or may have been unlicensed. A determination that we have failed to comply with one or more of these export controls could result in civil and/or criminal sanctions including the imposition of fines upon us as well as denial of export privileges and debarment from participation in U.S. government contracts. As of December 31, 2006 we had not accrued any amounts related to this matter.

Beginning in February 2007, the House Oversight and Government Reform Committee conducted hearings on the U.S. military s reliance on civilian contractors, including with respect to military operations in Iraq. We have provided testimony and information for these hearings. We expect hearings with respect to operations in Iraq to continue in this and other Congressional committees, including the House Armed Services Committee, and we expect to be asked to testify and provide information for these hearings.

SIGIR Report

In October 2006, the Special Inspector General for Iraq Reconstruction, or SIGIR, issued a report stating that we have improperly labeled reports provided to our customer, AMC, as proprietary data, when data marked does not related to internal contractor information. We will work with AMC to address the issues raised by the SIGIR report.

The Balkans

We have had inquiries in the past by the DCAA and the civil fraud division of the DOJ into possible overcharges for work performed during 1996 through 2000 under a contract in the Balkans, for which inquiry has not yet been completed by the DOJ. Based on an internal investigation, we credited our customer $2 million during 2000 and 2001 related to our work in the Balkans as a result of billings for which support was not readily available. We believe that the preliminary DOJ inquiry relates to potential overcharges in connection with a part of the Balkans contract under which approximately $100 million in work was done. We believe that any allegations of overcharges would be without merit. In the fourth quarter 2006, we reached a negotiated settlement with the DOJ. KBR was not accused of any wrongdoing and did not admit to any wrongdoing. The company is not suspended or debarred from bidding for or performing work for the US government. The settlement did not have a material impact on our operating results in 2006.

FCPA Investigations

The SEC is conducting a formal investigation into whether improper payments were made to government officials in Nigeria through the use of agents or subcontractors in connection with the construction and subsequent expansion by TSKJ of a multibillion dollar natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The DOJ is also conducting a related criminal investigation. The SEC has also issued subpoenas seeking information, which we are furnishing, regarding current and former agents used in connection with multiple projects, including current and prior projects, over the past 20 years located both in and outside of Nigeria in which we, The M.W. Kellogg Company, M.W. Kellogg Limited or their or our joint ventures are or were participants. In September 2006, the SEC requested that we enter into a tolling agreement with respect to its investigation. We anticipate that we will enter into an appropriate tolling agreement with the SEC.

TSKJ is a private limited liability company registered in Madeira, Portugal whose members are Technip SA of France, Snamprogetti Netherlands B.V. (a subsidiary of Saipem SpA of Italy), JGC Corporation of Japan, and Kellogg Brown & Root LLC (a subsidiary of ours and successor to The M.W. Kellogg Company), each of which had an approximate 25% interest in the venture at December 31, 2006. TSKJ and other similarly owned entities entered into various contracts to build and expand the liquefied natural gas project for Nigeria LNG Limited, which is owned by the Nigerian National Petroleum Corporation, Shell Gas B.V., Cleag Limited (an affiliate of Total), and Agip International B.V. (an affiliate of ENI SpA of Italy). M.W. Kellogg Limited is a joint venture in which we had a 55% interest at December 31, 2006, and M.W. Kellogg Limited and The M.W. Kellogg Company were subsidiaries of Dresser Industries before Halliburton s 1998 acquisition of Dresser Industries. The M.W. Kellogg Company was later merged with a Halliburton subsidiary to form Kellogg Brown & Root, one of our subsidiaries.

The SEC and the DOJ have been reviewing these matters in light of the requirements of the FCPA. Halliburton has been cooperating with the SEC and DOJ investigations and with other investigations into the Bonny Island project in France, Nigeria and Switzerland. We also believe that the Serious Frauds Office in the United Kingdom is conducting an investigation relating to the Bonny Island project. Halliburton s Board of Directors has appointed a committee of independent directors to oversee and direct the FCPA investigations. Halliburton, acting through its committee of independent directors, will continue to oversee and direct the investigations, and our directors that are independent of Halliburton and us, acting as a committee of our board of directors, will monitor the continuing investigations directed by Halliburton.

The matters under investigation relating to the Bonny Island project cover an extended period of time (in some cases significantly before Halliburton s 1998 acquisition of Dresser Industries and continuing through the current time period). We have produced documents to the SEC and the DOJ both voluntarily and pursuant to company subpoenas from the files of numerous officers and employees of Halliburton and KBR, including many current and former executives of Halliburton and KBR, and we are making our employees available to the SEC and the DOJ for interviews. In addition, we understand that the SEC has issued a subpoena to A. Jack Stanley, who formerly served as a consultant and chairman of Kellogg Brown & Root and to others, including certain of our current and former employees, former executive officers and at least one of our subcontractors. We further understand that the DOJ has issued subpoenas for the purpose of obtaining information abroad, and we understand that other partners in TSKJ have provided information to the DOJ and the SEC with respect to the investigations, either voluntarily or under subpoenas.

The SEC and DOJ investigations include an examination of whether TSKJ s engagements of Tri-Star Investments as an agent and a Japanese trading company as a subcontractor to provide services to TSKJ were utilized to make improper payments to Nigerian government officials. In connection with the Bonny Island project, TSKJ entered into a series of agency agreements, including with Tri-Star Investments, of which Jeffrey Tesler is a principal, commencing in 1995 and a series of subcontracts with a Japanese trading company commencing in 1996. We understand that a French magistrate has officially placed Mr. Tesler under investigation for corruption of a foreign public official. In Nigeria, a legislative committee of the National Assembly and the Economic and Financial Crimes Commission, which is organized as part of the executive branch of the government, are also investigating these matters. Our representatives have met with the French magistrate and Nigerian officials. In October 2004, representatives of TSKJ voluntarily testified before the Nigerian legislative committee.

We notified the other owners of TSKJ of information provided by the investigations and asked each of them to conduct their own investigation. TSKJ has suspended the receipt of services from and payments to Tri-Star Investments and the Japanese trading company and has considered instituting legal proceedings to declare all agency agreements with Tri-Star Investments terminated and to recover all amounts previously paid under those agreements. In February 2005, TSKJ notified the Attorney General of Nigeria that TSKJ would not oppose the Attorney General s efforts to have sums of money held on deposit in accounts of Tri-Star Investments in banks in Switzerland transferred to Nigeria and to have the legal ownership of such sums determined in the Nigerian courts.

As a result of these investigations, information has been uncovered suggesting that, commencing at least 10 years ago, members of TSKJ planned payments to Nigerian officials. We have reason to believe, based on the ongoing investigations, that payments may have been made by agents of TSKJ to Nigerian officials. In addition, information uncovered in the summer of 2006 suggests that, prior to 1998, plans may have been made by employees of The M.W. Kellogg Company to make payments to government officials in connection with the pursuit of a number of other projects in countries outside of Nigeria. Halliburton is reviewing a number of recently discovered documents related to KBR activities in countries outside of Nigeria with respect to agents for projects after 1998. Certain of the activities discussed in this paragraph involve current or former employees or persons who were or are consultants to us, and the investigation continues.

In June 2004, all relationships with Mr. Stanley and another consultant and former employee of M.W. Kellogg Limited were terminated. The terminations occurred because of violations of Halliburton s Code of Business Conduct that allegedly involved the receipt of improper personal benefits from Mr. Tesler in connection with TSKJ s construction of the Bonny Island project.

In 2006, Halliburton suspended the services of another agent who, until such suspension, had worked for us outside of Nigeria on several current projects and on numerous older projects going back to the early 1980s. The suspension will continue until such time, if ever, as Halliburton can satisfy itself regarding the agent s compliance with applicable law and Halliburton s Code of Business Conduct. In addition, Halliburton suspended the services of an additional agent on a separate current Nigerian project with respect to which Halliburton has received from a joint venture partner on that project allegations of wrongful payments made by such agent.

If violations of the FCPA were found, a person or entity found in violation could be subject to fines, civil penalties of up to $500,000 per violation, equitable remedies, including disgorgement (if applicable) generally of profits, including prejudgment interest on such profits, causally connected to the violation, and injunctive relief. Criminal penalties could range up to the greater of $2 million per violation or twice the gross pecuniary gain or loss from the violation, which could be substantially greater than $2 million per violation. It is possible that both the SEC and the DOJ could assert that there have been multiple violations which could lead to multiple fines. The amount of any fines or monetary penalties that could be assessed would depend on, among other factors, the findings regarding the amount, timing, nature and scope of any improper payments, whether any such payments were authorized by or made with knowledge of us or our affiliates, the amount of gross pecuniary gain or loss involved, and the level of cooperation provided to the government authorities during the investigations. Agreed dispositions of these types of violations also frequently result in an acknowledgement of wrongdoing by the entity and the appointment of a monitor on terms negotiated with the SEC and the DOJ to review and monitor current and future business practices, including the retention of agents, with the goal of assuring compliance with the FCPA. Other potential consequences could be significant and include suspension or debarment of our ability to contract with governmental agencies of the United States and of foreign countries. During 2006, KBR and its affiliates had revenue of approximately $5.8 billion from its government contracts work with agencies of the United States or state or local governments. In addition, we may be excluded from bidding on MoD contracts in the United Kingdom if we are convicted for a corruption offense or if the MoD determines that our actions constituted grave misconduct. During 2006, we had revenue of approximately $1.0 billion from our government contracts work with the MoD. Suspension or debarment from the government contracts business would have a material adverse effect on our business, results of operations, and cash flows.

These investigations could also result in (1) third-party claims against us, which may include claims for special, indirect, derivative or consequential damages, (2) damage to our business or reputation, (3) loss of, or adverse effect on, cash flow, assets, goodwill, results of operations, business, prospects, profits or business value, (4) adverse consequences on our ability to obtain or continue financing for current or future projects and/or (5) claims by directors, officers, employees, affiliates, advisors, attorneys, agents, debt holders or other interest holders or constituents of us or our subsidiaries. In this connection, we understand that the government of Nigeria gave notice in 2004 to the French magistrate of a civil claim as an injured party in that proceeding. We are not aware of any further developments with respect to this claim. In addition, we could incur costs and expenses for any monitor required by or agreed to with a governmental authority to review our continued compliance with FCPA law.

The investigations by the SEC and DOJ and foreign governmental authorities are continuing. We do not expect these investigations to be concluded in the immediate future. The various governmental authorities could conclude that violations of the FCPA or applicable analogous foreign laws have occurred with respect to the Bonny Island project and other projects in or outside of Nigeria. In such circumstances, the resolution or disposition of these matters, even after taking into account the indemnity from Halliburton with respect to liabilities for fines or other monetary penalties or direct monetary damages, including disgorgement, that may be assessed by the U.S. and certain foreign governments or governmental agencies against us or our greater than 50%-owned subsidiaries could have a material adverse effect on our business, prospects, results or operations, financial condition and cash flow. Under the terms of the master separation agreement entered into in connection with our initial public offering, Halliburton has agreed to indemnify us for, and any of our greater than 50%-owned subsidiaries for our share of, fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of claims made or assessed by a governmental authority of the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria or a settlement thereof relating to FCPA Matters (as defined), which could involve Halliburton and us through The M. W. Kellogg Company, M. W. Kellogg Limited or their or our joint ventures in projects both in and outside of Nigeria, including the Bonny Island, Nigeria project. Halliburton s indemnity will not apply to any other losses, claims, liabilities or damages assessed against us as a result of or relating to FCPA Matters or to any fines or other monetary penalties or direct monetary damages, including disgorgement, assessed by governmental authorities in jurisdictions other than the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria, or a settlement thereof, or assessed against entities such as TSKJ or Brown & Root Condor Spa, in which we do not have an interest greater than 50%. Please read *Forward-Looking Information and Risk Factors Risks Related to Our Affiliation With Halliburton Halliburton s indemnity for Foreign Corrupt Practices Act matters does not apply to all potential losses, Halliburton s actions may not be in our stockholders best interests and we may take or fail to take actions that could result in our indemnification from Halliburton with respect to Foreign Corrupt Practices Act matters no longer being available.*

Bidding Practices Investigations

In connection with the investigation into payments relating to the Bonny Island project in Nigeria, information has been uncovered suggesting that Mr. Stanley and other former employees may have engaged in coordinated bidding with one or more competitors on certain foreign construction projects and that such coordination possibly began as early as the mid-1980s.

Table of Contents

On the basis of this information, Halliburton and the DOJ have broadened their investigations to determine the nature and extent of any improper bidding practices, whether such conduct violated United States antitrust laws, and whether former employees may have received payments in connection with bidding practices on some foreign projects.

If violations of applicable U.S. antitrust laws occurred, the range of possible penalties includes criminal fines, which could range up to the greater of $10 million in fines per count for a corporation, or twice the gross pecuniary gain or loss, and treble civil damages in favor of any persons financially injured by such violations. Criminal prosecutions under applicable laws of relevant foreign jurisdictions and civil claims by, or relationship issues with customers, are also possible. Halliburton s indemnity does not apply to liabilities, if any, for fines, other monetary penalties or other potential losses arising out of violations of U.S. antitrust laws.

Possible Algerian Investigation

We believe that an investigation by a magistrate or a public prosecutor in Algeria may be pending with respect to sole source contracts awarded to Brown & Root-Condor Spa, a joint venture among Kellogg Brown & Root Ltd UK, Centre de Recherche Nuclear de Draria and Holding Services para Petroliers Spa. We had a 49% interest in this joint venture as of December 31, 2006.

Iraq Overtime Litigation

During the fourth quarter of 2005, a group of present and former employees working on the LogCAP III contract in Iraq and elsewhere filed a class action lawsuit alleging that we wrongfully failed to pay time and a half for hours worked in excess of 40 per work week and that uplift pay, consisting of a foreign service bonus, an area differential and danger pay, was only applied to the first 40 hours worked in any work week. The class alleged by plaintiffs consists of all current and former employees on the LogCAP III contract from December 2001 to present. The basis of plaintiffs claims is their assertion that they are intended third party beneficiaries of the LogCAP III contract, and that the LogCAP III contract obligated us to pay time and a half for all overtime hours. We have moved to dismiss the case on a number of bases. On September 26, 2006, the court granted the motion to dismiss insofar as claims for overtime pay and uplift pay are concerned, leaving only a contractual claim for miscalculation of employees pay. That claim remains pending. It is premature to assess the probability of an adverse result on that remaining claim. However, because the LogCAP III contract is cost-reimbursable, we believe that we could charge any adverse award to the customer. It is our intention to continue to vigorously defend the remaining claim. As of December 31, 2006, we had not accrued any amount related to this matter.

Asbestos and Silica Settlement and Prepackaged Chapter 11 Proceeding and Completion

In December 2003, six of our subsidiaries (and two other entities that are subsidiaries of Halliburton) sought Chapter 11 protection to avail themselves of the provisions of Sections 524(g) and 105 of the United States Bankruptcy Code to discharge current and future asbestos and silica personal injury claims and demands. Prior to proceeding with the Chapter 11 filing, the affected subsidiaries solicited acceptances from then known asbestos and silica claimants to a prepackaged plan of reorganization. Over 98% of voting asbestos claimants and over 99% of voting silica claimants approved the plan of reorganization, which was filed as part of the Chapter 11 proceedings. The order confirming the Chapter 11 plan of reorganization became final and nonappealable on December 31, 2004, and the plan of reorganization became effective in January 2005. Under the plan of reorganization, all then current and future asbestos and silica personal injury claims and demands against those subsidiaries were channeled into trusts established for the benefit of asbestos and silica personal injury claimants, thus releasing our subsidiaries from those claims.

In accordance with the plan of reorganization, in January 2005 Halliburton contributed the following to trusts for the benefit of current and future asbestos and silica personal injury claimants:

- approximately $2.3 billion in cash;
- 59.5 million shares of Halliburton common stock; and

Table of Contents

notes then valued at approximately $55 million.

Halliburton will reimburse us with respect to our obligations under one of the notes, which was valued at $10 million as of December 31, 2006. Pursuant to the plan of reorganization and the order confirming the plan, a permanent injunction has been issued enjoining the prosecution of asbestos and silica personal injury claims and demands against our subsidiaries and our affiliates.

Forward-Looking Information and Risk Factors

The Private Securities Litigation Reform Act of 1995 provides safe harbor provisions for forward looking information. Some of the statements contained in this annual report are forward-looking statements. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements. Forward-looking statements include information concerning our possible or assumed future financial performance and results of operations.

We have based these statements on our assumptions and analyses in light of our experience and perception of historical trends, current conditions, expected future developments and other factors we believe are appropriate in the circumstances. Forward-looking statements by their nature involve substantial risks and uncertainties that could significantly affect expected results, and actual future results could differ materially from those described in such statements. While it is not possible to identify all factors, factors that could cause actual future results to differ materially include the risks and uncertainties described under Risk Factors .

Many of these factors are beyond our ability to control or predict. Any of these factors, or a combination of these factors, could materially and adversely affect our future financial condition or results of operations and the ultimate accuracy of the forward-looking statements. These forward-looking statements are not guarantees of our future performance, and our actual results and future developments may differ materially and adversely from those projected in the forward-looking statements. We caution against putting undue reliance on forward-looking statements or projecting any future results based on such statements or present or prior earnings levels. In addition, each forward-looking statement speaks only as of the date of the particular statement, and we undertake no obligation to publicly update or revise any forward-looking statement.

Risk Factors

Risks Related to Our Customers and Contracts

Our G&I segment is directly affected by spending and capital expenditures by our customers and our ability to contract with our customers.

Our G&I segment is directly affected by spending and capital expenditures by our customers and our ability to contract with our customers. For example:

- *A decrease in the magnitude of work we perform for the U.S. government in Iraq and for the MoD through our DML joint venture or other decreases in governmental spending and outsourcing for* military and logistical support of the type that we provide could have a material adverse effect on our business, results of operations and cash flow. For example, the current level of government services being provided in the Middle East will not likely continue for an extended period of time, and the current rate of spending has decreased substantially compared to 2005 and 2004. Our government services revenue related to Iraq under our LogCAP III and other contracts totaled $4.7 billion in 2006, $5.4 billion in 2005 and $7.1 billion in 2004. In August 2006, the U.S. Department of Defense (DoD) issued a request for proposals on a new competitively bid, multiple service provider LogCAP IV contract to replace the current LogCAP III contract. We are currently the sole provider under the LogCAP III contract and in October 2006, we submitted the final portion of our bid on the LogCAP IV

53

contract. We expect that the contract will be awarded during the second quarter of 2007. We may not be awarded any part of the LogCAP IV contract, which may have a material adverse effect on future results of operations. Despite the award of the August 2006 task order under the LogCAP III contract and the possibility of being awarded a portion of the LogCAP IV contract, we expect the overall volume of work to decline as our customer scales back the amount of services we provide. We expect to complete all open task orders under our LogCAP III contract during the third quarter of 2007. We expect the volume of our work under the MoD contract with our DML joint venture to refit and refuel the MoD s nuclear submarine fleet to decline in 2009 and 2010 as DML completes this round of refueling of the current fleet.

The loss of the U.S. government as a customer would, and the loss of the MoD as a customer could, have a material adverse effect on our business, results of operations and cash flow. The loss of the U.S. government as a customer, or a significant reduction in our work for it, would have a material adverse effect on our business, results of operations and cash flow. Revenue from U.S. government agencies represented 61% of our revenues in 2006, 65% in 2005 and 67% in 2004. The MoD is also a substantial customer, the loss of which could have a material adverse effect on our business, results of operations and cash flow.

Our separation from Halliburton may adversely affect or result in the loss of our DML joint venture s interest in the operation of the Devonport Royal Dockyard in exchange for the fair value of the interest or the loss of our interest in DML in exchange for the lower of net asset value or fair market value, which could have a material adverse effect on our future prospects, business, results of operations and cash flow. On November 13, 2006, the MoD asked us to withdraw our initial public offering pending the MoD s financial analysis of KBR on a stand-alone basis. The MoD also advised us that if we proceeded with our initial public offering without satisfying the MoD, the MoD would have little option but to take steps to cause the MoD to use its power to safeguard the essential security interests of the United Kingdom with respect to the Devonport Royal Dockyard. If the MoD deems it to be in the essential security interests of the United Kingdom, the MoD has the right to make DML s interest in the Devonport Royal Dockyard non-voting and may have a right to remove DML s directors of the Devonport Royal Dockyard, in which case DML would retain its economic interest in the Devonport Royal Dockyard, or the MoD may assume at any time control of the Devonport Royal Dockyard and dispose of DML s interest on its behalf at fair value. In such a situation, the MoD would appoint an international firm of chartered accountants to determine the fair value for DML s interest. In such event, there would be a risk that we may not agree with the determined value of DML s interest in the Devonport Royal Dockyard, and it is unclear if and/or how we could challenge the determination. Any such action by the MoD would be an event of default under the DML shareholders agreement and would permit the other partners in our DML joint venture to acquire our interest in the DML joint venture at the lower of net asset value (generally a shareholder s initial and subsequent investment and the proportionate share of consolidated capital and revenue reserves) or fair market value, which would be determined by a chartered accountant and would be final and binding absent manifest error. We believe that the net asset value of our investment in our DML joint venture may be significantly less than the fair market value of that investment. Any exercise by our partners in the DML joint venture of their rights to acquire our interest in DML would not prejudice any other rights or remedies available to them under the joint venture agreement or otherwise. We are engaging in discussions with the MoD regarding KBR s ownership in DML and the possibility of reducing or disposing of our interest. Although no decision has been made with respect to a disposition or reduction of our interest in DML, we are supporting a process to identify potential bidders that may have an interest in acquiring our interest in DML. We do not know at this time if the process will result in a disposition or reduction of our interest in DML.

Revenue from our DML shipyard operations for the years ended December 31, 2006 and 2005 was $850 million and $863 million, respectively, representing 9% for both of the years ended December 31, 2006 and 2005, of our total revenue for each such period. Operating income from our DML shipyard

Table of Contents

operations for the years ended December 31, 2006 and 2005 was $86 million and $62 million, respectively, representing 35% and 14% respectively, of our total operating income for such periods. Cash flow provided by operating activities of our DML shipyard operations for the years ended December 31, 2006 and 2005 was $59 million and $46 million, respectively, representing 6% and 9%, respectively, of our total cash flow provided by operating activities for such periods. Basic and diluted income from continuing operations per share generated by our DML shipyard operations for the years ended December 31, 2006 and 2005 was $0.21 per share and $0.16 per share respectively, representing 36% and 10% respectively, of our total basic and diluted income from continuing operations per share. Accordingly, our separation from Halliburton without satisfying the MoD, or the loss of DML s interest in the Devonport Royal Dockyard and the loss of our interest in DML, could have a material adverse effect on our future prospects, business, results of operations and cash flow.

Potential consequences arising out of investigations into U.S. Foreign Corrupt Practices Act (FCPA) matters and antitrust matters and the investigation by the U.K. Serious Frauds Office could include suspension or debarment by the DoD or another federal, state or local government agency or by the MoD of us and our affiliates from our ability to contract with such parties, which could have a material adverse effect on our business, results of operations and cash flow. Please read Risks Relating to Investigations.

An increase in the magnitude of governmental spending and outsourcing for military and logistical support could materially and adversely affect our liquidity needs as a result of additional or continued working capital requirements to support this work. A rapid increase in the magnitude of work required under our government contracts, similar to what occurred in mid and late 2003 when military operations in Iraq ramped up quickly, could adversely affect our liquidity. Please read *Other Risks Related to Our Business We experience increased working capital requirements from time to time associated with our business, and such an increased demand for working capital could adversely affect our ability to meet liquidity needs.*

A decrease in capital spending for infrastructure and other projects of the type that we undertake could have a material adverse effect on our business, results of operations and cash flow.

Our E&C segment depends on demand and capital spending by oil and natural gas companies for our services, which is directly affected by trends in oil and gas prices and other factors affecting our customers.

Demand for many of the services of our E&C segment depends on capital spending by oil and natural gas companies, including national and international oil companies, which is directly affected by trends in oil and natural gas prices. Capital expenditures for refining and distribution facilities by large oil and gas companies have a significant impact on the activity levels of our businesses. Demand for LNG facilities for which we provide construction services would decrease in the event of a sustained reduction in crude oil prices. Perceptions of longer-term lower oil and natural gas prices by oil and gas companies or longer-term higher material and contractor prices impacting facility costs can similarly reduce or defer major expenditures given the long-term nature of many large-scale projects. Prices for oil and natural gas are subject to large fluctuations in response to relatively minor changes in the supply of and demand for oil and natural gas, market uncertainty, and a variety of other factors that are beyond our control. Factors affecting the prices of oil and natural gas include:

- worldwide political, military, and economic conditions;
- the cost of producing and delivering oil and natural gas;
- the level of demand for oil and natural gas;
- governmental regulations or policies, including the policies of governments regarding the use of energy and the exploration for and production and development of their oil and natural gas reserves;

a reduction in energy demand as a result of energy taxation or a change in consumer spending patterns;

economic growth in China and India;

Table of Contents

- the level of oil production by non-OPEC countries and the available excess production capacity within OPEC;
- global weather conditions and natural disasters;
- oil refining capacity;
- shifts in end-customer preferences toward fuel efficiency and the use of natural gas;
- potential acceleration of the development of alternative fuels; and
- environmental regulation, including limitations on fossil fuel consumption based on concerns about its relationship to climate change.

Historically, the markets for oil and natural gas have been volatile and are likely to continue to be volatile in the future.

Demand for services in our E&C segment may also be materially and adversely affected by the consolidation of our customers, which:

- could cause customers to reduce their capital spending, which in turn reduces the demand for our services; and
- could result in customer personnel changes, which in turn affects the timing of contract negotiations and settlements of claims and claim negotiations with engineering and construction customers on cost variances and change orders on major projects.

Our results of operations depend on the award of new contracts and the timing of the performance of these contracts.

Because a substantial portion of our revenue is generated from large-scale projects and the timing of new project awards is unpredictable, our results of operations and cash flow may be subject to significant periodic fluctuations. A substantial portion of our revenue is directly or indirectly derived from large-scale international and domestic projects. With regard to our E&C projects, worldwide resource constraints, escalating material and equipment prices, and ongoing supply chain pricing pressures are causing delays in awards of and, in some cases, cancellations of major gas monetization and upstream prospects. Of the eight very large scale (each defined for these purposes as having approximately $2 billion or more in estimated revenue to us or other parties (or total installed cost to the client) over the course of the project) natural gas projects that we have been pursuing for new awards, three have either been cancelled or awarded to competitors and we believe the awards of two others may also be significantly delayed or cancelled. Although two additional very large scale natural gas projects have subsequently been added to our pursuit list, due to the lengthy nature of the bidding process, we do not expect awards for these projects to be made in the near term. These developments may negatively and materially impact 2007 and 2008 results (excluding consideration of potential offsets such as the slower than expected decline in LogCAP III activity, or work in other areas and overhead reductions that may or may not be realized). It is generally very difficult to predict whether or when we will receive such awards as these contracts frequently involve a lengthy and complex bidding and selection process which is affected by a number of factors, such as market conditions, financing arrangements, governmental approvals and environmental matters. Because a significant portion of our revenue is generated from large projects, our results of operations and cash flow can fluctuate significantly from quarter to quarter depending on the timing of our contract awards. In addition, many of these contracts are subject to financing contingencies and, as a result, we are subject to the risk that the customer will not be able to secure the necessary financing for the project.

If we are unable to provide our customers with bonds, letters of credit or other credit enhancements, we may be unable to obtain new project awards. In addition, we cannot rely on Halliburton to provide payment and performance guarantees of our bonds, letters of credit and contracts entered into after our initial public offering

as it has done in the past, except to the extent Halliburton has agreed to do so under the terms of the master separation agreement. Customers may require us to provide credit enhancements, including bonds, letters of credit or performance or financial guarantees. In line with industry practice, we are often required to provide performance and surety bonds to customers. These bonds indemnify the customer should we fail to perform our obligations under the contract. We have minimal stand-alone bonding capacity and other credit support capacity without Halliburton and, except to the limited extent set forth in the master separation agreement, Halliburton is not obligated to provide credit support for our new surety bonds. We are engaged in discussions with surety companies to obtain additional stand-alone bonding capacity, but we may not be successful. If a bond is required for a particular project and we are unable to obtain an appropriate bond, we cannot pursue that project. Moreover, due to events that affect the insurance and bonding markets generally, bonding may be difficult to obtain or may

only be available at significant cost. Because of liquidity or other issues, we could at times be unable to provide necessary letters of credit. In addition, future projects may require us to obtain letters of credit that extend beyond the term of our current credit facility. Further, our credit facility limits the amount of new letters of credit and other debt we can incur outside of the credit facility to $250 million, which could adversely affect our ability to bid or bid competitively on future projects if the credit facility is not amended or replaced. Please read *Other Risks Related to Our Business We experience increased working capital requirements from time to time associated with our business, and such an increased demand for working capital could adversely affect our liquidity needs.* Prior to our initial public offering, Halliburton has provided guarantees of most of our surety bonds and letters of credit as well as most other payment and performance guarantees under our contracts. The credit support arrangements in existence at the completion of our initial public offering will remain in effect, but Halliburton is not expected to enter into any new credit support arrangements on our behalf, except to the limited extent Halliburton is obligated to do so under the master separation agreement. Please read Certain Relationships and Related Transactions, and Director Independence . We have agreed to indemnify Halliburton for all losses under our outstanding credit support instruments and any additional credit support instruments for which Halliburton may become obligated following our initial public offering, and under the master separation agreement, we have agreed to use our reasonable best efforts to attempt to release or replace Halliburton s liability thereunder for which such release or replacement is reasonably available. Any inability to obtain adequate bonding and/or provide letters of credit or other customary credit enhancements and, as a result, to bid on new work could have a material adverse effect on our business prospects and future revenue.

Our customers and prospective customers will need assurances that our financial stability on a stand-alone basis is sufficient to satisfy their requirements for doing or continuing to do business with them. We do not expect that Halliburton will provide, and Halliburton has not provided, payment and performance guarantees of our bonds, letters of credit and contracts entered into after our initial public offering as it has in the past, except to the extent Halliburton has agreed to do so under the terms of the master separation agreement. Our customers and prospective customers will need assurances that our financial stability on a stand-alone basis is sufficient to satisfy their requirements for doing or continuing to do business with them. If our customers or prospective customers are not satisfied with our financial stability absent the support from Halliburton that we have relied on in the past, it could have a material adverse effect on our ability to bid for and obtain or retain projects, our business prospects and future revenues.

Limitations on our use of agents as part of our efforts to comply with applicable laws, including the FCPA, could put us at a competitive disadvantage in pursuing large-scale international projects. Most of our large-scale international projects are pursued and executed using one or more agents to assist in understanding customer needs, local content requirements, and vendor selection criteria and processes and in communicating information from us regarding our services and pricing. In July 2006, we adopted enhanced procedures for the retention of agents to promote compliance with applicable laws, including with the FCPA. An agreed settlement or loss at trial relating to the FCPA matters described below under Risks Relating to Investigations and Risks Related to Our Affiliation With Halliburton could result in a monitor being appointed to review future practices for compliance with the FCPA, including with respect to the retention of agents. Our compliance procedures or having a monitor could result in a more limited use of agents on large-scale international projects than in the past.

Table of Contents

Accordingly, we could be at a competitive disadvantage in pursuing such projects, which could have a material adverse effect on our ability to win contracts and our future revenue and business prospects.

The DoD awards its contracts through a rigorous competitive process and our efforts to obtain future contract awards from the DoD, including the LogCAP IV contract, may be unsuccessful, and the DoD has recently favored multiple award task order contracts. The DoD conducts a rigorous competitive process for awarding most contracts. In the services arena, the DoD uses multiple contracting approaches. It uses omnibus contract vehicles, such as LogCAP, for work that is done on a contingency, or as-needed basis. In more predictable sustainment environments, contracts may include both fixed-price and cost-reimbursable elements. The DoD has also recently favored multiple award task order contracts, in which several contractors are selected as eligible bidders for future work. Such processes require successful contractors to continually anticipate customer requirements and develop rapid-response bid and proposal teams as well as have supplier relationships and delivery systems in place to react to emerging needs. We will face rigorous competition for any additional contract awards from the DoD, and we may be required to qualify or continue to qualify under the various multiple award task order contract criteria. The DoD has announced that the new LogCAP IV contract, which will replace the current LogCAP III contract under which we are the sole provider, will be a multiple award task order contract. We may not be awarded any part of the LogCAP IV contract, which may have a material adverse effect on future results of operations. It may be more difficult for us to win future awards from the DoD, and we may have other contractors sharing in any DoD awards that we win. In addition, negative publicity regarding findings out of DCAA and Congressional investigations may adversely affect our ability to obtain future awards.

The uncertainty of the timing of future contract awards may inhibit our ability to recover our labor costs. The uncertainty of our contract award timing can also present difficulties in matching workforce size with contract needs. In some cases, we maintain and bear the cost of a ready workforce that is larger than called for under existing contracts in anticipation of future workforce needs for expected contract awards. If an expected contract award is delayed or not received, we may not be able to recover our labor costs, which could have a material adverse effect on us.

A significant portion of our projects is on a fixed-price basis, subjecting us to the risks associated with cost over-runs, operating cost inflation and potential claims for liquidated damages.

Our long-term contracts to provide services are either on a cost-reimbursable basis or on a fixed-price basis. At December 31, 2006, 43% of our backlog for continuing operations was attributable to fixed-price contracts and 57% was attributable to cost-reimbursable contracts. Our failure to accurately estimate the resources and time required for a fixed-price project or our failure to complete our contractual obligations within the time frame and costs committed could have a material adverse effect on our business, results of operations and financial condition. In connection with projects covered by fixed-price contracts, we generally bear the risk of cost over-runs, operating cost inflation, labor availability and productivity, and supplier and subcontractor pricing and performance. Under both our fixed-price contracts and our cost-reimbursable contracts, we generally rely on third parties for many support services, and we could be subject to liability for engineering or systems failures. Risks under our contracts include:

- *Our engineering, procurement and construction projects may encounter difficulties in the design or engineering phases, related to the procurement of supplies, and due to schedule changes, equipment performance failures, and other factors that may result in additional costs to us, reductions in revenue, claims or disputes*. Our engineering, procurement and construction projects generally involve complex design and engineering, significant procurement of equipment and supplies, and extensive construction management. Many of these projects involve design and engineering, procurement and construction phases that may occur over extended time periods, often in excess of two years. We may encounter difficulties in the design or engineering, equipment and supply delivery, schedule changes, and other factors, some of which are beyond our control, that impact our ability to complete a project in accordance with the original delivery schedule. In some cases, the equipment we purchase for a project does not perform as expected, and these performance failures may result in delays in completion of the project or additional costs to us or the customer to complete the project and, in some cases, may require us to obtain alternate equipment at additional cost.

For example, in the second quarter of 2006, at the time of our first check estimate , we identified a $148 million charge, before income taxes and minority interest, related to our consolidated 50%-owned GTL project in Escravos, Nigeria. A first check estimate is a detailed process to reschedule and recost a project through its completion and occurs once sufficient engineering work has been completed allowing for a detailed cost re-estimate based on actual engineering drawings. This charge was primarily attributable to increases in the overall estimated cost to complete the project. The project has experienced delays relating to civil unrest and security on the Escravos River, near the project site, and further delays have resulted from scope changes and engineering and construction modifications.

We may not be able to obtain compensation for additional work or expenses incurred as a result of customer change orders or our customers providing deficient design or engineering information or equipment or materials. Some of our contracts may require that our customers provide us with design or engineering information or with equipment or materials to be used on the project. In some cases, the customer may provide us with deficient design or engineering information or equipment or materials or may provide the information or equipment or materials to us later than required by the project schedule. The customer may also determine, after commencement of the project, to change various elements of the project. Our project contracts generally require the customer to compensate us for additional work or expenses incurred due to customer requested change orders or failure of the customer to provide us with specified design or engineering information or equipment or materials. Under these circumstances, we generally negotiate with the customer with respect to the amount of additional time required to make these changes and the compensation to be paid to us. We are subject to the risk that we are unable to obtain, through negotiation, arbitration, litigation or otherwise, adequate amounts to compensate us for the additional work or expenses incurred by us due to customer-requested change orders or failure by the customer to timely provide required items. A failure to obtain adequate compensation for these matters could require us to record an adjustment to amounts of revenue and gross profit that were recognized in prior periods. Any such adjustments, if substantial, could have a material adverse effect on our results of operations and financial condition.

We may be required to pay liquidated damages upon our failure to meet schedule or performance requirements of our contracts. In certain circumstances, we guarantee facility completion by a scheduled acceptance date or achievement of certain acceptance and performance testing levels. Failure to meet any such schedule or performance requirements could result in additional costs, and the amount of such additional costs could exceed projected profit margins for the project. These additional costs include liquidated damages paid under contractual penalty provisions, which can be substantial and can accrue on a daily basis. In addition, our actual costs could exceed our projections. Performance problems for existing and future contracts could cause actual results of operations to differ materially from those anticipated by us and could cause us to suffer damage to our reputation within our industry and our customer base.

For example, our Tangguh contract provides for substantial liquidated damages should the project not be completed and provisionally accepted by the client by a specified date. The current estimated construction schedule for the Tangguh project indicates that construction will be completed just prior to the date specified in the contract whereby liquidated damages will be incurred.

Difficulties in engaging third party subcontractors, equipment manufacturers or materials suppliers or failures by third party subcontractors, equipment manufacturers or materials suppliers to perform could result in project delays and cause us to incur additional costs. We generally rely on third party subcontractors as well as third party equipment manufacturers and materials suppliers to assist us with the completion of our contracts. Recently, we have experienced extended delivery cycles and increasing prices for various subcontracted services, equipment and materials. To the extent that we cannot engage subcontractors or acquire equipment or materials, our ability to complete a project in a timely fashion or at a profit may be impaired. If the amount we are required to pay for services, equipment and materials exceeds the amount we have estimated in bidding for fixed-price work, we could experience losses in the performance of these contracts. Any delay by subcontractors to complete their portion of the project, any failure by a subcontractor to satisfactorily complete its portion of the project, and other factors beyond our control may result in delays in the project or may cause us to incur additional costs, or both. These delays and additional costs may be substantial, and we may not be able to recover these costs from our customer or may be required to compensate the customer for these delays. In such event, we may not be able to recover these additional costs from the responsible vendor, subcontractor or other third party. In addition, if a subcontractor or a manufacturer is unable to deliver its services, equipment or materials according to the negotiated terms and timetable for any reason, including the deterioration of its financial condition, we may be delayed in completing the project and/or be required to purchase the services, equipment or materials from another source at a higher price. This may reduce the profit or award fee to be realized or result in a loss on a project for which the services, equipment or materials were needed.

Difficulties in estimating and execution may result in additional costs and losses. During the fourth quarter of 2006, we recorded a $12 million loss in connection with our contract to design and build a U.S. embassy in Skopje, Macedonia. This project was approximately 13% complete at December 31, 2006, and we have the balance of the construction work to complete. In December 2006, we also received a letter from our client, the U.S. Department of State, stating various concerns including our delays experienced to date on this project. We have responded to the client s concerns including our plan to make up lost schedule. We could incur additional costs and losses on this project if our plan to make up lost schedule are not achieved or if material, labor or other costs incurred exceed the amounts we have estimated.

Our projects expose us to potential professional liability, product liability, warranty, performance and other claims that may exceed our available insurance coverage. We engineer, construct and perform services in large industrial facilities in which accidents or system failures can be disastrous. Any catastrophic occurrences in excess of insurance limits at locations engineered or constructed by us or where our services are performed could result in significant professional liability, product liability, warranty and other claims against us. The failure of any systems or facilities that we engineer or construct could result in warranty claims against us for significant replacement or reworking costs. In addition, once our construction is complete, we may face claims with respect to the performance of these facilities.

We could have a material weakness in our internal controls over financial reporting in the future. Our business may be adversely affected if we have material weaknesses or significant deficiencies in our internal control over financial reporting in the future.

As a public company we will incur significant legal, accounting, insurance and other expenses. The Sarbanes-Oxley Act of 2002, as well as compliance with other SEC and exchange listing rules, will increase our legal and financial compliance costs and make some activities more time-consuming and costly. Furthermore, SEC rules require that our chief executive officer and chief financial officer periodically certify the existence and effectiveness of our internal control over financial reporting. Our independent registered public accounting firm will be required, beginning with our Annual Report on Form 10-K for our fiscal year ending on December 31, 2007, to attest to our assessment of our internal control over financial reporting.

During the course of our testing, we may identify deficiencies that would have to be remediated to satisfy the SEC rules for certification of our internal controls over financial reporting. As a consequence, we may have to disclose in periodic reports we file with the SEC significant deficiencies or material weaknesses in our system of internal controls. The existence of a material weakness would preclude management from concluding that our internal control over financial reporting is effective, and would preclude our independent auditors from issuing an unqualified opinion that our internal control over financial reporting is effective. In addition, disclosures of

Table of Contents

this type in our SEC reports could cause investors to lose confidence in our financial reporting and may negatively affect the trading price of our common stock. Moreover, effective internal controls are necessary to produce reliable financial reports and to prevent fraud. If we have deficiencies in our disclosure controls and procedures or internal control over financial reporting it may negatively impact our business, results of operations and reputation.

We identified and remediated a material weakness in our internal controls over financial reporting in 2006 resulting from our failure to follow existing internal control policies and procedures for estimating project cost changes on our Escravos project. We have identified, developed and implemented a number of measures to strengthen our internal controls over financial reporting and address the material weakness that we identified. We could have significant deficiencies in the future and such conditions could rise to the level of a material weakness. The existence of one or more material weaknesses or significant deficiencies could result in errors in our financial statements or delays in the filing of our periodic reports required by the SEC.

Our government contracts work is regularly reviewed and audited by our customer, government auditors and others, and these reviews can lead to withholding or delay of payments to us, non-receipt of award fees, legal actions, fines, penalties and liabilities and other remedies against us.

Given the demands of working in Iraq and elsewhere for the U.S. government, we expect that from time to time we will have disagreements or experience performance issues with the various government customers for which we work. If performance issues arise under any of our government contracts, the government retains the right to pursue remedies, which could include threatened termination or termination under any affected contract. If any contract were so terminated, we may not receive award fees under the affected contract, and our ability to secure future contracts could be adversely affected, although we would receive payment for amounts owed for our allowable costs under cost-reimbursable contracts. Other remedies that our government customers may seek for any improper activities or performance issues include sanctions such as forfeiture of profits, suspension of payments, fines and suspensions or debarment from doing business with the government. Further, the negative publicity that could arise from disagreements with our customers or sanctions as a result thereof could have an adverse effect on our reputation in the industry, reduce our ability to compete for new contracts, and may also have a material adverse effect on our business, financial condition, results of operations and cash flow.

The DCAA reviews our government contracts operations and can recommend withholding payment for costs that have been incurred. Because of the scrutiny involving our government contracts operations, issues raised by the DCAA may be more difficult to resolve. Our operations under U.S. government contracts are regularly reviewed and audited by the Defense Contract Audit Agency (DCAA) and other governmental agencies. When issues are found during the governmental agency audit process, these issues are typically discussed and reviewed with us. The DCAA then issues an audit report with its recommendations to our customer s contracting officer. In the case of management systems and other contract administrative issues, the contracting officer is generally with the Defense Contract Management Agency (DCMA). If our customer or a government auditor finds that we improperly charged any costs to a contract, these costs are not reimbursable or, if already reimbursed, the costs must be refunded to the customer. The DCAA is continuously performing audits of costs incurred for the foregoing and other services provided by us under our government contracts. During these audits, there are likely to be questions raised by the DCAA about the reasonableness or allowability of certain costs or the quality or quantity of supporting documentation. The DCAA might recommend withholding some portion of the questioned costs while the issues are being resolved with our customer. For example, in June 2005, the DCAA recommended withholding certain costs associated with providing containerized housing for soldiers and supporting civilian personnel in Iraq. The DCAA recommended that the costs be withheld pending receipt of additional explanation or documentation to support the subcontract costs and $55 million has been withheld as of December 31, 2006, of which $17 million has been withheld from our subcontractors. In addition, the DCAA has raised questions regarding $95 million of costs related to dining facilities in Iraq. Because of the scrutiny involving our government contracts operations, issues raised by the DCAA may be more difficult to resolve.

Table of Contents

In February 2007, we received a letter from the Department of the Army informing us of their intent to adjust payments under the LogCAP III contract associated with the cost incurred by the subcontractors to provide security to their employees. Based on this letter, the DCAA withheld the Army s initial assessment of $20 million. The Army based its assessment on one subcontract wherein, based on communications with the subcontractor, the Army estimated 6% of the total subcontract cost related to the private security costs. The Army indicated that not all task orders and subcontracts have been reviewed and that they may make additional adjustments. The Army indicated that, within 60 days, they intend to begin making further adjustments equal to 6% of prior and current subcontractor costs unless we can provide timely information sufficient to show that such action is not necessary to protect the government s interest. We are working with the Army to provide the additional information they have requested.

The Army indicated that they believe our LogCAP III contract prohibits us from billing costs of privately acquired security. We believe that, while LogCAP III contract anticipates that the Army will provide force protection to KBR employees, it does not prohibit any of our subcontractors from using private security services to provide force protection to subcontractor personnel. In addition, a significant portion of our subcontracts are competitively bid lump sum or fixed price subcontracts. As a result, we do not receive details of the subcontractors cost estimate nor are we legally entitled to it. Accordingly, we believe that we are entitled to reimbursement by the Army for the cost of services provided by our subcontractors, even if they incurred costs for private force protection services. Therefore, we believe that the Army s position that such costs are unallowable and that they are entitled to withhold amounts incurred for such costs is wrong as a matter of law.

If we are unable to demonstrate that such action by the Army is not necessary, a 6% suspension of all subcontractor costs incurred to date could result in suspended costs of approximately $400 million. The Army has asked us to provide information that addresses the use of armed security either directly or indirectly charged to LogCAP III. The actual costs associated with these activities cannot be accurately measured at this time. As of December 31, 2006, no amounts have been accrued for suspended security billings.

If the DCMA were to conclude that our accounting system was not adequate for U.S. government cost reimbursement contracts, our ability to be awarded new contracts would be materially and adversely affected. Our accounting system is currently approved by the DCMA s contracting officer for cost reimbursement contracts. We have received two draft reports from the DCAA on our accounting system, which raised various issues and questions. We have responded to the points raised by the DCAA, but this review remains open. In the fourth quarter of 2006, the DCAA finalized its report and submitted it to the DCMA, who will make a determination of the adequacy of our accounting systems for government contracting. We have prepared an action plan considering the DCAA recommendations and continue to meet with these agencies to discuss the ultimate resolution. If the DCMA were to conclude that our accounting system was not adequate for U.S. government cost reimbursement contracts, our ability to be awarded new contracts would be materially and adversely affected. In addition, negative publicity regarding alleged accounting system inadequacies or findings arising out of DCAA and DCMA reviews may adversely affect our ability to attract and obtain other government and commercial contracts.

If we were determined to have liability as a result of investigations into our work in Iraq, Kuwait and Afghanistan it could have a material adverse effect on our results of operations and cash flow. We understand that the United States Department of Justice (DOJ), an Assistant U.S. Attorney based in Illinois, and others are investigating these and other individually immaterial matters we have reported relating to our government contract work in Iraq. If criminal wrongdoing were found, criminal penalties could range up to the greater of $500,000 in fines per count for a corporation or twice the gross pecuniary gain or loss. We also understand that current and former employees of KBR have received subpoenas and have given or may give grand jury testimony related to some of these matters.

The House Oversight and Government Reform Committee has conducted hearings on the U.S. military s reliance on civilian contractors, including with respect to military operations in Iraq. We have provided testimony and information for these hearings. We expect hearings with respect to operations in Iraq to continue in this and other Congressional committees, including the House Armed Services Committee, and we expect to be asked to testify and provide information for these hearings.

We also provided information to the DoD Inspector General s office in February 2004 about other contacts between former employees and our subcontractors. In the first quarter of 2005, the DOJ issued two indictments associated with overbilling issues we previously reported to the Department of Defense Inspector General s office as well as to our customer, the Army Materiel Command, against a former KBR procurement manager and a manager of La Nouvelle Trading & Contracting Company, W.L.L. In March 2006, one of these former employees pled guilty to taking money in exchange for awarding work to a Saudi Arabian subcontractor. The Inspector General s investigation of these matters may continue.

In October 2004, we reported to the DoD Inspector General s office that two former employees in Kuwait may have had inappropriate contacts with individuals employed by or affiliated with two third party subcontractors prior to the award of the subcontracts. The Inspector General s office may investigate whether these two employees may have solicited and/or accepted payments from those third party subcontractors while they were employed by us.

In October 2004, a civilian contracting official in the COE asked for a review of the process used by the COE for awarding some of the contracts to us. We understand that the DoD Inspector General s office may review the issues involved.

If we were determined to have liability as a result of any of these investigations, it could have a material adverse effect on our results of operations and cash flow.

We may be subject to qui tam actions filed by former employees for alleged wrongdoings relating to our LogCAP contracts. In the past, we became aware of *qui tam* actions filed against us by former employees alleging various wrongdoings in the form of overbillings of our customers on our LogCAP contracts and expect that we may be subject to similar actions in the future. These cases typically are filed pending the government s decision whether or not to participate in the suit.

To the extent that we export products, technical data and services outside the United States, we are subject to U.S. laws and regulations governing international trade and exports, including but not limited to the International Traffic in Arms Regulations, the Export Administration Regulations and trade sanctions against embargoed countries, which are administered by the Office of Foreign Assets Control within the Department of the Treasury. A failure to comply with these laws and regulations could result in civil and/or criminal sanctions, including the imposition of fines upon us as well as the denial of export privileges and debarment from participation in U.S. government contracts.

From time to time, we identify certain inadvertent or potential export or related violations. These violations may include, for example, transfers without required governmental authorizations. Although we do not currently anticipate that any past export practice will have a material adverse effect on our business, financial condition or results of operations, we can give no assurance as to whether we will ultimately be subject to sanctions as a result of such practices or the disclosure thereof, or the extent or effect thereof, if any sanctions are imposed, or whether individually or in the aggregate such practices or the disclosure thereof will have a material adverse effect on our business, financial condition or results of operations.

We continue to enhance our export control procedures and educate our executives and other employees who manage our exports concerning the requirements of applicable U.S. law. An effective control system regarding these matters is among our highest priorities. Nonetheless, a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met or that all violations have been or will be detected. We have reported to the U.S. Department of State and Department of Commerce that exports of materials, including personal protection equipment such as helmets, goggles, body armor and chemical protective suits, in connection with personnel deployed to Iraq and Afghanistan may not have been in accordance with current licenses or may have been unlicensed. A determination that we have failed to comply with one or more of these export controls could result in civil and/ or criminal sanctions, including the imposition of fines upon us as well as the denial of export privileges and debarment from participation in U.S. government contracts. Any one or more of such sanctions could have a material adverse effect on our business, financial condition or results of operations.

We are involved in a dispute with Petrobras with respect to responsibility for the failure of subsea flow-line bolts on the Barracuda-Caratinga project.

In June 2000, we entered into a contract with Barracuda & Caratinga Leasing Company B.V., the project owner, to develop the Barracuda and Caratinga crude oilfields, which are located off the coast of Brazil. The construction manager and project owner s representative is Petrobras, the Brazilian national oil company. The project consists of two converted supertankers, Barracuda and Caratinga, which are being used as floating production, storage, and offloading units, commonly referred to as FPSOs.

At Petrobras direction, we have replaced certain bolts located on the subsea flow-lines that have failed through mid-November 2005, and we understand that additional bolts have failed thereafter, which have been replaced by Petrobras. These failed bolts were identified by Petrobras when it conducted inspections of the bolts. The original design specification for the bolts was issued by Petrobras, and as such, we believe the cost resulting from any replacement is not our responsibility. Petrobras has indicated, however, that they do not agree with our conclusion. We have notified Petrobras that this matter is in dispute. We believe several possible solutions may exist, including replacement of the bolts. Estimates indicate that costs of these various solutions range up to $140 million. Should Petrobras instruct us to replace the subsea bolts, the prime contract terms and conditions regarding change orders require that Petrobras make progress payments of our reasonable costs incurred. Petrobras could, however, perform any replacement of the bolts and seek reimbursement from us. On March 9, 2006, Petrobras notified us that they have submitted this matter to arbitration claiming $220 million plus interest for the cost of monitoring and replacing the defective bolts and, in addition, all of the costs and expenses of the arbitration including the cost of attorneys fees. We disagree with Petrobras claim, since the bolts met Petrobras design specifications, and we do not believe there is any basis for the amount claimed by Petrobras. We intend to vigorously defend this matter and pursue recovery of the costs we have incurred to date through the arbitration process. Consequences of this matter could have a material adverse effect on our results of operations, financial condition and cash flow.

We are actively engaged in claims negotiations with some of our customers, and a failure to successfully resolve our unapproved claims may materially and adversely impact our results of operations.

We report revenue from contracts to provide construction, engineering, design or similar services under the percentage-of-completion method of accounting. The recording of profits and losses on long-term contracts requires an estimate of the total profit or loss over the life of each contract. Total estimated profit is calculated as the difference between total estimated contract value and total estimated costs. When calculating the amount of total profit or loss, we include unapproved claims as contract value when the collection is deemed probable based upon the four criteria for recognizing unapproved claims under the American Institute of Certified Public Accountants Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Including probable unapproved claims in this calculation increases the operating income (or reduces the operating loss) that would otherwise be recorded without consideration of the probable unapproved claims.

We are actively engaged in claims negotiations with some of our customers, and the success of claims negotiations has a direct impact on the profit or loss recorded for any related long-term contract. Unsuccessful claims negotiations could result in decreases in estimated contract profits or additional contract losses. As of

December 31, 2006, our probable unapproved claims, including those from unconsolidated related companies, related to eight contracts, most of which are complete or substantially complete. A significant portion of our probable unapproved claims as of December 31, 2006 arose from three completed projects for Petroleos Mexicanos (PEMEX) ($148 million related to our consolidated entities and $45 million related to our unconsolidated related companies) that are currently subject to arbitration proceedings. In addition, we have Other assets of $64 million for previously approved services that are unpaid by PEMEX and have been included in these arbitration proceedings. The arbitration proceedings are expected to extend through the remainder of 2007. Unfavorable outcomes for us in these arbitration proceedings could have a material adverse effect on our results of operations. In addition, even if the outcomes of these proceedings are favorable to us, there can be no assurance that we will ultimately be able to collect the amounts owed by PEMEX. In addition, as of December 31, 2006, we had $36 million of probable unapproved claims relating to our LogCAP III contract and $43 million of unapproved change orders relating to the Escravos project. Please read Notes 5, 6 and 14 to the consolidated financial statements included elsewhere in this annual report.

Risks Relating to Investigations

The SEC and the DOJ are investigating the actions of agents in foreign projects in light of the requirements of the United States Foreign Corrupt Practices Act, and the results of these investigations could have a material adverse effect on our business, prospects, results of operations, financial condition and cash flow.

The SEC is conducting a formal investigation into whether improper payments were made to government officials in Nigeria through the use of agents or subcontractors in connection with the construction and subsequent expansion by TSKJ, a joint venture in which one of our subsidiaries (a successor to The M.W. Kellogg Company) had an approximate 25% interest at December 31, 2006, of a multibillion dollar natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The DOJ is also conducting a related criminal investigation. The SEC has also issued subpoenas seeking information, which Halliburton is furnishing, regarding current and former agents used in connection with multiple projects, including current and prior projects, over the past 20 years located both in and outside of Nigeria in which we, The M.W. Kellogg Company, M.W. Kellogg Limited or their or our joint ventures are or were participants. The SEC and the DOJ have been reviewing these matters in light of the requirements of the FCPA. Please read Business Legal Proceedings FCPA Investigations for more information.

Halliburton has been investigating these matters and has been cooperating with the SEC and the DOJ investigations and with other investigations into the Bonny Island project in France, Nigeria and Switzerland. We also believe that the Serious Frauds Office in the United Kingdom is conducting an investigation relating to the Bonny Island project. As a result of these investigations, information has been uncovered suggesting that, commencing at least 10 years ago, members of TSKJ planned payments to Nigerian officials. We have reason to believe, based on the ongoing investigations, that payments may have been made by agents of TSKJ to Nigerian officials. In addition, information uncovered in the summer of 2006 suggests that, prior to 1998, plans may have been made by employees of The M.W. Kellogg Company to make payments to government officials in connection with the pursuit of a number of other projects in countries outside of Nigeria. Halliburton is reviewing a number of recently discovered documents related to KBR activities in countries outside of Nigeria with respect to agents for projects after 1998. Certain of the activities discussed in this paragraph involve current or former employees or persons who were or are consultants to us, and the investigation continues. Additionally, in 2006, Halliburton suspended the services of an agent that, until such suspension, had served on projects outside of Nigeria, and Halliburton suspended the services of an additional agent used in connection with a separate Nigerian project.

If violations of the FCPA were found, a person or entity found in violation could be subject to fines, civil penalties of up to $500,000 per violation, equitable remedies, including disgorgement (if applicable) generally of profits, including prejudgment interest on such profits, causally connected to the violation, and injunctive relief. Criminal penalties could range up to the greater of $2 million per violation or twice the gross pecuniary gain or loss from the violation, which could be substantially greater than $2 million per violation. It is possible that both the SEC and the DOJ could assert that there have been multiple violations, which could lead to multiple fines. The amount of any fines or monetary penalties which could be assessed would depend on, among other factors, the findings regarding the amount, timing, nature and scope of any improper payments, whether any such payments were authorized by or made with knowledge of us or our affiliates, the amount of gross pecuniary gain or loss involved, and the level of cooperation provided to the government authorities during the investigations. Agreed dispositions of these types of violations also frequently result in an acknowledgement of wrongdoing by the entity and the appointment of a monitor on terms negotiated with the SEC and the DOJ to review and monitor current and future business practices, including the retention of agents, with the goal of assuring compliance with the FCPA. Other potential consequences could be significant and include suspension or debarment of our ability to contract with governmental agencies of the United States and of foreign countries.

The investigations by the SEC and DOJ and foreign governmental authorities are continuing. We do not expect these investigations to be concluded or in the immediate future. The various governmental authorities could conclude that violations of the FCPA or applicable analogous foreign laws have occurred with respect to the Bonny Island project and other projects in or outside of Nigeria. In such circumstances, the resolution or disposition of these matters, even after taking into account the indemnity from Halliburton with respect to any liabilities for fines or other monetary penalties or direct monetary damages, including disgorgement, that may be assessed against us or our greater than 50%-owned subsidiaries by the U.S or foreign governmental authorities in the U.K., France, Nigeria, Switzerland or Algeria relating to FCPA matters, could have a material adverse effect on our business, prospects, results of operations, financial condition and cash flow. Please read *Risks Related to Our Relationship With Halliburton Halliburton s indemnity for Foreign Corrupt Practices Act matters does not apply to all potential losses, Halliburton s actions may not be in our stockholders best interests and we may take or fail to take actions that could result in our indemnification from Halliburton with respect to Foreign Corrupt Practices Act matters no longer being available.*

Information has been uncovered suggesting that former employees may have engaged in coordinated bidding with one or more competitors on certain foreign construction projects.

In connection with the investigation into payments relating to the Bonny Island project in Nigeria, information has been uncovered suggesting that former employees may have engaged in coordinated bidding with one or more competitors on certain foreign construction projects and that such coordination possibly began as early as the mid-1980s.

On the basis of this information, Halliburton and the DOJ have broadened their investigations to determine the nature and extent of any improper bidding practices, whether such conduct violated United States antitrust laws, and whether former employees may have received payments in connection with bidding practices on some foreign projects.

If violations of applicable United States antitrust laws occurred, the range of possible penalties includes criminal fines, which could range up to the greater of $10 million in fines per count for a corporation, or twice the gross pecuniary gain or loss, and treble civil damages in favor of any persons financially injured by such violations. Criminal prosecutions under applicable laws of relevant foreign jurisdictions and civil claims by, or relationship issues with customers, are also possible.

Halliburton s indemnity does not apply to liabilities, if any, for fines, other monetary penalties or other potential losses arising out of violations of United States antitrust laws.

Potential consequences arising out of the investigations into FCPA matters and antitrust matters could include suspension or debarment of our ability to contract with the United States, state or local governments, U.S. government agencies or the MoD, third party claims, loss of business, adverse financial impact, damage to reputation and adverse consequences on financing for current or future projects.

Potential consequences of a criminal indictment arising out of any of the investigations into FCPA matters and antitrust matters could include suspension of our ability to contract with the United States, state or local governments, U.S. government agencies or the MoD in the United Kingdom. If a criminal or civil violation were found, we and our affiliates could be debarred from future contracts or new orders under current contracts to provide services to any such parties. During 2006, we had revenue of $5.8 billion from our government contracts work with agencies of the United States or state or local governments. In addition, we may be excluded from bidding on MoD contracts in the United Kingdom if we are convicted of a corruption offense or if the MoD determines that our actions constituted grave misconduct. During 2006, we had revenue of $1.0 billion from our government contracts work with the MoD. Suspension or debarment from the government contracts business would have a material adverse effect on our business, results of operations and cash flow.

These investigations could also result in (1) third party claims against us, which may include claims for special, indirect, derivative or consequential damages, (2) damage to our business or reputation, (3) loss of, or adverse effect on, cash flow, assets, goodwill, results of operations, business, prospects, profits or business value, (4) adverse consequences on our ability to obtain or continue financing for current or future projects and/or (5) claims by directors, officers, employees, affiliates, advisors, attorneys, agents, debt holders or other interest holders or constituents of us. In connection with the French investigation into the Bonny Island project, we understand that the government of Nigeria gave notice in 2004 to the French magistrate of a civil claim as an injured party in that proceeding. In addition, our compliance procedures or having a monitor required or agreed to be appointed at our cost as part of the disposition of the investigations could result in a more limited use of agents on large-scale international projects than in the past and put us at a competitive disadvantage in pursuing such projects. Continuing negative publicity arising out of these investigations could also result in our inability to bid successfully for governmental contracts and adversely affect our prospects in the commercial marketplace. If we incur costs or losses as a result of these matters, we may not have the liquidity or funds to address those losses, in which case such losses could have a material adverse effect on our business, prospects, results of operations, financial condition and cash flow.

Other Risks Related to Our Business

We experience increased working capital requirements from time to time associated with our business, and such an increased demand for working capital could adversely affect our ability to meet our liquidity needs.

Our operations could require us to utilize large sums of working capital, sometimes on short notice and sometimes without the ability to completely recover the expenditures on a timely basis or at all. Circumstances or events which could create large cash outflows include, among others, losses resulting from fixed-price contracts; contract initiation costs, contract completion cost or delays in receipt of payments under our contracts; environmental liabilities; litigation costs; adverse political conditions; foreign exchange risks; and professional and product liability claims. If we encounter significant working capital requirements or cash outflows as a result of these or other factors, we may not have sufficient liquidity or the credit capacity to meet all of our cash needs.

Insufficient liquidity could have important consequences to us. For example, we could:

- have more difficulty in providing sufficient working capital under contracts such as LogCAP that may require a substantial and immediate ramp up in operations without immediate reimbursement; and

- have less success in obtaining new work if our sureties or our lenders were to limit our ability to provide new performance bonds or letters of credit for our projects.

All or any of the following liquidity matters, working capital demands or limitations under our credit facility could place us at a competitive disadvantage compared with competitors with more liquidity and could have a material adverse effect on our business, prospects, results of operations, financial condition and cash flow.

Demobilization from Iraq could require funding of substantial working capital expenses without timely reimbursement. Demobilization of the United States military or our personnel from Iraq would require us to utilize large sums of working capital to move personnel and equipment from Iraq. If the DoD does not immediately approve funding for such a demobilization, we could be required to fund the related working capital expenses without reimbursement on a timely basis.

We cannot rely on Halliburton to meet our liquidity needs or provide future credit support for required bonds, letters of credit, performance guarantees and other credit enhancement instruments, except to the extent Halliburton has agreed to do so under the terms of the master separation agreement. Prior to our initial public offering, we relied upon Halliburton to fund our working capital demands and assist us in meeting our liquidity needs, thereby providing us with a reliable source of cash, liquidity and credit support enhancements even in unusual or unexpected circumstances. We are no longer able to rely on Halliburton to meet future needs, except to the extent of credit support instruments outstanding at the completion of our initial public offering and to the limited extent Halliburton has agreed to provide additional guarantees, indemnification and reimbursement commitments for our benefit in connection with letters of credit, surety bonds and performance guarantees related to certain of our existing project contracts as provided for in the master separation agreement. Please read Certain Relationships and Related Transactions, and Director Independence Master Separation Agreement Credit Support Instruments. We have obtained a limited amount of surety capacity and are currently engaged in discussions with surety companies to obtain additional capacity. Our efforts to obtain this additional stand-alone bonding capacity may not be successful. We can provide no assurance that we will have sufficient working capital or surety support to allow us to secure large-scale contracts or satisfy contract performance specifications.

Our revolving credit facility imposes restrictions that limit our operating flexibility and may result in additional expenses, and this credit facility will not be available if financial covenants are not met or if an event of default occurs. In December 2005, we entered into a five-year, unsecured revolving credit facility that provides up to $850 million of borrowings and letters of credit. This facility serves to assist us in providing working capital and letters of credit for our projects. The revolving credit facility contains a number of covenants restricting, among other things, incurrence of additional indebtedness and liens, sales of our assets, the amount of investments we can make, dividends. We are also subject to certain financial covenants, including maintenance of ratios with respect to consolidated debt to total consolidated capitalization, leverage and fixed charge coverage. If we fail to meet the covenants or an event of default occurs, we would not have available the liquidity that the facility provides. Please read *It is an event of default under our $850 million revolving credit facility if a person other than Halliburton or our Company directly or indirectly acquires 25% or more of the ordinary voting equity interests of the borrower under the credit facility.* Any future credit facilities would also likely contain similar covenants.

In addition, under our existing revolving credit facility, and potentially under any future credit facility, we will be required to incur increased lending fees, costs and interest rates and, if future borrowings were to occur, to dedicate a substantial portion of cash flow from operations to the repayment of debt and the interest associated with that debt.

We conduct a large portion of our engineering and construction operations through joint ventures. As a result, we may have limited control over decisions and controls of joint venture projects and have returns that are not proportional to the risks and resources we contribute.

We conduct a large portion of our engineering and construction operations through joint ventures, where control may be shared with unaffiliated third parties. As with any joint venture arrangement, differences in views among the joint venture participants may result in delayed decisions or in failures to agree on major issues. We also cannot control the actions of our joint venture partners, including any nonperformance, default, or bankruptcy of our joint venture partners, and we typically have joint and several liability with our joint venture partners under these joint venture arrangements. These factors could potentially materially and adversely affect the business and operations of a joint venture and, in turn, our business and operations.

Operating through joint ventures in which we are minority holders results in us having limited control over many decisions made with respect to projects and internal controls relating to projects. These joint ventures may not be subject to the same requirements regarding internal controls and internal control reporting that we follow. As a result, internal control issues may arise, which could have a material adverse effect on our financial condition and results of operation. When entering into joint ventures, in order to establish or preserve relationships with our joint venture partners, we may agree to risks and contributions of resources that are proportionately greater than the returns we could receive, which could reduce our income and returns on these investments compared to what we would have received if the risks and resources we contributed were always proportionate to our returns.

We have recently been notified by a joint venture partner in Brown & Root Condor Spa that it wishes to dissolve the joint venture. Pursuant to the terms of our gas alliance agreement with JGC Corporation of Japan, when our separation from Halliburton has been completed, the alliance may be terminated by either party. Please read Business Joint Ventures and Alliances.

We make equity investments in privately financed projects on which we have sustained losses and could sustain additional losses.

We participate in privately financed projects that enable our government customers to finance large-scale projects, such as railroads, and major military equipment purchases. These projects typically include the facilitation of non-recourse financing, the design and construction of facilities, and the provision of operation and maintenance services for an agreed to period after the facilities have been completed.

We may incur contractually reimbursable costs and typically make an equity investment prior to an entity achieving operational status or completing its full project financing. If a project is unable to obtain financing, we could incur losses including our contractual receivables and our equity investment. After completion of these projects, our equity investments can be at risk, depending on the operation of the project, which may not be under our control. As a result, we could sustain a loss on our equity investment in these projects. Current equity investments of this type include the Alice Springs-Darwin railroad in Australia and the Allenby & Connaught project in the United Kingdom.

With respect to the Alice Springs-Darwin railroad project, we own a 36.7% interest in a joint venture that is the holder of a 50-year concession contract with the Australian government to operate and maintain the railway. We account for this investment using the equity method of accounting in our G&I segment. This joint venture has sustained losses since commencing operations due to lower than anticipated freight volume and a slowdown in the planned expansion of the Port of Darwin. At the end of the first quarter of 2006, the joint venture s revised financial forecast led us to record a $26 million impairment charge. At that time, the joint venture engaged investment bankers in an effort to raise additional capital for the venture. At the end of the second quarter of 2006, our valuation of our investment took into consideration the bids tendered at that time by interested parties, and no further impairment was evident. However, the efforts to raise additional capital ceased during the third quarter because all previous bids were subsequently rejected or withdrawn. In October 2006, the joint venture incurred an event of default under its loan agreement by failing to make an interest and principal payment. These loans are non-recourse to us. In light of the default and the realization that the joint venture efforts to raise additional equity from third parties was not successful, we recorded an additional $32 million impairment charge in the third quarter of 2006. We will receive no tax benefit as this impairment charge is not deductible for Australian tax purposes. In December 2006, the senior lenders agreed to waive existing defaults and concede certain rights under the existing indenture. Among these were a reduction in the joint venture s debt service reserve and the relinquishment of the right to receive principal payments for 27 months, through March 2009. In exchange for these concessions, the shareholders of the joint venture committed approximately $12 million of new subordinated financing, of which $6 million was committed by us. At December 31, 2006, our investment in this joint venture was $6 million. Our $6 million additional funding commitment was still outstanding.

We have an investment in a development corporation that has an indirect interest in the new Egypt Basic Industries Corporation (EBIC) ammonia plant project located in Egypt. We are performing the EPC work for the project and providing operations and maintenance services for the facility. In August 2006, the lenders providing the construction financing notified EBIC that it was in default of the terms of its debt agreement, which effectively prevents the project from making additional borrowings until such time as certain security interests in the ammonia plant assets related to the export facilities could be perfected. Indebtedness under the debt agreement is non-recourse to us. This default was cured on December 8, 2006 subject to EBIC s submission and the lender s acceptance of the remaining documents in March 2007. No event of default has occurred pursuant to our EPC contract and we have been paid all amounts due from EBIC. In September 2006, we were instructed by EBIC to cease work on one location of the project on which the ammonia storage tanks were originally planned to be constructed due to a decision to relocate the tanks. The new location has been selected and the client and its lenders have agreed to compensate us for approximately $6 million in costs resulting from the relocation of the storage tanks. We resumed work on the ammonia tanks in February 2007.

If Halliburton s anticipated disposition of our common stock is determined to be financially detrimental to our United Kingdom pension plans in meeting their funding liabilities, it may be necessary for us to purchase annuities to secure the pension plan benefits or fund some or all of the deficits either in a lump sum or over an agreed period.

Under regulations applicable to pension plans maintained for the benefit of our employees in the United Kingdom, a disposition of our common stock by Halliburton could constitute an event for which it would be advisable to obtain clearance from the Pensions Regulator in the United Kingdom if it were determined to be a change of control that is financially detrimental to the ability of a United Kingdom pension plan to meet its funding liabilities. In such event, should we fail to obtain clearance, the Pensions Regulator could issue a contribution notice, which could impose liability on an employer of an amount equal to the cost of securing all of the pension plan beneficiaries benefits by the purchase of annuities. As an alternative to obtaining clearance from the Pensions Regulator, we could agree with the trustee of some or all of the pension plans to provide additional security to the plans satisfactory to such trustees, which would not provide the same certainty as obtaining clearance, but may reduce the risk of receiving a contribution notice from the Pensions Regulator. While no determination has been made at this time as to the action, if any, that would be taken, if clearance were sought from the Pensions Regulator or an agreement was negotiated with the trustees for the United Kingdom pension plans, it may be necessary to fund some or all of the deficits under the United Kingdom pension plans, either in a lump sum or over an agreed period. Because the funding status of our United Kingdom pension plans is dependent on future events and circumstances and actuarial assumptions, we cannot estimate the range of exposure at this time.

Intense competition in the engineering and construction industry could reduce our market share and profits.

We serve markets that are highly competitive and in which a large number of multinational companies compete. These highly competitive markets require substantial resources and capital investment in equipment, technology and skilled personnel whether the projects are awarded in a sole source or competitive bidding process. Our projects are frequently awarded through a competitive bidding process, which is standard in our industry. We are constantly competing for project awards based on pricing and the breadth and technological sophistication of our services. Any increase in competition or reduction in our competitive capabilities could have a significant adverse impact on the margins we generate from our projects or our ability to retain market share.

If we are unable to attract and retain a sufficient number of affordable trained engineers and other skilled workers, our ability to pursue projects may be adversely affected and our costs may increase.

Our rate of growth will be confined by resource limitations as competitors and customers compete for increasingly scarce resources. We believe that our success depends upon our ability to attract, develop and retain a sufficient number of affordable trained engineers and other skilled workers that can execute our services in remote locations under difficult working conditions. The demand for trained engineers and other skilled workers is currently high. If we are unable to attract and retain a sufficient number of skilled personnel, our ability to pursue projects may be adversely affected and the costs of performing our existing and future projects may increase, which may adversely impact our margins.

If we are unable to enforce our intellectual property rights or if our intellectual property rights become obsolete, our competitive position could be adversely impacted.

We utilize a variety of intellectual property rights in our services. We view our portfolio of process and design technologies as one of our competitive strengths and we use it as part of our efforts to differentiate our service offerings. We may not be able to successfully preserve these intellectual property rights in the future and these rights could be invalidated, circumvented, or challenged. In addition, the laws of some foreign countries in which our services may be sold do not protect intellectual property rights to the same extent as the laws of the United States. Because we license technologies from third parties, there is a risk that our relationships with licensors may terminate or expire or may be interrupted or harmed. In some, but not all cases, we may be able to obtain the necessary intellectual property rights from alternative sources. If we are unable to protect and maintain our intellectual property rights, or if there are any successful intellectual property challenges or infringement proceedings against us, our ability to differentiate our service offerings could be reduced. In addition, if our intellectual property rights or work processes become obsolete, we may not be able to differentiate our service offerings, and some of our competitors may be able to offer more attractive services to our customers. As a result, our business and revenue could be materially and adversely affected.

It is an event of default under our $850 million revolving credit facility if a person other than Halliburton or us directly or indirectly acquires 25% or more of the ordinary voting equity interests of the borrower under the credit facility.

Under our $850 million revolving credit facility, it is an event of default if any person or two or more persons acting in concert, other than Halliburton or our Company, directly or indirectly acquires 25% or more of the combined voting power of all outstanding equity interests ordinarily entitled to vote in the election of directors of KBR Holdings, LLC, our wholly owned subsidiary, the borrower under the credit facility. In the event of a default, the banks under the facility could declare all amounts due and payable, cease to provide additional advances and require cash collateralization for all outstanding letters of credit. If we were unable to obtain a waiver from the banks or negotiate an amendment or a replacement credit facility prior to an event of default, it could have a material adverse effect on our liquidity, financial condition and cash flow.

Our business could be materially and adversely affected by problems encountered in the installation or operation of a new SAP financial system to replace our current systems.

We are in the process of installing a new SAP financial system to replace our current systems. Among other things, the new SAP system is intended to assist us in qualifying or continuing to qualify our estimating, purchasing and accounting system under requirements of the DoD and the DCAA. If we are unable to install the new SAP system in a timely manner or if we encounter problems in its installation or operation, we may not be able to obtain approval of our systems by the DoD and the DCAA, which could delay our ability to receive payments from our customer and could have a material adverse effect on our results of operations in our G&I segment.

Risks Related to Geopolitical and International Operations and Events

International and political events may adversely affect our operations.

A significant portion of our revenue is derived from our non-United States operations, which exposes us to risks inherent in doing business in each of the countries in which we transact business. The occurrence of any of the risks described below could have a material adverse effect on our results of operations and financial condition.

Our operations in countries other than the United States accounted for approximately 86% of our consolidated revenue during 2006, 87% of our consolidated revenue during 2005 and 90% of our consolidated

Table of Contents

revenue during 2004. Based on the location of services provided, 45% of our consolidated revenue in 2006, 50% in 2005 and 45% in 2004 was from our operations in Iraq, primarily related to our work for the United States government. Also, 12% of our consolidated revenue during 2006 was from the United Kingdom. Operations in countries other than the United States are subject to various risks peculiar to each country. With respect to any particular country, these risks may include:

- expropriation and nationalization of our assets in that country;
- political and economic instability;
- civil unrest, acts of terrorism, force majeure, war, or other armed conflict;
- natural disasters, including those related to earthquakes and flooding;
- inflation;
- currency fluctuations, devaluations, and conversion restrictions;
- confiscatory taxation or other adverse tax policies;
- governmental activities that limit or disrupt markets, restrict payments, or limit the movement of funds;
- governmental activities that may result in the deprivation of contract rights; and
- governmental activities that may result in the inability to obtain or retain licenses required for operation.

Due to the unsettled political conditions in many oil-producing countries and countries in which we provide governmental logistical support, our revenue and profits are subject to the adverse consequences of war, the effects of terrorism, civil unrest, strikes, currency controls, and governmental actions. Countries where we operate that have significant amounts of political risk include: Afghanistan, Algeria, Indonesia, Iraq, Nigeria, Russia, and Yemen. In addition, military action or continued unrest in the Middle East could impact the supply and pricing for oil and gas, disrupt our operations in the region and elsewhere, and increase our costs for security worldwide.

We work in international locations where there are high security risks, which could result in harm to our employees and contractors or substantial costs.

Some of our services are performed in high-risk locations, such as Iraq, Afghanistan, Nigeria and Algeria where the country or location is suffering from political, social or economic issues, or war or civil unrest. In those locations where we have employees or operations, we may incur substantial costs to maintain the safety of our personnel. Despite these precautions, the safety of our personnel in these locations may continue to be at risk, and we have in the past and may in the future suffer the loss of employees and contractors.

We are subject to significant foreign exchange and currency risks that could adversely affect our operations and our ability to reinvest earnings from operations, and our ability to limit our foreign exchange risk through hedging transactions may be limited.

A sizable portion of our consolidated revenue and consolidated operating expenses are in foreign currencies. As a result, we are subject to significant risks, including:

- foreign exchange risks resulting from changes in foreign exchange rates and the implementation of exchange controls; and

- limitations on our ability to reinvest earnings from operations in one country to fund the capital needs of our operations in other countries.

In particular, we conduct business in countries that have non-traded or soft currencies which, because of their restricted or limited trading markets, may be difficult to exchange for hard currencies. The national governments in some of these countries are often able to establish the exchange rates for the local currency. As a

Table of Contents

result, it may not be possible for us to engage in hedging transactions to mitigate the risks associated with fluctuations of the particular currency. We are often required to pay all or a portion of our costs associated with a project in the local soft currency. As a result, we generally attempt to negotiate contract terms with our customer, who is often affiliated with the local government, to provide that we are paid in the local currency in amounts that match our local expenses. If we are unable to match our costs with matching revenue in the local currency, we would be exposed to the risk of an adverse change in currency exchange rates.

Where possible, we selectively use hedging transactions to limit our exposure to risks from doing business in foreign currencies. Our ability to hedge is limited because pricing of hedging instruments, where they exist, is often volatile and not necessarily efficient.

In addition, the value of the derivative instruments could be impacted by:

- adverse movements in foreign exchange rates;
- interest rates;
- commodity prices; or
- the value and time period of the derivative being different than the exposures or cash flow being hedged.

Risks Related to Our Relationship With Halliburton

Halliburton s indemnity for FCPA matters does not apply to all potential losses, Halliburton s actions may not be in our stockholders best interests and we may take or fail to take actions that could result in our indemnification from Halliburton with respect to FCPA matters no longer being available.

Under the terms of the master separation agreement entered into in connection with our initial public offering, Halliburton has agreed to indemnify us for, and any of our greater than 50%-owned subsidiaries for our share of, fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of claims made or assessed by a governmental authority of the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria or a settlement thereof relating to FCPA Matters (as defined), which could involve Halliburton and us through The M. W. Kellogg Company, M. W. Kellogg Limited or their or our joint ventures in projects both in and outside of Nigeria, including the Bonny Island, Nigeria project. Halliburton s indemnity will not apply to any other losses, claims, liabilities or damages assessed against us as a result of or relating to FCPA Matters or to any fines or other monetary penalties or direct monetary damages, including disgorgement, assessed by governmental authorities in jurisdictions other than the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria, or a settlement thereof, or assessed against entities such as TSKJ or Brown & Root Condor Spa, in which we do not have an interest greater than 50%. For purposes of the indemnity, FCPA Matters include claims relating to alleged or actual violations occurring prior to the date of the master separation agreement of the FCPA or particular, analogous applicable statutes, laws, regulations and rules of U.S. and foreign governments and governmental bodies identified in the master separation agreement in connection with the Bonny Island project in Nigeria and in connection with any other project, whether located inside or outside of Nigeria, including without limitation the use of agents in connection with such projects, identified by a governmental authority of the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria in connection with the current investigations in those jurisdictions. Please read *Risks Relating to Investigations The SEC and the DOJ are investigating the actions of agents in foreign projects in light of the requirements of the United States Foreign Corrupt Practices Act, and the results of these investigations could have a material adverse effect on our business, prospects, results of operations, financial condition and cash flow and Our indemnification from Halliburton for FCPA Matters may not be enforceable as a result of being against governmental policy, and Related Party Transactions.*

Either before or after a settlement or disposition of FCPA Matters, we could incur losses as a result of or relating to FCPA Matters for which Halliburton s indemnity will not apply, and we may not have the liquidity or funds to address those losses, in which case such losses could have a material adverse effect on our business, prospects, results of operations, financial condition and cash flow.

In consideration of Halliburton s agreement to indemnify us for certain FCPA Matters, we have agreed that Halliburton will at all times, in its sole discretion, have and maintain control over the investigation, defense and/ or settlement of FCPA Matters until such time, if any, that we exercise our right to assume control of the investigation, defense and/or settlement of FCPA Matters. We have also agreed, at Halliburton s expense, to assist with Halliburton s full cooperation with any governmental authority in Halliburton s investigation of FCPA Matters and its investigation, defense and/or settlement of any claim made by a governmental authority or court relating to FCPA Matters, in each case even if we assume control of FCPA Matters.

Subject to the exercise of our right to assume control of the investigation, defense and/or settlement of FCPA Matters, Halliburton will have broad discretion to investigate and defend FCPA Matters. After Halliburton s disposition of our common stock that it owns, we expect that Halliburton will take actions that are in the best interests of its stockholders, which may not be in our or our stockholders best interests, particularly in light of the potential differing interests that Halliburton and we may have with respect to the matters currently under investigation and their defense and/or settlement. In addition, the manner in which Halliburton controls the investigation, defense and/or settlement of FCPA Matters and our ongoing obligation to cooperate with Halliburton in its investigation, defense and/or settlement thereof could adversely affect us and our ability to defend or settle FCPA or other claims against us, or result in other adverse consequences to us or our business that would not be subject to Halliburton s indemnification. We may take control over the investigation, defense and/or settlement of FCPA Matters or we may refuse to agree to a settlement of FCPA Matters negotiated by Halliburton. Notwithstanding our decision, if any, to assume control or refuse to agree to a settlement of FCPA Matters, we will have a continuing obligation to assist in Halliburton s full cooperation with any government or governmental agency, which may reduce any benefit of our taking control over the investigation of FCPA Matters or refusing to agree to a settlement. If we take control over the investigation, defense and/or settlement of FCPA Matters, refuse a settlement of FCPA Matters negotiated by Halliburton, enter into a settlement of FCPA Matters without Halliburton s consent, materially breach our obligation to cooperate with respect to Halliburton s investigation, defense and/or settlement of FCPA Matters or materially breach our obligation to consistently implement and maintain, for five years following our separation from Halliburton, currently adopted business practices and standards relating to the use of foreign agents, Halliburton may terminate the indemnity, which could have a material adverse effect on our financial condition, results of operations and cash flow.

Our indemnification from Halliburton for FCPA Matters may not be enforceable as a result of being against governmental policy.

Our indemnification from Halliburton relating to FCPA Matters (as defined under Risks Related to Our Relationship With Halliburton) may not be enforceable as a result of being against governmental policy. Under the indemnity with Halliburton, our share of any liabilities for fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of U.S. or certain foreign governmental claims or assessments relating to FCPA Matters would be funded by Halliburton and would not be borne by us and our public stockholders. If we are assessed by or agree with U.S. or certain foreign governments or governmental agencies to pay any such fines, monetary penalties or direct monetary damages, including disgorgement, and Halliburton s indemnity cannot be enforced or is unavailable because of governmental requirements of a settlement, we may not have the liquidity or funds to pay those penalties or damages, which would have a material adverse effect on our business, prospects, results of operations, financial condition and cash flow. Please read Related Party Transactions.

Halliburton s indemnity for matters relating to the Barracuda-Caratinga project only applies to the replacement of certain subsea bolts, and Halliburton s actions may not be in our stockholders best interests.

Under the terms of the master separation agreement, Halliburton agreed to indemnify us and any of our greater than 50%-owned subsidiaries as of November 20, 2006, the date of the master separation agreement, for out-of-pocket cash costs and expenses, or cash settlements or cash arbitration awards in lieu thereof, we incur as a result of the replacement of certain subsea flow-line bolts installed in connection with the Barracuda-Caratinga project, which we refer to as B-C Matters. Please read *Risks Related to Our Customers and Contracts We are involved in a dispute with Petrobras with respect to responsibility for the failure of subsea flow-line bolts on the Barracuda-Caratinga Project.*

Halliburton s indemnity will not apply to any other losses, claims, liabilities or damages against us relating to B-C Matters. Please read Related Party Transactions. If, either before or after a settlement or disposition of B-C Matters, we incur losses relating to the Barracuda-Caratinga project for which Halliburton s indemnity will not apply, we may not have the liquidity or funds to address those losses, in which case such losses could have a material adverse effect on our business, prospects, results of operations, financial condition and cash flow.

At our cost, we will control the defense, counterclaim and/or settlement with respect to B-C Matters, but Halliburton will have discretion to determine whether to agree to any settlement or other resolution of B-C Matters. We expect Halliburton will take actions that are in the best interests of its stockholders, which may or may not be in our or our stockholders best interests. Halliburton has the right to assume control over the defense, counterclaim and/or settlement of B-C Matters at any time. If Halliburton assumes control over the defense, counterclaim and/or settlement of B-C Matters, or refuses a settlement proposed by us, it could result in material and adverse consequences to us or our business that would not be subject to Halliburton s indemnification. In addition, if Halliburton assumes control over the defense, counterclaim and/or settlement of B-C Matters, and we refuse a settlement proposed by Halliburton, Halliburton may terminate the indemnity. Also, if we materially breach our obligation to cooperate with Halliburton or we enter into a settlement of B-C Matters without Halliburton s consent, Halliburton may terminate the indemnity.

The terms of the agreements and other transactions between us and Halliburton entered into in connection with our initial public offering were determined by Halliburton and thus may be less favorable to us than the terms we could have obtained from an unaffiliated third party.

The transactions and agreements between us and Halliburton entered into in connection with our initial public offering presented, and in the future may present, conflicts between our interests and those of Halliburton. These transactions and agreements included agreements related to the separation of our business from Halliburton that provide for, among other things, our responsibility for liabilities related to our business and the responsibility of Halliburton for liabilities unrelated to our business, the respective rights, responsibilities and obligations of us and Halliburton with respect to taxes and tax benefits, and the terms of various interim and ongoing relationships between us and Halliburton, as described in Certain Relationships and Transactions, and Director Independence. Because the terms of these transactions and agreements were determined by Halliburton, their terms may be less favorable to us than the terms we could have obtained from an unaffiliated third party. In addition, while Halliburton controls us, it could cause us to amend these agreements on terms that may be less favorable to us than the current terms of the agreements. We may not be able to resolve any potential conflict, and even if we do, the resolution may be less favorable than if we were dealing with an unaffiliated party. We may enter into other material agreements with Halliburton in the future.

If the anticipated exchange offer and any subsequent spin-off distribution fail to qualify as a tax-free transaction because of actions we take or because of a change of control of us, we will be required to indemnify Halliburton for any resulting taxes, and this potential obligation to indemnify Halliburton may prevent or delay a change of control of us.

In connection with the anticipated exchange offer and any subsequent spin-off distribution, we and Halliburton will be required to comply with representations that have been made to Halliburton s tax counsel in connection with the tax opinion that was issued to Halliburton regarding the tax-free nature of the exchange offer and any subsequent spin-off distribution to Halliburton s stockholders and with representations that have been made to the Internal Revenue Service in connection with the private letter ruling that Halliburton has requested. If we breach

Table of Contents

any representations with respect to the opinion or any ruling request or takes any action that causes such representations to be untrue and which causes the exchange offer and any spin-off to be taxable, we will be required to indemnify Halliburton for any and all taxes incurred by Halliburton or any of its affiliates resulting from the failure of the exchange offer and any spin-off to qualify as tax-free transactions as provided in the tax sharing agreement between us and Halliburton. Further, we have agreed not to enter into transactions for two years after the completion of the exchange offer and any subsequent spin-off distribution that would result in a more than immaterial possibility of a change of control of us pursuant to a plan unless a ruling is obtained from the Internal Revenue Service or an opinion is obtained from a nationally recognized law firm that the transaction will not affect the tax-free nature of the exchange offer and any subsequent spin-off distribution. For these purposes, certain transactions are deemed to create a more than immaterial possibility of a change of control of us pursuant to a plan, and thus require such a ruling or opinion, including, without limitation, the merger of us with or into any other corporation, stock issuances (regardless of size) other than in connection with our employee incentive plans, or the redemption or repurchase of any of our capital stock (other than in connection with future employee benefit plans or pursuant to a future market purchase program involving 5% or less of KBR s publicly traded stock). If we take any action which results in the exchange offer and/or any subsequent spin-off distribution becoming a taxable transaction, we will be required to indemnify Halliburton for any and all taxes incurred by Halliburton or any of its affiliates, on an after-tax basis, resulting from such actions. The amounts of any indemnification payments would be substantial and would have a material adverse effect on our financial condition.

Depending on the facts and circumstances, the exchange offer and any subsequent spin-off distribution may be taxable to Halliburton if KBR undergoes a 50% or greater change in stock ownership within two years after the exchange offer and any subsequent spin-off distribution. Under the tax sharing agreement, as amended, between KBR and Halliburton, Halliburton is entitled to reimbursement of any tax costs incurred by Halliburton as a result of a change in control of KBR after the exchange offer. Halliburton would be entitled to such reimbursement even in the absence of any specific action by KBR, and even if actions of Halliburton (or any of its officers, directors or authorized representatives) contributed to a change in control of KBR. These costs may be so great that they delay or prevent a strategic acquisition, a change in control of KBR or an attractive business opportunity. Actions by a third party after the exchange offer causing a 50% or greater change in KBR s stock ownership could also cause the exchange offer and any subsequent spin-off distribution by Halliburton to be taxable and require reimbursement by KBR.

We completed our initial public offering in November 2006 and have only a limited history of operating as a publicly traded company, and we may encounter difficulties in making the changes necessary to operate as a independent publicly traded company, and we may incur greater costs as a independent, publicly traded company following the anticipated exchange offer and subsequent spin-off that may adversely affect our results.

Halliburton currently assists us in performing various corporate functions, including the following:

- information technology and communications;
- human resource services such as payroll and benefit plan administration;
- legal;
- tax;
- accounting;
- office space and office support;
- risk management;

treasury and corporate finance; and

investor services, investor relations and corporate communications.

Following our anticipated complete separation from Halliburton, Halliburton will have no obligation to provide these functions to us other than the interim services that will be provided by Halliburton under a transition services agreement which is described in Related Party Transactions. Also, after the termination of this agreement, we may not be able to replace the transition services in a timely manner or on terms and conditions, including costs, as favorable as those we receive from Halliburton.

Additionally, we will incur costs in connection with our anticipated separation and operation as a separate publicly-traded company. In 2007, we anticipate incurring approximately $12 million annually of additional cost of services and approximately $23 million annually of additional general and administrative expense associated with being a separate publicly traded company. Please read Management s Discussion and Analysis of Financial Condition and Results of Operations Executive Summary.

The loss of executive officers or key employees could have a material adverse effect on our business.

We depend greatly on the efforts of our executive officers and other key employees to manage our operations. The loss or unavailability of any of our executive officers or other key employees could have a material adverse effect on our business.

Provisions in our charter documents and Delaware law may inhibit a takeover or impact operational control of our company following the time Halliburton ceases to beneficially own a majority of our outstanding voting stock, which could adversely affect the value of our common stock.

Our certificate of incorporation and bylaws, as well as Delaware corporate law, contain provisions that could delay or prevent a change of control or changes in our management that a stockholder might consider favorable. These provisions include, among others, a staggered board of directors, prohibiting stockholder action by written consent, advance notice for raising business or making nominations at meetings of stockholders and the issuance of preferred stock with rights that may be senior to those of our common stock without stockholder approval. Many of these provisions become effective following the anticipated exchange offer and subsequent spin-off or at the time Halliburton ceases to beneficially own a majority of our outstanding voting stock. These provisions would apply even if a takeover offer may be considered beneficial by some of our stockholders. If a change of control or change in management is delayed or prevented, the market price of our common stock could decline.

We will be controlled by Halliburton as long as it owns a majority of our outstanding voting stock, and you will be unable to affect the outcome of stockholder voting during that time.

Halliburton owns 81% of our outstanding common stock. As long as Halliburton owns, directly or indirectly, a majority of our outstanding voting stock, Halliburton will be able to exert significant control over us, including the ability to elect or remove and replace our entire board of directors and take other actions without calling a special meeting. The concentration of ownership may also make some transactions, including mergers or other changes in control, more difficult or impossible without the support of Halliburton and Halliburton s interests may conflict with your interests as a stockholder. Currently, our public stockholders, by themselves, are not able to affect the outcome of any stockholder vote. As a result, Halliburton, subject to any fiduciary duty owed to our minority stockholders under Delaware law, will be able to control matters affecting us, including:

- the composition of our board of directors and, through it, any determination with respect to our business direction and policies, including the appointment and removal of officers;
- the determination of incentive compensation, which may affect our ability to retain key employees;
- the allocation of business opportunities between Halliburton and us;
- any determinations with respect to mergers or other business combinations;

our acquisition or disposition of assets;

Table of Contents

- our financing decisions and our capital raising activities;
- the payment of dividends on our common stock;
- conduct in regulatory and legal proceedings;
- amendments to our certificate of incorporation or bylaws; and
- determinations with respect to our tax returns.

In addition, the master separation agreement we entered into with Halliburton also contains several provisions regarding our corporate governance that apply for so long as Halliburton owns specified percentages of our common stock. For example, Halliburton has, among other rights, contractual rights relating to representation on our board of directors and board committees and, for so long as Halliburton beneficially owns 80% of our outstanding voting stock, a subscription right to purchase our securities. In addition, as long as Halliburton beneficially owns at least a majority of our outstanding voting stock. Halliburton s board of directors will review and approve all of our projects that have a value in excess of $250 million. Moreover, Halliburton may transfer all or any portion of its contractual corporate governance rights to a transferee form Halliburton which holds at least 15% of our outstanding voting stock. Your interests as our stockholders, and the interests of Halliburton or its transferee, may differ. For a description of these provisions, please read Certain Relationships and Related Transaction, and Director Independence Master Separation Agreement Corporate Governance.

In addition, Halliburton may enter into credit agreements, indentures or other contracts that commit it to limit our activities and the activities of Halliburton s other subsidiaries. Halliburton s representatives on our board or board committees could direct our business so as not to breach any of these agreements.

We are a controlled company under the rules of the New York Stock Exchange and, as a result, we qualify for, and intend to rely on, exemptions from some of the corporate governance requirements of the New York Stock Exchange. Accordingly, our stockholders will not have as many corporate governance protections as stockholders of some other publicly traded companies.

Halliburton continues to own more than 80% of our outstanding common stock and we are considered a controlled company under the corporate governance rules of the New York Stock Exchange until such time as the anticipated exchange offer and/or subsequent spin-off occurs. As a controlled company. We are eligible for exemptions from some of the requirements of these rules, including the requirements (i) that a majority of our board of directors consists of independent directors, (ii) that we have a nominating and governance committee and a compensation committee, and that each such committee be composed entirely of independent directors and governed by a written charter addressing the committee s purpose and responsibilities and (iii) for annual performance evaluations of the nominating and governance committee and the compensation committee. We intend to utilize some or all of these exemptions for so long as Halliburton or any other person or entity continues to own a majority of our outstanding voting securities. Accordingly, our stockholders will not have as many corporate governance protections as stockholders of some other publicly traded companies.

We have no plans to pay dividends on our common stock, and you may not receive funds without selling your common stock.

We do not intend to declare or pay dividends on our common stock in the foreseeable future. Instead, we generally intend to invest any future earnings in our business. Subject to Delaware law, our board of directors will determine the payment of future dividends on our common stock, if any, and the amount of any dividends in light of any applicable contractual restrictions limiting our ability to pay dividends, our earnings and cash flow, our capital requirements, our financial condition, and other factors our board of directors deems relevant. Our $850 million revolving credit facility also restricts our ability to pay dividends. Accordingly, you may have to sell some or all of your common stock in order to generate cash flow from your investment. You may not receive a gain on your investment when you sell our common stock and may lose the entire amount of your investment.

Table of Contents

The price of our common stock may be volatile.

The market price of our common stock could be subject to significant fluctuations and may decline. Among the factors that could affect our stock price are:

- our operating and financial performance and prospects;
- quarterly variations in the rate of growth of our financial indicators, such as earnings per share, net income and revenue;
- the outcome of the FCPA and other investigations;
- publication of research reports by analysts;
- speculation in the press or investment community;
- strategic actions by us or our competitors, such as acquisitions, restructurings or innovations;
- sales of our common stock by Halliburton and other stockholders;
- actions by institutional investors or by Halliburton;
- fluctuations in oil and natural gas prices;
- departure of key personnel;
- general market conditions;
- U.S. and international political, economic, legal and regulatory factors unrelated to our performance; and
- the other risks described in this Risk Factors section.

The stock markets in general have experienced extreme volatility that has at times been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

Table of Contents

Item 7A. Quantitative and Qualitative Discussion about Market Risk

Information relating to market risk is included in Management s Discussion and Analysis of Financial Condition and Results of Operations under the caption Financial Instrument Market Risk on page 41 of this annual report.

Item 8. Financial Statements and Supplementary Data

The related financial statement schedules are included under Part IV, Item 15 of this annual report.

Table of Contents

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

KBR, Inc.:

We have audited the accompanying consolidated balance sheets of KBR, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of KBR, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 3 and 22, respectively, to the consolidated financial statements, the Company changed its method of accounting for stock-based compensation plans as of January 1, 2006, and its method of accounting for defined benefit and other post retirement plans as of December 31, 2006.

/s/ KPMG LLP

Houston, Texas

February 26, 2007

Table of Contents

KBR, Inc.

Consolidated Statements of Operations

(In millions, except for per share data)

	Years ended December 31		
	2006	**2005**	**2004**
Revenue:			
Services	$ 9,626	$ 10,206	$ 11,960
Equity in earnings (losses) of unconsolidated affiliates, net	7	(60)	(54)
Total revenue	9,633	10,146	11,906
Operating costs and expenses:			
Cost of services	9,285	9,716	12,171
General and administrative	108	85	92
Gain on sale of assets, net	(6)	(110)	
Total operating costs and expenses	9,387	9,691	12,263
Operating income (loss)	246	455	(357)
Interest expense related party	(36)	(24)	(15)
Interest income (expense), net	26	(4)	2
Foreign currency gains (losses), net related party		3	(18)
Foreign currency gains (losses), net	(16)	4	5
Other, net		(1)	(2)
Income (loss) from continuing operations before income taxes and minority interest	220	433	(385)
Benefit (provision) for income taxes	(129)	(182)	96
Minority interest in net (income) loss of subsidiaries	(10)	(41)	(25)
Income (loss) from continuing operations	$ 81	$ 210	$ (314)
Income from discontinued operations, net of tax provision of $(48), $(14) and $(6)	87	30	11
Net income (loss)	$ 168	$ 240	$ (303)
Basic and diluted income (loss) per share:			
Continuing operations	$ 0.58	$ 1.54	$ (2.31)
Discontinued operations	0.62	0.22	0.08
Net income (loss)	$ 1.20	$ 1.76	$ (2.23)
Basic and diluted weighted average shares outstanding	140	136	136

See accompanying notes to consolidated financial statements.

Table of Contents

KBR, Inc.

Consolidated Balance Sheets

(In millions except share data)

	December 31 2006	December 31 2005
Assets		
Current assets:		
Cash and equivalents	$ 1,461	$ 394
Receivables:		
Notes and accounts receivable (less allowance for bad debts of $57 and $51)	823	1,118
Unbilled receivables on uncompleted contracts	1,222	1,429
Total receivables	2,045	2,547
Deferred income taxes	120	99
Due from parent, net		121
Other current assets	272	209
Current assets related to discontinued operations		140
Total current assets	3,898	3,510
Property, plant, and equipment, net of accumulated depreciation of $360 and $305	492	444
Goodwill	289	285
Equity in and advances to related companies	289	277
Noncurrent deferred income taxes	188	124
Unbilled receivables on uncompleted contracts	194	195
Other assets	57	280
Noncurrent assets related to discontinued operations		67
Total assets	$ 5,407	$ 5,182
Liabilities, Minority Interest and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 1,276	$ 1,444
Due to parent, net	152	
Advance billings on uncompleted contracts	903	657
Reserve for estimated losses on uncompleted contracts	184	43
Current portion of employee compensation and benefits	269	255
Current maturities of long-term debt	18	16
Other current liabilities	181	96
Current liabilities related to discontinued operations		55
Total current liabilities	2,983	2,566
Note payable to parent		774
Employee compensation and benefits	412	268
Long-term debt	2	18
Other liabilities	155	121
Noncurrent liabilities related to discontinued operations		10
Noncurrent deferred tax liability	33	26
Total liabilities	3,585	3,783
Minority interest in consolidated subsidiaries	35	143

Shareholders equity and accumulated other comprehensive loss:		
Preferred stock, $0.001 par value, 50,000,000 shares authorized, 0 shares issued and outstanding		
Common stock, $0.001 par value, 300,000,000 shares authorized, 167,643,000 issued and outstanding		
Paid-in capital in excess of par	2,051	
Member s equity		1,384
Accumulated other comprehensive loss	(291)	(128)
Retained earnings	27	
Total shareholders equity and accumulated other comprehensive loss	1,787	1,256
Total liabilities, minority interest and shareholders equity and accumulated other comprehensive loss	$ 5,407	$ 5,182

See accompanying notes to consolidated financial statements.

Table of Contents

KBR, Inc.

Consolidated Statements of Shareholders Equity

(In millions)

	December 31		
	2006	**2005**	**2004**
Balance at January 1,	$ 1,256	$ 812	$ 944
Net proceeds from initial public offering	511		
Stock-based compensation	1		
Contributions from parent and other activities	15	300	
Adoption of SFAS No. 158	(152)		
Settlement of taxes with parent	(1)	22	37
Comprehensive income (loss):			
Net income (loss)	168	240	(303)
Other comprehensive income (loss), net of tax (provision):			
Cumulative translation adjustments	31	(46)	32
Pension liability adjustments, net of taxes of $(24), $(19) and $41	(57)	(44)	97
Other comprehensive gains (losses) on derivatives:			
Unrealized gains (losses) on derivatives	19	(21)	39
Reclassification adjustments to net income (loss)	1	(21)	(26)
Income tax benefit (provision) on derivatives	(5)	14	(8)
Total comprehensive income (loss)	157	122	(169)
Balance at December 31,	$ 1,787	$ 1,256	$ 812

See accompanying notes to consolidated financial statements.

Table of Contents

KBR, Inc.

Consolidated Statements of Cash Flows

(In millions)

	Years ended December 31		
	2006	**2005**	**2004**
Cash flows from operating activities:			
Net income (loss)	$ 168	$ 240	$ (303)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	47	56	52
Distributions from (to) related companies, net of equity in earnings (losses)	(41)	40	1
Deferred income taxes	12	3	26
Gain on sale of assets, net	(126)	(110)	
Impairment of equity method investments	68		
Other	48	(18)	68
Changes in operating assets and liabilities:			
Receivables	281	203	(101)
Unbilled receivables on uncompleted contracts	232	272	(50)
Accounts payable	(187)	(420)	450
Advance billings on uncompleted contracts	209	120	(175)
Accrued employee compensation and benefits	19	125	(1)
Reserve for loss on uncompleted contracts	140	(93)	(88)
Other assets	(38)	(35)	26
Other liabilities	99	144	34
Total cash flows provided by (used in) operating activities	931	527	(61)
Cash flows from investing activities:			
Capital expenditures	(57)	(76)	(74)
Sales of property, plant and equipment	6	26	14
Dispositions (acquisitions) of businesses, net of cash	276	87	(22)
Other investing activities		(17)	(3)
Total cash flows provided by (used in) investing activities	225	20	(85)
Cash flows from financing activities:			
Payments to related party, net	(629)	(350)	(42)
Net repayments of short-term borrowings	(2)		
Proceeds from long-term borrowings	8		
Payments on long-term borrowings	(25)	(21)	(19)
Net proceeds from issuance of stock	512		
Other financing activities	(3)	(4)	(22)
Total cash flows used in financing activities	(139)	(375)	(83)
Effect of exchange rate changes on cash	50	(12)	24
Increase (decrease) in cash and cash equivalents	1,067	160	(205)
Cash and equivalents at beginning of period	394	234	439
Cash and equivalents at end of period	$ 1,461	$ 394	$ 234

Supplemental disclosure of cash flow information:			
Cash payments during the year for:			
Interest paid to third party	$ 11	$ 12	$ 8
Income taxes	$ 57	$ 79	$ 44
Noncash financing activities			
Contribution from parent and other activities	$ 15	$ 300	$

See accompanying notes to consolidated financial statements.

KBR, Inc.

Notes to Consolidated Financial Statements

Note 1. Description of KBR Holdings, LLC Business

KBR, Inc. and its subsidiaries (collectively, KBR) is an indirect 81% owned subsidiary of Halliburton Company (Halliburton) and a global engineering, construction and services company supporting the energy, petrochemicals, government services and civil infrastructure sectors. We offer our wide range of services through our two business segments, Energy and Chemicals (E&C) and Government and Infrastructure (G&I).

Energy and Chemicals. Our E&C segment designs and constructs energy and petrochemical projects, including large, technically complex projects in remote locations around the world. Our expertise includes onshore oil and gas production facilities, offshore oil and gas production facilities, including platforms, floating production and subsea facilities (which we refer to collectively as our offshore projects), onshore and offshore pipelines, liquefied natural gas (LNG) and gas-to-liquids (GTL) gas monetization facilities (which we refer to collectively as our gas monetization projects), refineries, petrochemical plants and synthesis gas (Syngas). We provide a wide range of Engineering Procurement Construction Commissioning Start-up (EPC-CS) services, as well as program and project management, consulting and technology services.

Government and Infrastructure. Our G&I segment delivers on-demand support services across the full military mission cycle from contingency logistics and field support to operations and maintenance on military bases. In the civil infrastructure market, we operate in diverse sectors, including transportation, waste and water treatment, and facilities maintenance. We provide program and project management, contingency logistics, operations and maintenance, construction management, engineering, and other services to military and civilian branches of governments and private customers worldwide. A significant portion of our G&I segment s current operations relate to the support of United States government operations in the Middle East, which we refer to as our Middle East operations. We are also the majority owner of Devonport Management Limited (DML), which owns and operates Devonport Royal Dockyard, one of Western Europe s largest naval dockyard complexes. Our DML shipyard operations are primarily engaged in refueling nuclear submarines and performing maintenance on surface vessels for the U.K. Ministry of Defence as well as limited commercial projects.

Note 2. Background and Basis of Presentation

KBR, Inc., a Delaware corporation, was formed on March 21, 2006 as an indirect, wholly owned subsidiary of Halliburton. KBR, Inc. was formed to own and operate KBR Holdings, LLC (KBR Holdings). At inception, KBR, Inc. issued 1,000 shares of common stock for $1 to Halliburton. On October 27, 2006, KBR effected a 135,627-for-one split of its common stock. In connection with the stock split, the certificate of incorporation was amended and restated to increase the number of authorized shares of common stock from 1,000 to 300,000,000 and to authorize 50,000,000 shares of preferred stock with a par value of $0.001 per share. All share data of the company has been adjusted to reflect the stock split.

In November 2006, KBR, Inc. completed an initial public offering of 32,016,000 shares of its common stock (the Offering) at $17.00 per share. The Company received net proceeds of $511 million from the Offering after underwriting discounts and commissions. Halliburton currently owns 135,627,000 shares, or 81%, of the outstanding common stock of KBR, Inc. Simultaneous with the Offering, Halliburton contributed 100% of the common stock of KBR Holdings, LLC to KBR, Inc. KBR had no operations from the date of its formation to the date of the contribution of KBR Holdings.

In connection with the Offering, we entered into various agreements to complete the separation of our business from Halliburton, including, among others, a master separation agreement, transition services agreements and a tax sharing agreement. Pursuant to our master separation agreement, we have agreed to indemnify Halliburton for, among other matters, all past, present and future liabilities related to our business and operations. We have also agreed to indemnify Halliburton for liabilities under various outstanding and certain

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

additional credit support instruments relating to our businesses and for liabilities under litigation matters related to our business. Halliburton has agreed to indemnify us for, among other things, liabilities unrelated to our business, for certain other agreed matters relating to the FCPA investigations and the Barracuda-Caratinga project and for other litigation matters related to Halliburton s business.

The tax sharing agreement provides for certain allocations of U.S. income tax liabilities and other agreements between us and Halliburton with respect to tax matters. The services to be provided under the transition services agreement between Halliburton and KBR are substantially the same as the services historically provided. Similarly, the related costs of such services will be substantially the same as the costs incurred and recorded in our historical financial statements. Further, the tax sharing agreement contains substantially the same tax sharing provisions as included in our previous tax sharing agreements.

Under the transition services agreements, Halliburton is expected to continue providing various interim corporate support services to us and we will continue to provide interim corporate support services to Halliburton.

On February 26, 2007, Halliburton s board of directors approved a plan under which Halliburton will dispose of its remaining interest in KBR through a tax-free exchange with Halliburton s stockholders pursuant to an exchange offer and, following the completion or termination of the exchange offer, a special pro-rata dividend distribution of any and all of Halliburton s remaining KBR, Inc. shares. In connection with the anticipated exchange offer, KBR will file with the SEC a registration statement on Form S-4 with respect to the terms and conditions of the exchange offer and Halliburton will file with the SEC a Schedule TO. The exchange offer will be conditioned on a minimum number of shares being tendered. Any sale or exchange of KBR stock pursuant to the exchange offer will be registered under the Securities Act of 1933, and such shares of common stock will only be offered and sold by means of a prospectus. The exchange offer and any subsequent spin-off will complete the separation of KBR from Halliburton and will result in two independent companies.

Effective June 30, 2005 for accounting purposes, DII Industries, LLC (DII, a wholly owned Halliburton entity) created a newly formed, wholly owned subsidiary, KBR Holdings, LLC, with 100 shares of common stock and contributed to it KBR Group Holdings, LLC and Kellogg Brown & Root, Inc. Prior to such restructuring, KBR Group Holdings, LLC and Kellogg Brown & Root, Inc. were subsidiaries of DII whose ultimate parent is Halliburton. The transaction was accounted for using the historic cost basis of accounting. Accordingly, the financial statements for periods prior to December 31, 2005 are presented on a combined basis and include the historical operations of KBR Group Holdings, LLC, Kellogg Brown & Root LLC (formerly Kellogg Brown & Root, Inc.) and their subsidiaries. The financial statements as of December 31, 2006, represent the consolidated operations of KBR Holdings. The accompanying financial statements are hereinafter referred to as the Consolidated Financial Statements and include all engineering, construction and related services of KBR Group Holdings, LLC, Kellogg Brown & Root LLC and their subsidiaries.

Our consolidated financial statements include the accounts of majority-owned, controlled subsidiaries and variable interest entities where we are the primary beneficiary (see Note 20). The equity method is used to account for investments in affiliates in which we have the ability to exert significant influence over the affiliates operating and financial policies. The cost method is used when we do not have the ability to exert significant influence. All material intercompany accounts and transactions are eliminated.

Our revenue includes both equity in the earnings of unconsolidated affiliates as well as revenue from the sales of services into the joint ventures. We often participate on larger projects as a joint venture partner and also provide services to the venture as a subcontractor. The amount included in our revenue represents total project revenue, including equity in the earnings from joint ventures impairments of equity investments in joint ventures, if any, and revenue from services provided to joint ventures.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Our consolidated financial statements reflect all costs of doing business, including those incurred by Halliburton on KBR s behalf. Such costs have been charged to KBR in accordance with Staff Accounting Bulletin (SAB) No. 55, Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity.

Note 3. Significant Accounting Policies

Use of estimates

Our financial statements are prepared in conformity with accounting principles generally accepted in the United States, requiring us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. Ultimate results could differ from those estimates.

Revenue recognition

Engineering and construction contracts. Revenue from contracts to provide construction, engineering, design, or similar services is reported on the percentage-of-completion method of accounting. Progress is generally based upon physical progress, man-hours, or costs incurred, depending on the type of job. Physical progress is determined as a combination of input and output measures as deemed appropriate by the circumstances. All known or anticipated losses on contracts are provided for when they become evident. Claims and change orders that are in the process of being negotiated with customers for extra work or changes in the scope of work are included in contract value when collection is deemed probable.

Accounting for government contracts. Most of the services provided to the United States government are governed by cost-reimbursable contracts. Services under our LogCAP, RIO, PCO Oil South, and Balkans support contracts are examples of these types of arrangements. Generally, these contracts contain both a base fee (a fixed profit percentage applied to our actual costs to complete the work) and an award fee (a variable profit percentage applied to definitized costs, which is subject to our customer s discretion and tied to the specific performance measures defined in the contract, such as adherence to schedule, health and safety, quality of work, responsiveness, cost performance and business management).

Revenue is recorded at the time services are performed, and such revenues include base fees, actual direct project costs incurred and an allocation of indirect costs. Indirect costs are applied using rates approved by our government customers. The general, administrative, and overhead cost reimbursement rates are estimated periodically in accordance with government contract accounting regulations and may change based on actual costs incurred or based upon the volume of work performed. Revenue is reduced for our estimate of costs that either are in dispute with our customer or have been identified as potentially unallowable per the terms of the contract or the federal acquisition regulations.

Award fees are generally evaluated and granted periodically by our customer. For contracts entered into prior to June 30, 2003, all award fees are recognized during the term of the contract based on our estimate of amounts to be awarded. Once award fees are granted and task orders underlying the work are definitized, we adjust our estimate of award fees to actual amounts earned. Our estimates are often based on our past award experience for similar types of work.

For contracts containing multiple deliverables entered into subsequent to June 30, 2003 (such as PCO Oil South), we analyze each activity within the contract to ensure that we adhere to the separation guidelines of Emerging Issues Task Force Issue (EITF) No. 00-21, Revenue Arrangements with Multiple Deliverables, and the revenue recognition guidelines of SAB No. 104, Revenue Recognition. For service-only contracts, and service elements of multiple deliverable arrangements, award fees are recognized only when definitized and

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

awarded by the customer. Award fees on government construction contracts are recognized during the term of the contract based on our estimate of the amount of fees to be awarded.

Accounting for pre-contract costs

Pre-contract costs incurred in anticipation of a specific contract award are deferred only if the costs can be directly associated with a specific anticipated contract and their recoverability from that contract is probable. Pre-contract costs related to unsuccessful bids are written off no later than the period we are informed that we are not awarded the specific contract. Costs related to one-time activities such as introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer, or commencing new operations are expensed when incurred.

Legal expenses

We expense legal costs in the period in which such costs are incurred.

Cash and equivalents

We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents. Cash and equivalents include cash from advanced payments related to contracts in progress held by ourselves or our joint ventures that we consolidate for accounting purposes. The use of these cash balances are limited to the specific projects or joint venture activities and are not available for other projects, general cash needs or distribution to us without approval of the board of directors of the respective joint venture or subsidiary. At December 31, 2006 and 2005, cash and equivalents included approximately $527 million and $223 million, respectively, in cash from advanced payments held by us or our joint ventures that we consolidate for accounting purposes. Our total cash provided by operating activities at December 31, 2006, 2005 and 2004, included $304 million, $175 million and $15 million, respectively, of cash provided by operating activities from project joint ventures that we consolidate for accounting purposes.

Allowance for bad debts

We establish an allowance for bad debts through a review of several factors including historical collection experience, current aging status of the customer accounts, financial condition of our customers, and whether the receivables involve retentions.

Goodwill and other intangibles

The reported amounts of goodwill for each reporting unit and intangible assets are reviewed for impairment at least annually and more frequently when negative conditions such as significant current or projected operating losses exist. The annual impairment test for goodwill is a two-step process and involves comparing the estimated fair value of each reporting unit to the reporting unit s carrying value, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered impaired, and the second step of the impairment test is unnecessary. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test would be performed to measure the amount of impairment loss to be recorded, if any. Our annual impairment tests resulted in no goodwill or intangible asset impairment.

Patents and other intangibles totaled $55 million and $54 million at December 31, 2006 and 2005, respectively, and are included in Other assets on the consolidated balance sheets. Patents and other intangibles are amortized over their estimated useful lives of up to 15 years. Related accumulated amortization was $32 million and $29 million at December 31, 2006 and 2005, respectively. Patent and other intangible amortization expense was $3 million for the years ended December 31, 2006 and 2005.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Evaluating impairment of long-lived assets

When events or changes in circumstances indicate that long-lived assets other than goodwill may be impaired, an evaluation is performed. For an asset classified as held for use, the estimated future undiscounted cash flow associated with the asset are compared to the asset s carrying amount to determine if a write-down to fair value is required. When an asset is classified as held for sale, the asset s book value is evaluated and adjusted to the lower of its carrying amount or fair value less cost to sell. In addition, depreciation or amortization is ceased while it is classified as held for sale.

Impairment of equity method investments

KBR evaluates its equity method investment for impairment when events or changes in circumstances indicate, in management s judgment, that the carrying value of such investment may have experienced an other-than-temporary decline in value. When evidence of loss in value has occurred, management compares the estimated fair value of the investment to the carrying value of the investment to determine whether an impairment has occurred. Management assesses the fair value of its equity method investment using commonly accepted techniques, and may use more than one method, including, but not limited to, recent third party comparable sales, internally developed discounted cash flow analysis and analysis from outside advisors. If the estimated fair value is less than the carrying value and management considers the decline in value to be other than temporary, the excess of the carrying value over the estimated fair value is recognized in the financial statements as an impairment.

Income taxes

Income tax expense for KBR is calculated on a pro rata basis. Under this method, income tax expense is determined based on KBR operations and their contributions to income tax expense of the Halliburton consolidated group.

KBR is currently included in the consolidated U.S. federal income tax return of Halliburton. Additionally, many subsidiaries and divisions of Halliburton are subject to consolidation, group relief or similar provisions of tax law in foreign jurisdictions that allow for sharing of tax attributes with other Halliburton affiliates. For purposes of determining income tax expense, it is assumed that KBR will continue to file on this combined basis.

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been recognized in the financial statements or tax returns. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will not be realized.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, we believe it is more likely than not that we will realize the benefits of these deductible differences, net of the existing valuation allowances.

KBR is a party to a tax sharing agreement with Halliburton. The tax sharing agreement provides, in part, for settlement of utilized tax attributes on a consolidated basis. Therefore, intercompany settlements due to the utilized attributes are only established to the extent that the attributes decreased the tax liability of an affiliate in any given jurisdiction. The adjustment to reflect the difference between the tax provision/benefit calculated as described above and the amount settled with Halliburton pursuant to the tax sharing agreement is recorded to equity.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Derivative instruments

At times, we enter into derivative financial transactions to hedge existing or projected exposures to changing foreign currency exchange rates. We do not enter into derivative transactions for speculative or trading purposes. We recognize all derivatives on the balance sheet at fair value. Derivatives that are not accounted for as hedges under Statement of Financial Accounting Standard (SFAS) No. 133 Accounting for Derivative Instruments and Hedging Activities are adjusted to fair value and reflected through the results of operations. If the derivative is designated as a hedge, depending on the nature of the hedge, changes in the fair value of derivatives are either offset against the change in fair value of the hedged assets, liabilities or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings.

The ineffective portion of a derivative s change in fair value is recognized in earnings. Recognized gains or losses on derivatives entered into to manage foreign exchange risk are included in foreign currency gains and losses in the consolidated statements of operations.

Concentration of credit risk

Revenue from the United States government, which was derived almost entirely from our G&I segment, totaled $5.8 billion, or 61% of consolidated revenue, in 2006, $6.6 billion, or 65% of consolidated revenue, in 2005, and $8.0 billion, or 67% of consolidated revenue, in 2004. Revenue from the government of the United Kingdom totaled $1.0 billion, or 11% of consolidated revenue, for the year ended December 31, 2006. No other customers represented 10% or more of consolidated revenues in any of the periods presented.

Our receivables are generally not collateralized. At December 31, 2006, 62% of our total receivables were related to our United States government contracts. At December 31, 2005, 72% of our total receivables were related to our United States government contracts, primarily for projects in the Middle East.

Foreign currency translation

Our foreign entities for which the functional currency is the United States dollar translate monetary assets and liabilities at year-end exchange rates, and non-monetary items are translated at historical rates. Income and expense accounts are translated at the average rates in effect during the year, except for depreciation and expenses associated with non-monetary balance sheet accounts which are translated at historical rates. Foreign currency transaction gains or losses are recognized in income in the year of occurrence. Our foreign entities for which the functional currency is not the United States dollar translate net assets at year-end rates and income and expense accounts at average exchange rates. Adjustments resulting from these translations are reflected in accumulated other comprehensive income in member s equity.

Stock-based compensation

Effective January 1, 2006, we adopted the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 123 (revised 2004), Share Based Payment (SFAS No. 123(R)), using the modified prospective application. Accordingly, we are recognizing compensation expense for all newly granted awards and awards modified, repurchased, or cancelled after January 1, 2006. Compensation cost for the unvested portion of awards that were outstanding as of January 1, 2006 is recognized ratably over the remaining vesting period based on the fair value at date of grant. Also, beginning with the January 1, 2006 purchase period, compensation expense for Halliburton s ESPP is being recognized. The cumulative effect of this change in accounting principle related to stock-based awards was immaterial. Prior to January 1, 2006, we accounted for these plans under the recognition and measurement provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Under APB Opinion No. 25, no compensation expense was recognized for stock options or the ESPP. Compensation expense was recognized for restricted stock awards. As a result of adopting SFAS No. 123(R), the incremental pretax expense related to employee stock option awards and Halliburton s ESPP totaled approximately $7 million in 2006 or $0.03 per diluted share after tax. There was no effect on our cash flows from operating or financing activities for the year ended December 31, 2006 from the adoption of SFAS No. 123(R).

Total stock-based compensation expense, net of related tax effects, was $11 million in 2006. Total income tax benefit recognized in net income for stock-based compensation arrangements was $6 million in 2006, $5 million in 2005, and $4 million in 2004. Total incremental compensation cost resulting from modifications of previously granted stock-based awards was $6 million in 2006, $8 million in 2005, and $5 million in 2004. These modifications allowed certain employees to retain their awards after leaving the company.

The following table summarizes the pro forma effect on net income (loss) and income (loss) per share for 2005 and 2004 as if we had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

Millions of dollars	**Years ended December 31** **2005**	**2004**
Net income (loss), as reported	$ 240	$ (303)
Add: Total stock-based compensation expense included in net income, net of related tax effects	8	6
Less: Total stock-based compensation expense determined under fair-value-based method for all awards, net of related tax effects	(15)	(14)
Net income (loss), pro forma	$ 233	$ (311)
Basic and diluted income (loss) per share:		
As reported	$ 1.76	$ (2.23)
Pro forma	$ 1.71	$ (2.29)

There were no Halliburton stock options granted to our employees in 2006. For Halliburton stock options granted in 2005, the fair value of options at the date of grant was estimated using the Black-Scholes option pricing model. The expected volatility of Halliburton stock options granted to our employees in 2005 and 2004 is based upon the historical volatility of Halliburton s common stock.

Once Halliburton s ownership interest in KBR is 20% or less, outstanding awards to KBR employees of options to purchase Halliburton stock and unvested Halliburton restricted stock under the Halliburton 1993 Plan will be converted into similar KBR awards under its new Transitional Stock Adjustment Plan, with the intention of preserving approximately the equivalent value of the previous awards under the Halliburton 1993 Plan.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

For KBR stock options granted in 2006, the fair value of options at the date of grant was estimated using the Black-Scholes option pricing model. The expected volatility of KBR options granted in 2006 is based upon a blended rate that uses the historical and implied volatility of common stock for selected peers. The expected term of Halliburton 2005 and 2004 is based upon historical observation of actual time elapsed between date of grant and exercise of options for all employees. The expected term of KBR options granted in 2006 is based upon the average of the life of the option and the vesting period of the option. The assumptions and resulting fair values of options granted were as follows:

	Years ended December 31		
	2006	2005	2004
Halliburton Options			
Expected term (in years)	N/A	5.00	5.00
Expected volatility	N/A	51%	54%
Expected dividend yield	N/A	.8%	1.3%
Risk-free interest rate	N/A	4.3%	3.7%
Weighted average grant-date fair value per share	N/A	$ 9.97	$ 6.67
KBR Options			
Expected term (in years)	6.00	N/A	N/A
Expected volatility	35%	N/A	N/A
Expected dividend yield	0%	N/A	N/A
Risk-free interest rate	4.6%	N/A	N/A
Weighted average grant-date fair value per share	$ 9.34	N/A	N/A

The fair value of Halliburton s ESPP shares was estimated using the Black-Scholes option pricing model. The expected volatility is a one-year historical volatility of Halliburton common stock. The assumptions and resulting fair values of options granted were as follows:

	Offering Period July 1 to December 31		
	2006	2005	2004
Expected term (in years)	0.5	0.5	0.5
Expected volatility	37.77%	30.46%	55.50%
Expected dividend yield	0.80%	0.73%	1.48%
Risk-free interest rate	5.29%	3.89%	3.29%
Weighted average grant-date fair value per share	$ 9.32	$ 5.50	$ 4.31

	Offering Period January 1 to June 30		
	2006	2005	2004
Expected term (in years)	0.5	0.5	0.5
Expected volatility	35.65%	26.93%	57.47%
Expected dividend yield	0.75%	1.16%	1.65%
Risk-free interest rate	4.38%	3.15%	2.71%
Weighted average grant-date fair value per share	$ 7.91	$ 4.15	$ 3.74

See Note 18 for further detail on stock incentive plans.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 4. Correction of prior period results

In connection with a review of our consolidated 50%-owned GTL project in Escravos, Nigeria, which is part of our E&C segment, we identified increases in the overall estimated cost to complete the project. As a result, during the second quarter of 2006, we identified a $148 million charge, before income taxes and minority interest. We determined that $16 million of the $148 million charge was based on information available to us but not reported as of March 31, 2006. Of the $16 million related to the prior periods, $9 million was related to the quarter ended March 31, 2006 and $7 million was related to the quarter ended December 31, 2005. We restated our financial statements for the quarter ended March 31, 2006 to include the $9 million charge ($2.9 million after minority interest and tax) as well as for other unrelated, individually insignificant adjustments that subsequently became known to us. The $9 million adjustment related to Escravos had the effect of reducing income (loss) from continuing operations before income taxes and minority interest by $9 million, increasing benefit (provision) for income taxes by $1.6 million, increasing minority interest in net income of subsidiaries by $2.9 million (net of tax of $1.6 million), and reducing net income by $2.9 million for the quarter ended March 31, 2006. These other adjustments had the effect of reducing pretax income and net income by $2 million and $5 million for the quarter ended March 31, 2006, respectively. We recorded the remaining $7 million charge ($2.3 million after minority interest and income taxes) in the quarter ended June 30, 2006, since the amounts were not material to 2005 or 2006 based on our 2006 projections.

In addition to the above, we adjusted our member s equity and other balance sheet accounts as of January 1, 2003 to reflect a correction to DML s initial purchase price allocation from a 1997 acquisition. DML s original purchase price allocation did not adequately record the prepaid pension asset that existed at the acquisition date. The corrected allocation of purchase price to the pension asset also had the effect of increasing negative goodwill. The resulting negative goodwill would have been reversed in 2002 upon the adoption of SFAS 141, Business Combinations , and reflected in cumulative effect of change in an accounting principle, net . Accordingly, our January 1, 2003 consolidated balance sheet has been adjusted to increase member s equity by $34 million, to increase prepaid pension asset by $72 million, to decrease property, plant, and equipment by $2 million, to decrease deferred taxes by $12 million and to increase minority interest by $24 million. Currency translation adjustments on the above resulted in increased equity at December 31, 2005, 2004 and 2003 of $9 million, $17 million and $8 million, respectively. We do not believe these adjustments had a material impact on balances as previously reported in our registration statement filed with the SEC on May 26, 2006.

We also reclassified deferred income taxes of $53 million and $58 million from current to non-current for the years ended December 31, 2005 and 2004, respectively.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

The following table reflects the originally reported and restated amounts for the years ended December 31, 2005 and 2004:

	December 31, 2005		December 31, 2004	
Millions of dollars	**Restated**	**As previously reported**	**Restated**	**As previously reported**
Assets:				
Deferred income taxes	$ 99	$ 47	$ 79	$ 21
Other current assets	209	208	207	207
Total current assets	3,510	3,457	3,732	3,674
Property, plant, and equipment, net	444	446	467	469
Noncurrent deferred income taxes	124	165	116	170
Other assets	280	199	323	234
Total assets	5,182	5,091	5,487	5,396
Liabilities:				
Noncurrent deferred tax liability	26		19	
Total liabilities	3,783	3,757	4,560	4,541
Minority interest in consolidated subsidiaries	143	121	115	94
Member s equity	1,384	1,350		
Accumulated other comprehensive loss	(128)	(137)	(10)	(27)
Parent net investment			822	788
Total member s equity and accumulated other comprehensive loss	1,256	1,213	812	761
Total liabilities, minority interest and member s equity and accumulated other comprehensive loss	5,182	5,091	5,487	5,396

Note 5. Percentage-of-Completion Contracts

Revenue from contracts to provide construction, engineering, design, or similar services is reported on the percentage-of-completion method of accounting using measurements of progress toward completion appropriate for the work performed. Commonly used measurements are physical progress, man-hours, and costs incurred.

Billing practices for these projects are governed by the contract terms of each project based upon costs incurred, achievement of milestones, or pre-agreed schedules. Billings do not necessarily correlate with revenue recognized using the percentage-of-completion method of accounting. Billings in excess of recognized revenue are recorded in Advance billings on uncompleted contracts. When billings are less than recognized revenue, the difference is recorded in Unbilled receivables on uncompleted contracts. With the exception of claims and change orders that are in the process of being negotiated with customers, unbilled receivables are usually billed during normal billing processes following achievement of the contractual requirements.

Recording of profits and losses on percentage-of-completion contracts requires an estimate of the total profit or loss over the life of each contract. This estimate requires consideration of contract value, change orders and claims reduced by costs incurred, and estimated costs to complete. Anticipated losses on contracts are recorded in full in the period they become evident. Except in a limited number of projects that have significant uncertainties in the estimation of costs, we do not delay income recognition until projects have reached a specified percentage of completion. Generally, profits are recorded from the commencement date of the contract based upon the total estimated contract profit multiplied by the current percentage complete for the contract.

When calculating the amount of total profit or loss on a percentage-of-completion contract, we include unapproved claims in total estimated contract value when the collection is deemed probable based upon the four

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

criteria for recognizing unapproved claims under the American Institute of Certified Public Accountants (AICPA) Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Including unapproved claims in this calculation increases the operating income (or reduces the operating loss) that would otherwise be recorded without consideration of the probable unapproved claims. Probable unapproved claims are recorded to the extent of costs incurred and include no profit element. In all cases, the probable unapproved claims included in determining contract profit or loss are less than the actual claim that will be or has been presented to the customer.

When recording the revenue and the associated unbilled receivable for unapproved claims, we only accrue an amount equal to the costs incurred related to probable unapproved claims. Therefore, the difference between the probable unapproved claims included in determining contract profit or loss and the probable unapproved claims accrued revenue recorded in unbilled receivables on uncompleted contracts relates to forecasted costs which have not yet been incurred. The amounts included in determining the profit or loss on contracts and the amounts booked to Unbilled receivables on uncompleted contracts for each period are as follows:

Millions of dollars	Years ended December 31 2006	2005	2004
Probable unapproved claims	$ 189	$ 175	$ 182
Probable unapproved claims accrued revenue	187	172	182
Probable unapproved claims from unconsolidated related companies	78	92	45

As of December 31, 2006, the probable unapproved claims, including those from unconsolidated related companies, related to eight contracts, most of which were complete or substantially complete. See Note 14 for a discussion of U.S. government contract claims, which are not included in the table above.

A significant portion of the probable unapproved claims as of December 31, 2006 arose from three completed projects with Petroleos Mexicanos (PEMEX) ($148 million related to our consolidated entities and $45 million related to our unconsolidated related companies) that are currently subject to arbitration proceedings. In addition, we have Other assets of $64 million for previously approved services that are unpaid by PEMEX and have been included in these arbitration proceedings. Actual amounts we are seeking from PEMEX in the arbitration proceedings are in excess of these amounts. The arbitration proceedings are expected to extend through 2007. PEMEX has asserted unspecified counterclaims in each of the three arbitrations; however, it is premature based upon our current understanding of those counterclaims to make any assessment of their merits. As of December 31, 2006, we had not accrued any amounts related to the counterclaims in the arbitrations.

We have contracts with probable unapproved claims that will likely not be settled within one year totaling $175 million and $172 million at December 31, 2006 and 2005, respectively, included in the table above, which are reflected as a non-current asset in Unbilled receivables on uncompleted contracts on the consolidated balance sheets. Other probable unapproved claims that we believe will be settled within one year, included in the table above, have been recorded as a current asset in Unbilled receivables on uncompleted contracts on the consolidated balance sheets.

Unapproved change orders

We have other contracts for which we are negotiating change orders to the contract scope and have agreed upon the scope of work but not the price. These change orders amounted to $81 million and $52 million at December 31, 2006 and 2005, respectively.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Unconsolidated related companies

Our unconsolidated related companies include probable unapproved claims as revenue to determine the amount of profit or loss for their contracts. Probable unapproved claims from our related companies are included in Equity in and advances to related companies, and our share totaled $78 million and $92 million at December 31, 2006 and 2005, respectively. In addition, our unconsolidated related companies are negotiating change orders to the contract scope where we have agreed upon the scope of work but not the price. Our share of these change orders totaled $3 million and $5 million at December 31, 2006 and 2005, respectively.

Note 6. Escravos Project

In connection with our review of a 50% owned GTL project in Escravos, Nigeria, during the second quarter of 2006, we identified increases in the overall cost to complete this four-plus-year project of $400 million, which resulted in our recording a $148 million charge before minority interest and taxes during the second quarter of 2006. These cost increases were caused primarily by schedule delays related to civil unrest and security on the Escravos River, changes in the scope of the overall project, engineering and construction changes due to necessary front-end engineering design changes and increases in procurement cost due to project delays. The increased costs were identified as a result of our first check estimate process.

Of the $400 million increase in estimated project costs, higher forecasted engineering, procurement and project management hours increased costs by $63 million due to changes in the scope of the overall project and necessary front-end engineering design changes. Equipment and materials costs increased by $110 million due to changes in the scope of the overall project and the increased inflation cost caused by delays. Site construction costs increased by $227 million due to design changes, additional security costs due to civil unrest on the Escravos River and additional inflation caused by delays. The increases in the estimated future project costs were partially offset by estimated revenues associated with unapproved change orders of $200 million and the elimination of unrecognized profit of $52 million resulting in a $148 million loss on the project.

Since we completed our first check estimate in the second quarter of 2006, the project has continued to estimate significant additional cost increases. We currently expect to recover these recently identified cost increases through change orders.

As of September 30, 2006, we had approximately $269 million in unapproved change orders related to this project. In the fourth quarter of 2006, we reached agreement with the project owner to settle $264 million of these change orders. As a result, portions of the remaining work now have a lower risk profile, particularly with respect to security and logistics. Since we completed our first check estimate in the second quarter of 2006, the project has continued to estimate significant additional cost increases. We currently expect to recover these recently identified cost increases through change orders. As of December 31, 2006, we have recorded $43 million of unapproved change orders which primarily relates to these cost increases. We recorded an additional $9 million loss in the fourth quarter of 2006 related to non-billable engineering services we provided to the Escravos joint venture.

Because of the civil unrest and security issues that currently exist in Nigeria, uncertainty regarding soil conditions at the property site, and other matters, we could experience substantial additional cost increases in the future. We believe that future cost increases attributed to civil unrest, security matters and potential differences in actual other than anticipated soil conditions should ultimately be recoverable through future change orders pursuant to the terms of our contract as amended in 2006. However, should this occur, there could be timing differences between the recognition of cost and recognition of offsetting potential recoveries from our client, if any.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 7. Barracuda-Caratinga Project

In June 2000, we entered into a contract with Barracuda & Caratinga Leasing Company B.V., the project owner, to develop the Barracuda and Caratinga crude oilfields, which are located off the coast of Brazil. We recorded losses on the project of $19 million, $8 million and $407 million for the years ended December 31, 2006, 2005 and 2004, respectively. We have been in negotiations with the project owner since 2003 to settle the various issues that have arisen and have entered into several agreements to resolve those issues. As part of these settlements, we agreed to pay $22 million in liquidated damages. We funded approximately $37 million in cash shortfalls, net of revenue received, during 2006.

In April 2006, we executed an agreement with Petrobras that enabled us to achieve conclusion of the Lenders Reliability Test and final acceptance of the FPSOs. These acceptances eliminated any further risk of liquidated damages being assessed but did not address the bolt arbitration discussed below. Our remaining obligation under the April 2006 agreement is primarily for warranty on the two vessels.

At Petrobras direction, we replaced certain bolts located on the subsea flowlines that have failed through mid-November 2005, and we understand that additional bolts have failed thereafter, which have been replaced by Petrobras. These failed bolts were identified by Petrobras when it conducted inspections of the bolts. The original design specification for the bolts was issued by Petrobras, and as such, we believe the cost resulting from any replacement is not our responsibility. In March 2006, Petrobras notified us that they have submitted this matter to arbitration claiming $220 million plus interest for the cost of monitoring and replacing the defective stud bolts and, in addition, all of the costs and expenses of the arbitration including the cost of attorneys fees. We disagree with Petrobras claim since the bolts met Petrobras design specifications, and we do not believe there is any basis for the amount claimed by Petrobras. We intend to vigorously defend this matter and pursue recovery of the costs we have incurred to date through the arbitration process. The arbitration hearing is not expected to begin until the first quarter of 2008. Under the master separation agreement we entered into with Halliburton in connection with our initial public offering, Halliburton agreed, subject to certain conditions, to indemnify us and hold us harmless from all cash costs and expenses incurred as a result of the replacement of the subsea bolts. As of December 31, 2006, we had not accrued any amounts related to this arbitration.

Note 8. Dispositions

Production Services. In May 2006, we completed the sale of our Production Services group, which was part of our E&C segment. In connection with the sale, we received net proceeds of $265 million. The sale of Production Services resulted in a pre-tax gain of approximately $120 million, net of post-closing adjustments. See Note 26 (Discontinued Operations).

Dulles Greenway Toll Road. As part of our infrastructure projects, we occasionally take an ownership interest in the constructed asset, with a view toward monetization of that ownership interest after the asset has been operating for some period and increases in value. In September 2005, we sold our 13% interest in a joint venture that owned the Dulles Greenway toll road in Virginia. We received $85 million in cash from the sale. In addition, prior to the sale of our investment in Dulles Greenway Toll Road, we received a distribution and recorded a corresponding gain of $11 million in 2005. Because of unfavorable early projections of traffic to support the toll road after it had opened, we wrote down our investment in the toll road in 1996. At the time of the sale, our investment had a net book value of zero, and therefore, we recorded the entire $85 million of cash proceeds to operating income in our G&I segment.

Note 9. Business Segment Information

We provide a wide range of services, but the management of our business is heavily focused on major projects within each of our reportable segments. At any given time, a relatively few number of projects and joint

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

ventures represent a substantial part of our operations. We have organized our reporting structure based on similar products and services resulting in the following two segments.

Energy and Chemicals. Our E&C segment designs and constructs energy and petrochemical projects, including large, technically complex projects in remote locations around the world. Our expertise includes onshore and offshore oil and gas production facilities (including platforms, floating production and subsea facilities), onshore and offshore pipelines, LNG and GTL gas monetization facilities, refineries, petrochemical plants and Syngas. We provide a complete range of EPC-CS services, as well as program and project management, consulting and technology services.

TSKJ is a joint venture formed to design and construct large-scale projects in Nigeria. TSKJ s members are Technip, SA of France, Snamprogetti Netherlands B.V., which is a subsidiary of Saipem SpA of Italy, JGC Corporation of Japan, and us, each of which has a 25% ownership interest. TSKJ has completed five LNG production facilities on Bonny Island, Nigeria and is currently working on a sixth such facility. We account for this investment using the equity method of accounting.

M. W. Kellogg Limited (MWKL) is a London-based joint venture that provides full EPC-CS related services for LNG, GTL, and onshore oil and gas projects. MWKL is owned 55% by us and 45% by JGC Corporation. We consolidate MWKL for financial accounting purposes.

Government and Infrastructure. Our G&I segment delivers on-demand support services across the full military mission cycle from contingency logistics and field support to operations and maintenance on military bases. In the civil infrastructure market, we operate in diverse sectors, including transportation, waste and water treatment, and facilities maintenance. We provide program and project management, contingency logistics, operations and maintenance, construction management, engineering, and other services to military and civilian branches of governments and private clients worldwide. We are also the majority owner of DML, which owns and operates Devonport Royal Dockyard, one of Western Europe s largest naval dockyard complexes.

In addition, this segment includes the Alice Springs-Darwin railroad. The Alice Springs-Darwin railroad is a privately financed project that was formed in 2001 to build, operate and own the transcontinental railroad from Alice Springs to Darwin, Australia and has been granted a 50-year concession period by the Australian government. We provided engineering, procurement, and construction (EPC) services for the project and are the largest equity holder in the project with a 36.7% interest, with the remaining equity held by eleven other participants. We account for this investment using the equity method of accounting.

Also included in this segment is Aspire Defence, a joint venture between us, Mowlem Plc. and a financial investor. The joint venture was awarded a privately financed project contract, the Allenby & Connaught project, by the MoD to upgrade and provide a range of services to the British Army s garrisons at Aldershot and around Salisbury Plain in the United Kingdom. We indirectly own a 45% interest in Aspire Defence. In addition, we own a 50% interest in each of two joint ventures that provide the construction and the related support services to Aspire Defence. We account for our interests in each of the entities using the equity method of accounting.

General corporate. General corporate represents assets not included in an operating segment and is primarily composed of cash and cash equivalents, tax assets, corporate accounts payable and reserves for employee benefits.

Other. Intersegment revenues and revenue between geographic areas are immaterial. Our equity in pretax earnings and losses of unconsolidated affiliates that are accounted for using the equity method of accounting is included in revenue and operating income of the applicable segment.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

The tables below present information on our business segments.

Operations by Business Segment

Millions of dollars	Years ended December 31 2006	2005	2004
Revenue:			
Government and Infrastructure	$ 7,249	$ 8,136	$ 9,409
Energy and Chemicals	2,384	2,010	2,497
Total	$ 9,633	$ 10,146	$ 11,906
Operating income (loss):			
Government and Infrastructure	$ 201	$ 332	$ 82
Energy and Chemicals	45	123	(439)
Total	$ 246	$ 455	$ (357)
Capital Expenditures:			
Government and Infrastructure	$ 18	$ 33	$ 41
Energy and Chemicals	12	4	9
General Corporate	27	39	24
Total	$ 57	$ 76	$ 74
Equity in earnings (losses) of unconsolidated affiliates, net:			
Government and Infrastructure	$ (61)	$ (26)	$ (30)
Energy and Chemicals	68	(34)	(24)
Total	$ 7	$ (60)	$ (54)
Depreciation and amortization:			
Government and Infrastructure	$ 22	$ 32	$ 27
Energy and Chemicals	7	9	11
General Corporate(a)	18	15	14
Total	$ 47	$ 56	$ 52
Restructuring charge (Note 23):			
Government and Infrastructure	$ 2	$	$ 12
Energy and Chemicals	3	1	28
Total	$ 5	$ 1	$ 40

(a) Depreciation and amortization associated with corporate assets is allocated to our two operating segments for determining operating income or loss.

Within KBR, not all assets are associated with specific segments. Those assets specific to segments include receivables, inventories, certain identified property, plant and equipment and equity in and advances to related companies, and goodwill. The remaining assets, such as cash and the remaining property, plant and equipment, are considered to be shared among the segments.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Balance Sheet Information by Operating Segment

Millions of dollars	December 31 2006	December 31 2005
Total assets:		
Government and Infrastructure	$ 2,072	$ 2,708
Energy and Chemicals	1,904	1,776
General Corporate	1,431	491
Assets related to discontinued operations		207
Total	$ 5,407	$ 5,182
Equity in/advances to related companies:		
Government and Infrastructure	$ 20	$ 158
Energy and Chemicals	258	106
General Corporate	11	13
Total	$ 289	$ 277

Revenue by country is determined based on the location of services provided. Long-lived assets by country are determined based on the location of tangible assets.

Selected Geographic Information

Millions of dollars	Years ended December 31 2006	2005	2004
Revenue:			
United States	$ 1,351	$ 1,273	$ 1,222
Iraq	4,331	5,116	5,360
Kuwait	217	320	1,773
United Kingdom	1,130	1,142	995
Other Countries	2,604	2,295	2,556
Total	$ 9,633	$ 10,146	$ 11,906

	December 31 2006	December 31 2005
Long-Lived Assets:		
United States	$ 112	$ 88
United Kingdom	323	302

Other Countries	57	54
Total	$ 492	$ 444

101

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 10. Receivables

Our receivables are generally not collateralized. In May 2004, we entered into an agreement to sell, assign, and transfer the entire title and interest in specified United States government accounts receivable of KBR Holdings to a third party. The face value of the receivables sold to the third party is reflected as a reduction of accounts receivable in our consolidated balance sheets. The amount of receivables that could have been sold under the agreement varied based on the amount of eligible receivables at any given time and other factors, and the maximum amount that could have been sold and outstanding under this agreement at any given time was $650 million. The total amount of receivables outstanding under this agreement as of December 31, 2004 was approximately $263 million. As of December 31, 2005, these receivables were collected, the balance was retired, and the facility was terminated.

Note 11. Property, Plant and Equipment

Other than those assets that have been written down to their fair values due to impairment, property, plant, and equipment are reported at cost less accumulated depreciation, which is generally provided on the straight-line method over the estimated useful lives of the assets. Some assets are depreciated on accelerated methods. Accelerated depreciation methods are also used for tax purposes, wherever permitted. Upon sale or retirement of an asset, the related costs and accumulated depreciation are removed from the accounts and any gain or loss is recognized.

Property, plant and equipment are composed of the following:

	Estimated Useful	December 31	
Millions of dollars	Lives in Years	2006	2005
Land	N/A	$ 32	$ 32
Buildings and property improvements	5-40	245	206
Machinery, equipment and other	3-25	575	511
Total		852	749
Less accumulated depreciation		(360)	(305)
Net property, plant and equipment		$ 492	$ 444

Note 12. Resolution of Asbestos and Silica-Related Lawsuits

Kellogg Brown & Root, Inc., had been named as a defendant in a large number of asbestos- and silica-related lawsuits. The plaintiffs alleged injury primarily as a result of exposure to asbestos and silica in materials used in the construction and maintenance projects of Kellogg Brown & Root, Inc. or its subsidiaries.

In January 2005, DII Industries, LLC and certain of its affiliates, including certain subsidiaries of KBR resolved all open and future asbestos and silica claims and related insurance recoveries pursuant to prepackaged Chapter 11 proceedings. These proceedings commenced in December 2003 and the order confirming the plan of reorganization became final and non-appealable effective December 31, 2004. Under the plan of reorganization, all current and future asbestos and silica personal injury claims against DII Industries, LLC and its affiliates were channeled into trusts established for the benefit of asbestos and silica claimants.

Based upon this plan of reorganization and the final settlement agreement with claimants, approximately $44 million of the total settlement was allocated to KBR. This allocation was primarily based upon a product

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

identification due diligence process undertaken to establish that the claimants injuries were based on exposure to products of DII Industries, LLC., Kellogg Brown & Root LLC and their subsidiaries or former businesses. This $44 million liability was recorded in 2002 and paid in January 2005.

Note 13. Debt

Long-term debt consists of the following:

Millions of dollars	December 31 2006	2005
Long-term debt	$ 20	$ 34
Less current portion	18	16
Noncurrent portion of long-term debt	$ 2	$ 18

Effective December 16, 2005, we entered into an unsecured $850 million five year revolving credit facility (Revolving Credit Facility) with Citibank, N.A., as agent, and a group of banks and institutional lenders. This facility, which extends through December 2010, serves to assist in providing our working capital and letters of credit to support our operations. Amounts drawn under the Revolving Credit Facility bear interest at variable rates based on a base rate (equal to the higher of Citibank s publicly announced base rate, the Federal Funds rate plus 0.5% or a calculated rate based on the certificate of deposit rate) or the Eurodollar Rate, plus, in each case, the applicable margin. The applicable margin will vary based on our utilization spread. We are also charged an issuance fee for the issuance of letters of credit, a per annum charge for outstanding letters of credit and a per annum commitment fee for any unused portion of the credit line. The Revolving Credit Facility contains a number of covenants restricting, among other things, our ability to incur additional indebtedness and liens, sales of our assets and payment of dividends, as well as limiting the amount of investments we can make and payments to Halliburton under two subordinated intercompany notes. Furthermore, we are limited in the amount of additional letters of credit and other debt we can incur outside of the Revolving Credit Facility. Also, under the current provisions of the Revolving Credit Facility, it is an event of default if any person or two or more persons acting in concert, other than Halliburton or us, directly or indirectly acquire 25% or more of the combined voting power of all outstanding equity interests ordinarily entitled to vote in the election of directors of KBR Holdings, LLC, the borrower under the Revolving Credit Facility and a wholly owned subsidiary of KBR. The Revolving Credit Facility requires us to maintain certain financial ratios, as defined by the Revolving Credit Facility agreement, including a debt-to-capitalization ratio that does not exceed 55% until June 30, 2007 and 50% thereafter; a leverage ratio that does not exceed 3.5; and a fixed charge coverage ratio of at least 3.0. At December 31, 2006, we were in compliance with these ratios and other covenants. As of December 31, 2006, there were zero borrowings and $55 million in letters of credit outstanding under this facility.

In connection with entering into the Revolving Credit Facility, we entered into two subordinated intercompany notes with Halliburton where accounts payable to Halliburton in the aggregate of $774 million were structured into two five-year subordinated notes payable to subsidiaries of Halliburton as further described in Note 21.

On November 29, 2002, DML entered into a credit facility denominated in British pounds with Bank of Scotland, HSBC Bank and The Royal Bank of Scotland totaling $157 million. The U.S. dollar amounts presented were converted using published exchange rates for the applicable periods. This facility, which is non-recourse to us, matures in September 2009, provides for a $137 million term loan facility and a $20 million revolving credit facility. The interest rate for both the term loan and revolving credit facility is variable based on an adjusted LIBOR rate and DML must maintain certain financial covenants. At December 31, 2006, there was $18 million outstanding

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

under this term loan facility, which is payable in quarterly installments through September 2009. At December 31, 2006, there were no amounts outstanding under the revolving credit facility. In addition, DML had $2 million of other long-term debt outstanding at December 31, 2006. The interest rate on this debt is variable and payments are due quarterly through October 2008. DML also has a $29 million overdraft facility for which there was no outstanding balance at December 31, 2006.

On June 6, 2005, our 55%-owned subsidiary, M.W. Kellogg Limited, entered into a credit facility with Barclays Bank totaling $29 million. The U.S. dollar amounts presented were converted using published exchange rates for the applicable periods. This facility, which is non-recourse to us is primarily used for bonding, guarantee, and other indemnity purposes. Fees are assessed monthly in the amount of 0.25% per annum of the average outstanding balance. Amounts outstanding under the facility are payable upon demand and the lender may require cash collateral for any amounts outstanding under the facility. At December 31, 2006, there was $2 million of bank guarantees outstanding under the facility.

Maturities

At December 31, 2006, our debt matures as follows: $18 million in 2007 and $2 million in 2008.

Note 14. United States Government Contract Work

We provide substantial work under our government contracts to the United States Department of Defense and other governmental agencies. These contracts include our worldwide United States Army logistics contracts, known as LogCAP and U.S. Army Europe (USAREUR). Our government services revenue related to Iraq totaled approximately $4.7 billion in 2006, $5.4 billion in 2005, and $7.1 billion in 2004.

Given the demands of working in Iraq and elsewhere for the United States government, we expect that from time to time we will have disagreements or experience performance issues with the various government customers for which we work. If performance issues arise under any of our government contracts, the government retains the right to pursue remedies which could include threatened termination or termination, under any affected contract. If any contract were so terminated, we may not receive award fees under the affected contract, and our ability to secure future contracts could be adversely affected, although we would receive payment for amounts owed for our allowable costs under cost-reimbursable contracts. Other remedies that could be sought by our government customers for any improper activities or performance issues include sanctions such as forfeiture of profits, suspension of payments, fines, and suspensions or debarment from doing business with the government. Further, the negative publicity that could arise from disagreements with our customers or sanctions as a result thereof could have an adverse effect on our reputation in the industry, reduce our ability to compete for new contracts, and may also have a material adverse effect on our business, financial condition, results of operations, and cash flow.

DCAA audit issues

Our operations under United States government contracts are regularly reviewed and audited by the Defense Contract Audit Agency (DCAA) and other governmental agencies. The DCAA serves in an advisory role to our customer. When issues are found during the governmental agency audit process, these issues are typically discussed and reviewed with us. The DCAA then issues an audit report with its recommendations to our customer s contracting officer. In the case of management systems and other contract administrative issues, the contracting officer is generally with the Defense Contract Management Agency (DCMA). We then work with our customer to resolve the issues noted in the audit report. If our customer or a government auditor finds that we improperly charged any costs to a contract, these costs are not reimbursable, or, if already reimbursed, the costs must be refunded to the customer. Our revenue recorded for government contract work is reduced for our estimate of costs that may be categorized as disputed or unallowable as a result of cost overruns or the audit process.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Security. In February 2007, we received a letter from the Department of the Army informing us of their intent to adjust payments under the LogCAP III contract associated with the cost incurred by the subcontractors to provide security to their employees. Based on this letter, the DCAA withheld the Army s initial assessment of $20 million. The Army based its assessment on one subcontract wherein, based on communications with the subcontractor, the Army estimated 6% of the total subcontract cost related to the private security costs. The Army indicated that not all task orders and subcontracts have been reviewed and that they may make additional adjustments. The Army indicated that, within 60 days, they intend to begin making further adjustments equal to 6% of prior and current subcontractor costs unless we can provide timely information sufficient to show that such action is not necessary to protect the government s interest. We are working with the Army to provide the additional information they have requested.

The Army indicated that they believe our LogCAP III contract prohibits us from billing costs of privately acquired security. We believe that, while the LogCAP III contract anticipates that the Army will provide force protection to KBR employees, it does not prohibit any of our subcontractors from using private security services to provide force protection to subcontractor personnel. In addition, a significant portion of our subcontracts are competitively bid lump sum or fixed price subcontracts. As a result, we do not receive details of the subcontractors cost estimate nor are we legally entitled to it. Accordingly, we believe that we are entitled to reimbursement by the Army for the cost of services provided by our subcontractors, even if they incurred costs for private force protection services. Therefore, we believe that the Army s position that such costs are unallowable and that they are entitled to withhold amounts incurred for such costs is wrong as a matter of law.

If we are unable to demonstrate that such action by the Army is not necessary, a 6% suspension of all subcontractor costs incurred to date could result in suspended costs of approximately $400 million. The Army has asked us to provide information that addresses the use of armed security either directly or indirectly charged to LogCAP III. The actual costs associated with these activities cannot be accurately estimated at this time, but we believe that they should be less than 6% of the total subcontractor costs. As of December 31, 2006, no amounts have been accrued for suspended security billings.

Laundry. Prior to the fourth quarter of 2005, we received notice from the DCAA that it recommended withholding $18 million of subcontract costs related to the laundry service for one task order in southern Iraq, for which it believed we and our subcontractors did not provide adequate levels of documentation supporting the quantity of the services provided. In the fourth quarter of 2005, the DCAA issued a notice to disallow costs totaling approximately $12 million, releasing $6 million of amounts previously withheld. In the second quarter of 2006, we successfully resolved this matter with the DCAA and received payment of the remaining $12 million.

Containers. In June 2005, the DCAA recommended withholding certain costs associated with providing containerized housing for soldiers and supporting civilian personnel in Iraq. The DCAA recommended that the costs be withheld pending receipt of additional explanation or documentation to support the subcontract costs. Approximately $55 million has been withheld as of December 31, 2006, of which $17 million was withheld from our subcontractor. During 2006, we resolved approximately $25 million of the withheld amounts with our contracting officer which was received in the first quarter of 2007. We will continue working with the government and our subcontractors to resolve the remaining amounts.

Dining facilities. In September 2005, Eurest Support Services (Cyprus) International Limited, or ESS, filed suit against us alleging various claims associated with its performance as a subcontractor in conjunction with our LogCAP contract in Iraq. The case was settled during the first quarter of 2006 without material impact to us.

In the third quarter of 2006, the DCAA has raised questions regarding $95 million of costs related to dining facilities in Iraq. We have responded to the DCAA that our costs are reasonable.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Other issues. The DCAA is continuously performing audits of costs incurred for the foregoing and other services provided by us under our government contracts. During these audits, there have been questions raised by the DCAA about the reasonableness or allowability of certain costs or the quality or quantity of supporting documentation. The DCAA might recommend withholding some portion of the questioned costs while the issues are being resolved with our customer. Because of the intense scrutiny involving our government contracts operations, issues raised by the DCAA may be more difficult to resolve. We do not believe any potential withholding will have a significant or sustained impact on our liquidity.

Investigations

We also provided information to the DoD Inspector General s office in February 2004 about other contacts between former employees and our subcontractors. In the first quarter of 2005, the DOJ issued two indictments associated with overbilling issues we previously reported to the Department of Defense Inspector General s office as well as to our customer, the Army Materiel Command, against a former KBR procurement manager and a manager of La Nouvelle Trading & Contracting Company, W.L.L. In March 2006, one of these former employees pled guilty to taking money in exchange for awarding work to a Saudi Arabian subcontractor. The Inspector General s investigation of these matters may continue.

In October 2004, we reported to the Department of Defense Inspector General s office that two former employees in Kuwait may have had inappropriate contacts with individuals employed by or affiliated with two third-party subcontractors prior to the award of the subcontracts. The Inspector General s office may investigate whether these two employees may have solicited and/or accepted payments from these third-party subcontractors while they were employed by us.

In October 2004, a civilian contracting official in the Army Corps of Engineers (COE) asked for a review of the process used by the COE for awarding some of the contracts to us. We understand that the Department of Defense Inspector General s office may review the issues involved.

We understand that the DOJ, an Assistant United States Attorney based in Illinois, and others are investigating these and other individually immaterial matters we have reported related to our government contract work in Iraq. If criminal wrongdoing were found, criminal penalties could range up to the greater of $500,000 in fines per count for a corporation or twice the gross pecuniary gain or loss. We also understand that current and former employees of KBR have received subpoenas and have given or may give grand jury testimony related to some of these matters.

The House Oversight and Government Reform Committee has conducted hearings on the U.S. military s reliance on civilian contractors, including with respect to military operations in Iraq. We have provided testimony and information for these hearings. We expect hearings with respect to operations in Iraq to continue in this and other Congressional committees, including the House Armed Services Committee, and we expect to be asked to testify and provide information for these hearings.

We have reported to the U.S. Department of State and Department of Commerce that exports of materials, including personal protection equipment such as helmets, goggles, body armor and chemical protective suits, in connection with personnel deployed to Iraq and Afghanistan may not have been in accordance with current licenses or may have been unlicensed. A failure to comply with these laws and regulations could result in civil and/or criminal sanctions, including the imposition of fines upon us as well as the denial of export privileges and debarment from participation in U.S. government contracts. As of December 31, 2006, we had not accrued any amounts related to this matter.

Fuel. In December 2003, the DCAA issued a preliminary audit report that alleged that we may have overcharged the Department of Defense by $61 million in importing fuel into Iraq. The DCAA questioned costs

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

associated with fuel purchases made in Kuwait that were more expensive than buying and transporting fuel from Turkey. We responded that we had maintained close coordination of the fuel mission with the Army Corps of Engineers (COE), which was our customer and oversaw the project, throughout the life of the task orders and that the COE had directed us to use the Kuwait sources. After a review, the COE concluded that we obtained a fair price for the fuel. Nonetheless, Department of Defense officials referred the matter to the agency s inspector general, which we understand commenced an investigation.

The DCAA issued various audit reports related to task orders under the RIO contract that reported $275 million in questioned and unsupported costs. The majority of these costs were associated with the humanitarian fuel mission. In these reports, the DCAA compared fuel costs we incurred during the duration of the RIO contract in 2003 and early 2004 to fuel prices obtained by the Defense Energy Supply Center (DESC) in April 2004 when the fuel mission was transferred to that agency. During the fourth quarter of 2005, we resolved all outstanding issues related to the RIO contract with our customer and settled the remaining questioned costs under this contract.

Withholding of payments

During 2004, the AMC issued a determination that a particular contract clause could cause it to withhold 15% from our invoices until our task orders under the LogCAP contract are definitized. The AMC delayed implementation of this withholding pending further review. During the third quarter of 2004, we and the AMC identified three senior management teams to facilitate negotiation under the LogCAP task orders, and these teams concluded their effort by successfully negotiating the final outstanding task order definitization on March 31, 2005. This made us current with regard to definitization of historical LogCAP task orders and eliminated the potential 15% withholding issue under the LogCAP contract.

Upon the completion of the RIO contract definitization process, the COE released all previously withheld amounts related to this contract in the fourth quarter of 2005.

The PCO Oil South project has definitized substantially all of the task orders, and we have collected a significant portion of any amounts previously withheld. We do not believe the withholding will have a significant or sustained impact on our liquidity because the withholding is temporary, and the definitization process is substantially complete. The amount of payments withheld by the client under the PCO Oil South project was less than $1 million at December 31, 2006 and $1.1 million at December 31, 2005. The PCO Oil South contract provides the customer the right to withhold payment of 15% of the amount billed, thus remitting a net of 85% of costs incurred until a task order is definitized. Once a task order is definitized, this contract provides that 100% of the costs billed will be paid pursuant to the Allowable Cost and Payment Clause of the contract.

We are working diligently with our customers to proceed with significant new work only after we have a fully definitized task order, which should limit withholdings on future task orders for all government contracts.

Claims

We had unapproved claims totaling $36 million at December 31, 2006 and $69 million at December 31, 2005 for the LogCAP and PCO Oil South contracts. The unapproved claims outstanding at December 31, 2006 are considered to be probable of collection and have been recognized as revenue. Similarly, of the $69 million of unapproved claims outstanding at December 31, 2005, $57 million were considered to be probable of collection and have been recognized as revenue. The remaining $12 million of unapproved claims were not considered probable of collection and have not been recognized as revenue. These unapproved claims related to contracts where our costs have exceeded the customer s funded value of the task order.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

In addition, as of December 31, 2006, we had incurred approximately $159 million of costs under the LogCAP III contract that could not be billed to the government due to lack of appropriate funding on various task orders. These amounts were associated with task orders that had sufficient funding in total, but the funding was not appropriately allocated within the task order. We are in the process of preparing a request for a reallocation of funding to be submitted to the client for negotiation, and we anticipate the negotiations will result in an appropriate distribution of funding by the client and collection of the full amounts due.

DCMA system reviews

Report on estimating system. In December 2004, the DCMA granted continued approval of our estimating system, stating that our estimating system is acceptable with corrective action. We are in the process of completing these corrective actions. Specifically, based on the unprecedented level of support that our employees are providing the military in Iraq, Kuwait, and Afghanistan, we needed to update our estimating policies and procedures to make them better suited to such contingency situations. Additionally, we have completed our development of a detailed training program and have made it available to all estimating personnel to ensure that employees are adequately prepared to deal with the challenges and unique circumstances associated with a contingency operation.

Report on purchasing system. As a result of a Contractor Purchasing System Review by the DCMA during the fourth quarter of 2005, the DCMA granted the continued approval of our government contract purchasing system. The DCMA s October 2005 approval letter stated that our purchasing system s policies and practices are effective and efficient, and provide adequate protection of the Government s interest. During the fourth quarter 2006, the DCMA granted, again, continued approval of our government contract purchasing system.

Report on accounting system. We received two draft reports on our accounting system, which raised various issues and questions. We have responded to the points raised by the DCAA, but this review remains open. In the fourth quarter 2006, the DCAA finalized its report and submitted it to the DCMA, who will make a determination of the adequacy of our accounting systems for government contracting. We have prepared an action plan considering the DCAA recommendations and continue to meet with these agencies to discuss the ultimate resolution. The DCMA has approved KBR s accounting system as acceptable for accumulating costs incurred under US Government contracts.

SIGIR Report

In October 2006, the Special Inspector General for Iraq Reconstruction, or SIGIR, issued a report stating that we have improperly labeled reports provided to our customer, AMC, as proprietary data, when data marked does not relate to internal contractor information. We will work with AMC to address the issues raised by the SIGIR report.

The Balkans

We have had inquiries in the past by the DCAA and the civil fraud division of the DOJ into possible overcharges for work performed during 1996 through 2000 under a contract in the Balkans, for which inquiry has not been completed by the DOJ. Based on an internal investigation, we credited our customer approximately $2 million during 2000 and 2001 related to our work in the Balkans as a result of billings for which support was not readily available. We believe that the preliminary DOJ inquiry relates to potential overcharges in connection with a part of the Balkans contract under which approximately $100 million in work was done. We believe that any allegations of overcharges would be without merit. In the fourth quarter 2006, we reached a negotiated settlement with the DOJ. KBR was not accused of any wrongdoing and did not admit to any wrongdoing. The company is not suspended or debarred from bidding for or performing work for the US government. The settlement did not have a material impact on our operating results in 2006.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

McBride Qui Tam suit

In September 2006, we became aware of a *qui tam* action filed against us by a former employee alleging various wrongdoings in the form of overbillings of our customer on the LogCAP III contract. This case was originally filed pending the government s decision whether or not to participate in the suit. In June 2006, the government formally declined to participate. The principal allegations are that our compensation for the provision of Morale, Welfare and Recreation (MWR) facilities under LogCAP III is based on the volume of usage of those facilities and that we deliberately overstated that usage. In accordance with the contract, we charged our customer based on actual cost, not based on the number of users. It was also alleged that, during the period from November 2004 into mid-December 2004, we continued to bill the customer for lunches, although the dining facility was closed and not serving lunches. There are also allegations regarding housing containers and our provision of services to our employees and contractors. Our investigation is ongoing. However, we believe the allegations to be without merit, and we intend to vigorously defend this action. As of December 31, 2006, no amounts were accrued in connection with this matter.

Wilson and Warren Qui Tam Suit

During November 2006, we became aware of a *qui tam* action filed against us alleging that we overcharged the military $30 million by failing to adequately maintain trucks used to move supplies in convoys and by sending empty trucks in convoys. It was alleged that the purpose of these acts was to cause the trucks to break down more frequently than they would if properly maintained and to unnecessarily expose them to the risk of insurgent attacks, both for the purpose of necessitating their replacement thus increasing our revenue. The suit also alleges that in order to silence the plaintiffs, who allegedly were attempting to report those allegations and other alleged wrongdoing, we unlawfully terminated them. On February 6, 2007, the court granted our motion to dismiss the plaintiffs qui tam claims as legally insufficient and ordered the plaintiffs to arbitrate their claims that they were unlawfully discharged. As of December 31, 2006, we had not accrued any amounts in connection with this matter.

Note 15. Other Commitments and Contingencies

Foreign Corrupt Practices Act investigations

The SEC is conducting a formal investigation into whether improper payments were made to government officials in Nigeria through the use of agents or subcontractors in connection with the construction and subsequent expansion by TSKJ of a multibillion dollar natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The DOJ is also conducting a related criminal investigation. The SEC has also issued subpoenas seeking information, which we are furnishing, regarding current and former agents used in connection with multiple projects, including current and prior projects, over the past 20 years located both in and outside of Nigeria in which we, The M.W. Kellogg Company, M.W. Kellogg Limited or their or our joint ventures are or were participants. In September 2006, the SEC requested that we enter into a tolling agreement with respect to its investigation. We anticipate that we will enter into an appropriate tolling agreement with the SEC.

TSKJ is a private limited liability company registered in Madeira, Portugal whose members are Technip SA of France, Snamprogetti Netherlands B.V. (a subsidiary of Saipem SpA of Italy), JGC Corporation of Japan, and Kellogg Brown & Root LLC (a subsidiary of ours and successor to The M.W. Kellogg Company), each of which had an approximately 25% interest in the venture at December 31, 2006. TSKJ and other similarly owned entities entered into various contracts to build and expand the liquefied natural gas project for Nigeria LNG Limited, which is owned by the Nigerian National Petroleum Corporation, Shell Gas B.V., Cleag Limited (an affiliate of Total), and Agip International B.V. (an affiliate of ENI SpA of Italy). M.W. Kellogg Limited is a joint venture in

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

which we had a 55% interest at December 31, 2006, and M.W. Kellogg Limited and The M.W. Kellogg Company were subsidiaries of Dresser Industries before Halliburton s 1998 acquisition of Dresser Industries. The M.W. Kellogg Company was later merged with a Halliburton subsidiary to form Kellogg Brown & Root, one of our subsidiaries.

The SEC and the DOJ have been reviewing these matters in light of the requirements of the FCPA. Halliburton has been cooperating with the SEC and DOJ investigations and with other investigations into the Bonny Island project in France, Nigeria and Switzerland. We also believe that the Serious Frauds Office in United Kingdom is conducting an investigation relating to the Bonny Island project. Halliburton s Board of Directors has appointed a committee of independent directors to oversee and direct the FCPA investigations. Halliburton, acting through its committee of independent directors, will continue to oversee and direct the investigations, and our directors that are independent of Halliburton and us, acting as a committee of our board of directors, will monitor the continuing investigations directed by Halliburton.

The matters under investigation relating to the Bonny Island project cover an extended period of time (in some cases significantly before Halliburton s 1998 acquisition of Dresser Industries and continuing through the current time period). We have produced documents to the SEC and the DOJ both voluntarily and pursuant to company subpoenas from the files of numerous officers and employees of Halliburton and KBR, including many current and former executives of Halliburton and KBR, and we are making our employees available to the SEC and the DOJ for interviews. In addition, we understand that the SEC has issued a subpoena to A. Jack Stanley, who formerly served as a consultant and chairman of Kellogg Brown & Root and to others, including certain of our current and former employees, former executive officers and at least one of our subcontractors. We further understand that the DOJ issued subpoenas for the purpose of obtaining information abroad, and we understand that other partners in TSKJ have provided information to the DOJ and the SEC with respect to the investigations, either voluntarily or under subpoenas.

The SEC and DOJ investigations include an examination of whether TSKJ s engagement of Tri-Star Investments as an agent and a Japanese trading company as a subcontractor to provide services to TSKJ were utilized to make improper payments to Nigerian government officials. In connection with the Bonny Island project, TSKJ entered into a series of agency agreements, including with Tri-Star Investments, of which Jeffrey Tesler is a principal, commencing in 1995 and a series of subcontracts with a Japanese trading company commencing in 1996. We understand that a French magistrate has officially placed Mr. Tesler under investigation for corruption of a foreign public official. In Nigeria, a legislative committee of the National Assembly and the Economic and Financial Crimes Commission, which is organized as part of the executive branch of the government, are also investigating these matters. Our representatives have met with the French magistrate and Nigerian officials. In October 2004, representatives of TSKJ voluntarily testified before the Nigerian legislative committee.

We notified the other owners of TSKJ of information provided by the investigations and asked each of them to conduct their own investigation. TSKJ has suspended the receipt of services from and payments to Tri-Star Investments and the Japanese trading company and has considered instituting legal proceedings to declare all agency agreements with Tri-Star Investments terminated and to recover all amounts previously paid under those agreements. In February 2005, TSKJ notified the Attorney General of Nigeria that TSKJ would not oppose the Attorney General s efforts to have sums of money held on deposit in accounts of Tri-Star Investments in banks in Switzerland transferred to Nigeria and to have the legal ownership of such sums determined in the Nigerian courts.

As a result of these investigations, information has been uncovered suggesting that, commencing at least 10 years ago, members of TSKJ planned payments to Nigerian officials. We have reason to believe, based on the ongoing investigations, that payments may have been made by agents of TSKJ to Nigerian officials. In addition,

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

information recently uncovered in the summer of 2006 suggests that, prior to 1998, plans may have been made by employees of The M.W. Kellogg Company to make payments to government officials in connection with the pursuit of a number of other projects in countries outside of Nigeria. Halliburton is reviewing a number of recently discovered documents related to KBR activities in countries outside of Nigeria with respect to agents for projects after 1998. Certain of the activities discussed in this paragraph involve current or former employees or persons who were or are consultants to us, and the investigation continues.

In June 2004, all relationships with Mr. Stanley and another consultant and former employee of M.W. Kellogg Limited were terminated. The termination of Mr. Stanley occurred because of violations of Halliburton s Code of Business Conduct that allegedly involved the receipt of improper personal benefits from Mr. Tesler in connection with TSKJ s construction of the Bonny Island project.

In 2006, Halliburton suspended the services of another agent who, until such suspension, had worked for us outside of Nigeria on several current projects and on numerous older projects going back to the early 1980s. The suspension will continue until such time, if ever, as Halliburton can satisfy itself regarding the agent s compliance with applicable law and Halliburton s Code of Business Conduct. In addition, Halliburton suspended the services of an additional agent on a separate current Nigerian project with respect to which Halliburton has received from a joint venture partner on that project allegations of wrongful payments made by such agent.

If violations of the FCPA were found, a person or entity found in violation could be subject to fines, civil penalties of up to $500,000 per violation, equitable remedies, including disgorgement (if applicable) generally of profits, including prejudgment interest on such profits, causally connected to the violation, and injunctive relief. Criminal penalties could range up to the greater of $2 million per violation or twice the gross pecuniary gain or loss from the violation, which could be substantially greater than $2 million per violation. It is possible that both the SEC and the DOJ could assert that there have been multiple violations, which could lead to multiple fines. The amount of any fines or monetary penalties which could be assessed would depend on, among other factors, the findings regarding the amount, timing, nature and scope of any improper payments, whether any such payments were authorized by or made with knowledge of us or our affiliates, the amount of gross pecuniary gain or loss involved, and the level of cooperation provided the government authorities during the investigations. Agreed dispositions of these types of violations also frequently result in an acknowledgement of wrongdoing by the entity and the appointment of a monitor on terms negotiated with the SEC and the DOJ to review and monitor current and future business practices, including the retention of agents, with the goal of assuring compliance with the FCPA. Other potential consequences could be significant and include suspension or debarment of our ability to contract with governmental agencies of the United States and of foreign countries. During 2006, we had revenue of approximately $5.8 billion from our government contracts work with agencies of the United States or state or local governments. If necessary, we would seek to obtain administrative agreements or waivers from the DoD and other agencies to avoid suspension or debarment. In addition, we may be excluded from bidding on MoD contracts in the United Kingdom if we are convicted for a corruption offense or if the MoD determines that our actions constituted grave misconduct. During 2006, we had revenue of approximately $1.0 billion from our government contracts work with the MoD. Suspension or debarment from the government contracts business would have a material adverse effect on our business, results of operations, and cash flow.

These investigations could also result in (1) third-party claims against us, which may include claims for special, indirect, derivative or consequential damages, (2) damage to our business or reputation, (3) loss of, or adverse effect on, cash flow, assets, goodwill, results of operations, business, prospects, profits or business value, (4) adverse consequences on our ability to obtain or continue financing for current or future projects and/or (5) claims by directors, officers, employees, affiliates, advisors, attorneys, agents, debt holders or other interest holders or constituents of us or our subsidiaries. In this connection, we understand that the government of Nigeria gave notice in 2004 to the French magistrate of a civil claim as an injured party in that proceeding. In addition,

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

our compliance procedures or having a monitor required or agreed to be appointed at our cost as part of the disposition of the investigations could result in a more limited use of agents on large-scale international projects than in the past and put us at a competitive disadvantage in pursuing such projects. Continuing negative publicity arising out of these investigations could also result in our inability to bid successfully for governmental contracts and adversely affect our prospects in the commercial marketplace. We are not aware of any further developments with respect to this claim. In addition, we could incur costs and expenses for any monitor required by or agreed to with a governmental authority to review our continued compliance with FCPA law.

The investigations by the SEC and DOJ and foreign governmental authorities are continuing. We do not expect these investigations to be concluded in the immediate future. The various governmental authorities could conclude that violations of the FCPA or applicable analogous foreign laws have occurred with respect to the Bonny Island project and other projects in or outside of Nigeria. In such circumstances, the resolution or disposition of these matters, even after taking into account the indemnity from Halliburton with respect to any liabilities for fines or other monetary penalties or direct monetary damages, including disgorgement, that may be assessed by the U.S. and certain foreign governments or governmental agencies against us or our greater than 50%-owned subsidiaries could have a material adverse effect on our business, prospects, results or operations, financial condition and cash flow. Under the terms of the master separation agreement entered into in connection with our initial public offering, Halliburton has agreed to indemnify us for, and any of our greater than 50%-owned subsidiaries for our share of, fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of claims made or assessed by a governmental authority of the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria or a settlement thereof relating to FCPA Matters (as defined), which could involve Halliburton and us through The M. W. Kellogg Company, M. W. Kellogg Limited or, their or our joint ventures in projects both in and outside of Nigeria, including the Bonny Island, Nigeria project. Halliburton s indemnity will not apply to any other losses, claims, liabilities or damages assessed against us as a result of or relating to FCPA Matters or to any fines or other monetary penalties or direct monetary damages, including disgorgement, assessed by governmental authorities in jurisdictions other than the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria, or a settlement thereof, or assessed against entities such as TSKJ or Brown & Root Condor Spa, in which we do not have an interest greater than 50%.

As of December 31, 2006, we are unable to estimate an amount of probable loss or a range of possible loss related to these matters.

Halliburton has incurred $14 million, $9 million and $8 million for the years ended December 31, 2006, 2005 and 2004, respectively, for expenses relating to the FCPA and bidding practices investigations. In 2004, $1.5 million of the $8 million incurred was charged to us. Except for this $1.5 million, Halliburton has not charged these costs to us. These expenses were incurred for the benefit of both Halliburton and us, and we and Halliburton have no reasonable basis for allocating these costs between Halliburton and us.

Bidding practices investigation

In connection with the investigation into payments relating to the Bonny Island project in Nigeria, information has been uncovered suggesting that Mr. Stanley and other former employees may have engaged in coordinated bidding with one or more competitors on certain foreign construction projects, and that such coordination possibly began as early as the mid-1980s.

On the basis of this information, Halliburton and the DOJ have broadened their investigations to determine the nature and extent of any improper bidding practices, whether such conduct violated United States antitrust laws, and whether former employees may have received payments in connection with bidding practices on some foreign projects.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

If violations of applicable United States antitrust laws occurred, the range of possible penalties includes criminal fines, which could range up to the greater of $10 million in fines per count for a corporation, or twice the gross pecuniary gain or loss, and treble civil damages in favor of any persons financially injured by such violations. Criminal prosecutions under applicable laws of relevant foreign jurisdictions and civil claims by or relationship issues with customers are also possible.

The results of these investigations may have a material adverse effect on our business and results of operations.

As of December 31, 2006, we are unable to estimate an amount of probable loss or range of possible loss related to these matters.

Possible Algerian investigation

We believe that an investigation by a magistrate or a public prosecutor in Algeria may be pending with respect to sole source contracts awarded to Brown & Root-Condor Spa, a joint venture among Kellogg Brown & Root Ltd UK, Centre de Recherche Nuclear de Draria and Holding Services para Petroliers Spa. We had a 49% interest in this joint venture as of December 31, 2006.

Improper payments reported to the SEC

During the second quarter of 2002, we reported to the SEC that one of our foreign subsidiaries operating in Nigeria made improper payments of approximately $2.4 million to entities owned by a Nigerian national who held himself out as a tax consultant, when in fact he was an employee of a local tax authority. The payments were made to obtain favorable tax treatment and clearly violated our Code of Business Conduct and our internal control procedures. The payments were discovered during our audit of the foreign subsidiary. We conducted an investigation assisted by outside legal counsel, and, based on the findings of the investigation, we terminated several employees. None of our senior officers were involved. We are cooperating with the SEC in its review of the matter. We took further action to ensure that our foreign subsidiary paid all taxes owed in Nigeria. A preliminary assessment of approximately $4 million was issued by the Nigerian tax authorities in the second quarter of 2003. We are cooperating with the Nigerian tax authorities to determine the total amount due as quickly as possible.

Litigation brought by La Nouvelle

In October 2004, La Nouvelle, a subcontractor to us in connection with our government services work in Kuwait and Iraq, filed suit alleging breach of contract and interference with contractual and business relations. The relief sought included $224 million in damages for breach of contract, which included $34 million for wrongful interference and an unspecified sum for consequential and punitive damages. The dispute arose from our termination of a master agreement pursuant to which La Nouvelle operated a number of dining facilities in Kuwait and Iraq and the replacement of La Nouvelle with ESS, which, prior to La Nouvelle s termination, had served as La Nouvelle s subcontractor. In addition, La Nouvelle alleged that we wrongfully withheld from La Nouvelle certain sums due La Nouvelle under its various subcontracts. During the second quarter of 2005, this litigation was settled without material impact to us.

Iraq overtime litigation

During the fourth quarter of 2005, a group of present and former employees working on the LogCAP contract in Iraq and elsewhere filed a class action lawsuit alleging that KBR wrongfully failed to pay time and a half for hours worked in excess of 40 per work week and that uplift pay, consisting of a foreign service bonus,

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

an area differential, and danger pay, was only applied to the first 40 hours worked in any work week. The class alleged by plaintiffs consists of all current and former employees on the LogCAP contract from December 2001 to present. The basis of plaintiffs claims is their assertion that they are intended third party beneficiaries of the LogCAP contract and that the LogCAP contract obligated KBR to pay time and a half for all overtime hours. We have moved to dismiss the case on a number of bases. On September 26, 2006, the court granted the motion to dismiss insofar as claims for overtime pay and uplift pay are concerned, leaving only a contractual claim for miscalculation of employees pay. That claim remains pending. It is premature to assess the probability of an adverse result on that remaining claim. However, because the LogCAP contract is cost-reimbursable, we believe that we could charge any adverse award to the customer. It is our intention to continue to vigorously defend the remaining claim. As of December 31, 2006, we have not accrued any amounts related to this matter.

Environmental

We are subject to numerous environmental, legal and regulatory requirements related to our operations worldwide. In the United States, these laws and regulations include, among others:

- the Comprehensive Environmental Response, Compensation and Liability Act;
- the Resources Conservation and Recovery Act;
- the Clean Air Act;
- the Federal Water Pollution Control Act; and
- the Toxic Substances Control Act.

In addition to the federal laws and regulations, states and other countries where we do business often have numerous environmental, legal and regulatory requirements by which we must abide. We evaluate and address the environmental impact of our operations by assessing and remediating contaminated properties in order to avoid future liabilities and comply with environmental, legal and regulatory requirements. On occasion, we are involved in specific environmental litigation and claims, including the remediation of properties we own or have operated as well as efforts to meet or correct compliance-related matters. Our Health, Safety and Environment group has several programs in place to maintain environmental leadership and to prevent the occurrence of environmental contamination. We do not expect costs related to environmental matters will have a material adverse effect on our consolidated financial position or our results of operations.

Letters of credit

In connection with certain projects, we are required to provide letters of credit, surety bonds or other financial and performance guarantees to our customers. As of December 31, 2006, we had approximately $676 million in letters of credit and financial guarantees outstanding, of which, $55 million were issued under our Revolving Credit Facility. Approximately $597 million of the remaining $621 million were issued under various facilities and are irrevocably and unconditionally guaranteed by Halliburton. Of the total outstanding, approximately $516 million relate to our joint venture operations, including $159 million issued in connection with our Allenby & Connaught project. The remaining $160 million of outstanding letters of credit relate to various other projects. At December 31, 2006, $248 million of the $676 million outstanding letters of credit have triggering events that would entitle a bank to require cash collateralization.

In addition, Halliburton has guaranteed surety bonds and provided direct guarantees primarily related to our performance. We expect to cancel these letters of credit, surety bonds and other guarantees as we complete the underlying projects. We and Halliburton have agreed that the existing surety bonds, letters of credit, performance

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

guarantees, financial guarantees and other credit support instruments guaranteed by Halliburton will remain in full force and effect following the separation of our companies. In addition, we and Halliburton have agreed that until December 31, 2009, Halliburton will issue additional guarantees, indemnification and reimbursement commitments for our benefit in connection with (a) letters of credit necessary to comply with our EBIC contract, our Allenby & Connaught project and all other contracts that were in place as of December 15, 2005; (b) surety bonds issued to support new task orders pursuant to the Allenby & Connaught project, two job order contracts for our G&I segment and all other contracts that were in place as of December 25, 2005; and (c) performance guarantees in support of these contracts. Each credit support instrument outstanding at the time of our initial public offering and any additional guarantees, indemnification and reimbursement commitments will remain in effect until the earlier of: (1) the termination of the underlying project contract or our obligations thereunder or (2) the expiration of the relevant credit support instrument in accordance with its terms or release of such instrument by our customer. In addition, we have agreed to use our reasonable best efforts to attempt to release or replace Halliburton s liability under the outstanding credit support instruments and any additional credit support instruments relating to our business for which Halliburton may become obligated for which such release or replacement is reasonably available. For so long as Halliburton or its affiliates remain liable with respect to any credit support instrument, we have agreed to pay the underlying obligation as and when it becomes due. Furthermore, we agreed to pay to Halliburton a quarterly carry charge for its guarantees of our outstanding letters of credit and surety bonds and agreed to indemnify Halliburton for all losses in connection with the outstanding credit support instruments and any new credit support instruments relating to our business for which Halliburton may become obligated following the separation.

Other commitments

As of December 31, 2006, we had commitments to provide funds of $156 million, including $119 million related to our privately financed projects. As of December 31, 2005, these commitments were approximately $79 million to related companies including $35 million to fund our privately financed projects. These commitments arose primarily during the start-up of these entities or due to losses incurred by them. We expect approximately $13 million of the commitments at December 31, 2006 to be paid during 2007. In addition, we continue to fund operating cash shortfalls on the Barracuda-Caratinga project and are obligated to fund total shortage over the remaining life of the project. The remaining project costs, net of revenue received, was $10 million at December 31, 2006.

Liquidated damages

Many of our engineering and construction contracts have milestone due dates that must be met or we may be subject to penalties for liquidated damages if claims are asserted and we were responsible for the delays. These generally relate to specified activities within a project by a set contractual date or achievement of a specified level of output or throughput of a plant we construct. Each contract defines the conditions under which a customer may make a claim for liquidated damages. However, in most instances, liquidated damages are not asserted by the customer, but the potential to do so is used in negotiating claims and closing out the contract. We had not accrued for liquidated damages of $43 million and $70 million at December 31, 2006 and 2005, respectively (including amounts related to our share of unconsolidated subsidiaries), that we could incur based upon completing the projects as forecasted.

Leases

We are obligated under operating leases, principally for the use of land, offices, equipment, field facilities, and warehouses. We recognize minimum rental expenses over the term of the lease. When a lease contains a fixed escalation of the minimum rent or rent holidays, we recognize the related rent expense on a straight-line

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

basis over the lease term and record the difference between the recognized rental expense and the amounts payable under the lease as deferred lease credits. We have certain leases for office space where we receive allowances for leasehold improvements. We capitalize these leasehold improvements as property, plant, and equipment and deferred lease credits. Leasehold improvements are amortized over the shorter of their economic useful lives or the lease term. Total rent expense, net of sublease rentals, was $178 million, $383 million and $387 million in 2006, 2005 and 2004, respectively.

Future total rentals on noncancelable operating leases are as follows: $48 million in 2007; $50 million in 2008; $42 million in 2009; $39 million in 2010; $39 million in 2011; and $41 million thereafter.

Note 16. Income Taxes

The components of the (provision)/benefit for income taxes on continuing operations were:

	Years ended December 31		
Millions of dollars	**2006**	**2005**	**2004**
Current income taxes:			
Federal	$ (56)	$ (118)	$ 140
Foreign	(80)	(52)	(27)
State	(2)	(8)	7
Total current	(138)	(178)	120
Deferred income taxes:			
Federal	27	22	(5)
Foreign	(17)	(25)	(20)
State	(1)	(1)	1
Total deferred	9	(4)	(24)
(Provision) benefit for income taxes	$ (129)	$ (182)	$ 96

Income tax expense for KBR, Inc. is calculated on a pro rata basis. Under this method, income tax expense is determined based on KBR, Inc. operations and their contributions to income tax expense of the Halliburton consolidated group.

KBR, Inc. is the parent of a group of our domestic companies which are currently included in the consolidated federal income tax return of Halliburton. Additionally, many subsidiaries and divisions of Halliburton are subject to consolidation, group relief or similar provisions of tax law in foreign jurisdictions that allow for sharing of tax attributes with other Halliburton affiliates. For purposes of determining income tax expense, it is assumed that KBR, Inc. will continue to file on this combined basis.

As noted above, we have calculated income tax expense based on a pro rata method. A second method which is available for determining tax expense is the separate return method. Under the separate return method, KBR income tax expense is calculated as if we had filed tax returns for its own operations, excluding other Halliburton operations. If we had calculated income tax expense from continuing operations using the separate return method as of January 1, 2006, the income tax expense from continuing operations recorded in 2006 would have been $108 million resulting in an effective tax rate of 49% under the separate return method. Similarly, if we had calculated income tax expense from discontinued operations using the separate return method as of

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

January 1, 2006, the income tax expense recorded in 2006 would have been $44 million resulting in an effective tax rate of 33% under the separate return method.

The United States and foreign components of income (loss) from continuing operations before income taxes and minority interest were as follows:

Millions of dollars	Years ended December 31 2006	2005	2004
United States	$ 59	$ 294	$ (51)
Foreign	161	139	(334)
Total	$ 220	$ 433	$ (385)

The reconciliations between the actual provision for income taxes on continuing operations and that computed by applying the United States statutory rate to income from continuing operations before income taxes and minority interest are as follows:

	Years ended December 31 2006	2005	2004
United States Statutory Rate	35%	35.0%	35.0%
Rate differentials on foreign earnings	(9.8)	2.2	(2.2)
Non-deductible loss	9.2		
State income taxes	0.6	1.3	1.3
Prior year foreign taxes	11.2	(1.6)	(2.7)
Prior year federal & state taxes	8.0	1.2	
Valuation allowance	(1.1)	0.9	(5.3)
Foreign tax credit displacement	4.8	4.4	
Other	0.6	(1.3)	(1.2)
Total effective tax rate on continuing operations	58.5%	42.1%	24.9%

We generally do not provide income taxes on the undistributed earnings of non-United States subsidiaries because such earnings are intended to be reinvested indefinitely to finance foreign activities. Taxes are provided as necessary with respect to earnings that are not permanently reinvested. The American Job Creations Act of 2004 introduced a special dividends received deduction with respect to the repatriation of certain foreign earnings to a United States taxpayer under certain circumstances. Based on its analysis of the Act, the Halliburton U.S. consolidated group decided not to utilize the special deduction. KBR s tax calculation reflects this position.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

The primary components of our deferred tax assets and liabilities and the related valuation allowances are as follows:

Millions of dollars	Years ended December 31 2006	2005
Gross deferred tax assets:		
Depreciation and amortization	$ 10	$ 4
Employee compensation and benefits	176	52
Foreign tax credit carryforward	67	67
Construction contract accounting	89	81
Loss carryforwards	55	69
Insurance accruals	15	17
Interest accruals		6
Allowance for bad debt	14	18
All other	26	32
Total	$ 452	$ 346
Gross deferred tax liabilities:		
Depreciation and amortization	$ 38	$ 6
Construction contract accounting	58	53
Total	$ 96	$ 59
Valuation Allowances:		
Foreign tax credit carryforward	$ 67	$ 67
Loss carryforwards	21	23
Total	$ 88	$ 90
Net deferred income tax asset	$ 268	$ 197

At December 31, 2006, we had $171 million of net operating loss carryforwards that expire from 2006 through 2016 and loss carryforwards of $26 million with indefinite expiration dates.

Foreign tax credit carryforwards recorded in the financial statements reflect the credits actually generated by KBR operations, reduced for the amount considered utilized pursuant to the tax sharing agreement. Should KBR leave the Halliburton U.S. consolidated group at some point in the future, the amount of foreign tax credit carryforward taken by KBR will be determined by operation of U.S. tax law. The amount of such carryforward taken by KBR could be significantly different than the amount recorded in the financial statements.

We have established a valuation allowance for certain foreign loss carryforwards and foreign tax credit carryforwards on the basis that we believe these assets will not be utilized in the statutory carryover period. KBR is subject to a tax sharing agreement. The tax sharing agreement provides, in part, for settlement of utilized tax attributes on a consolidated basis. Therefore, intercompany settlements due to the utilized attributes are only established to the extent that the attributes decreased the tax liability of an affiliate in any given jurisdiction. The adjustment to reflect the difference between the tax provision/benefit calculated as described above and the amount settled with Halliburton pursuant to the tax sharing agreement is recorded to equity. The adjustment resulted in a charge to equity of $1 million in 2006, credit to equity of $22 million in 2005 and $37 million in 2004. The amount of settlement reflected in the intercompany account is a payable of $94 million as of December 31, 2006, a payable of $36 million as of December 31, 2005 and a receivable of $290 million as of December 31, 2004.

118

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 17. Shareholders Equity

The following tables summarize our shareholders equity activity:

Millions of dollars	Common Stock	Member s Equity	Parent Net Investment	Paid-in Capital in Excess of par	Retained Earnings	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2003		$	$ 1,088	$	$	$ (144)
Intercompany settlement of taxes			37			
Comprehensive income:						
Net loss			(303)			
Other comprehensive income, net of tax (provision):						
Cumulative translation adjustment						32
Pension liability adjustment, net of tax of $41						97
Other comprehensive gains (losses) on derivatives:						
Unrealized gains (losses) on derivatives						39
Reclassification adjustments to net income (loss)						(26)
Income tax benefit (provision) on derivatives						(8)
Total comprehensive income (loss)			(303)			134
Balance at December 31, 2004		$	$ 822	$	$	$ (10)
Intercompany settlement of taxes			22			
Contribution from parent			300			
Comprehensive income:						
Net income		149	91			
Other comprehensive income, net of tax (provision):						
Cumulative translation adjustment						(46)
Pension liability adjustment, net of tax of $(19)						(44)
Other comprehensive gains (losses) on derivatives:						
Unrealized gains (losses) on derivatives						(21)
Reclassification adjustments to net income (loss)						(21)
Income tax benefit (provision) on derivatives						14
Total comprehensive income (loss)		149	91			(118)
Transfer to member s equity		1,235	(1,235)			
Balance at December 31, 2005		$ 1,384	$	$	$	$ (128)
Contribution from parent and other activities		26		(11)		
Transfer to common stock and paid-in capital in excess of par		(1,551)		1,551		
Initial public offering				511		
Stock-based compensation				1		
Adoption of SFAS No. 158, net of tax of $(107)						(152)
Intercompany settlement of taxes				(1)		
Comprehensive income:						

Net income	141			27	
Other comprehensive income, net of tax (provision):					
Cumulative translation adjustment:					
Cumulative translation adjustments					31
Pension liability adjustment, net of tax of $(24)					(57)
Other comprehensive gains (losses) on derivatives:					
Unrealized gains (losses) on derivative					19
Reclassification adjustments to net income (loss)					1
Income tax benefit (provision) on derivatives					(5)
Total comprehensive income	141			27	(163)
Balance at December 31, 2006	$	$	$ 2,051	$ 27	$ (291)

119

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Accumulated other comprehensive income

	December 31		
Millions of dollars	**2006**	**2005**	**2004**
Cumulative translation adjustments	$ 43	$ 12	$ 58
Pension liability adjustments	(335)	(126)	(82)
Unrealized gains (losses) on derivatives	1	(14)	14
Total accumulated other comprehensive income	$ (291)	$ (128)	$ (10)

Note 18. Stock Incentive Plans

Stock Plans

In 2006 Stock-based compensation awards were granted to employees under KBR stock-based compensation plans. In addition, KBR employees participate in Halliburton compensation plans and received grants under these plans in 2005 and 2004.

KBR 2006 Stock and Incentive Plan

In November 2006, KBR established the KBR 2006 Stock and Incentive Plan (KBR 2006 Plan) which provides for the grant of any or all of the following types of stock-based awards:

- stock options, including incentive stock options and nonqualified stock options;
- stock appreciation rights, in tandem with stock options or freestanding;
- restricted stock;
- restricted stock unit;
- performance awards; and
- stock value equivalent awards.

Under the terms of the KBR 2006 Plan, 10 million shares of common stock have been reserved for issuance to employees and non-employee directors. The plan specifies that no more than 3.5 million shares can be awarded as restricted stock or restricted stock units or pursuant to performance awards. At December 31, 2006, approximately 8.0 million shares were available for future grants under the KBR 2006 Plan, of which approximately 2.5 million shares remained available for restricted stock awards or restricted stock unit awards.

KBR Share Based Payment Plans

Stock Options

Under KBR s 2006 Plan, effective as of the closing date of the KBR initial public offering, stock options are granted with an exercise price not less than the fair market value of the common stock on the date of the grant and a term no greater than 10 years. The term and vesting periods are established at the discretion of the Compensation Committee at the time of each grant.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

The following table presents stock options granted, exercised, and forfeited under KBR stock-based compensation plans.

KBR Stock Options

Stock Options	Number of Shares	Exercise Price per Share	Weighted Average Exercise Price per Share
Outstanding at December 31, 2005			
Granted	991,093	$ 21.81	$ 21.81
Exercised			
Forfeited			
Outstanding at December 31, 2006	991,093	$ 21.81	$ 21.81

KBR stock options outstanding at December 31, 2006 had a weighted average remaining contractual life of 9.9 years. None of the options outstanding were exercisable at December 31, 2006. As of December 31, 2006 and net of estimated forfeitures, there was $8.3 million of unrecognized compensation cost net of estimated forfeitures related to non-vested KBR stock options, expected to be recognized over a weighted average period of approximately 2.9 years. The aggregate intrinsic value attributable to these options was $4.3 million as of December 31, 2006.

Restricted stock

Restricted shares issued under the KBR s 2006 Plan are restricted as to sale or disposition. These restrictions lapse periodically over an extended period of time not exceeding 10 years. Restrictions may also lapse for early retirement and other conditions in accordance with our established policies. Upon termination of employment, shares on which restrictions have not lapsed must be returned to us, resulting in restricted stock forfeitures. The fair market value of the stock on the date of grant is amortized and ratably charged to income over the period during which the restrictions lapse.

The following table presents the restricted stock awards and restricted stock units granted, vested, and forfeited during 2006 under KBR s 2006 Stock and Incentive Plan.

Restricted Stock	Number of Shares	Weighted Average Grant-Date Fair Value per Share
Nonvested shares at January 1, 2006		
Granted	964,677	$ 21.16
Vested		
Forfeited		
Nonvested shares at December 31, 2006	964,677	$ 21.16

The weighted average grant-date fair value of restricted KBR shares granted to employees during 2006 was $21.16. As of December 31, 2006, there was $18.7 million of unrecognized compensation cost, net of estimated forfeitures, related to KBR s nonvested restricted stock and restricted sock units, which is expected to be recognized over a weighted average period of 4.9 years.

Halliburton share based payment plans

Halliburton has stock-based employee compensation plans in which certain key employees of KBR participate. Stock options under Halliburton s 1993 Stock and Incentive Plan are granted at the fair market value

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

of the common stock at the grant date, vest ratably over a three- or four-year period, and generally expire 10 years from the grant date. Under the terms of the 1993 Stock and Incentive Plan, as amended, 98 million shares of common stock have been reserved for issuance to key Halliburton employees, including key employees of KBR. The plan specifies that no more than 32 million shares can be awarded as restricted stock. At December 31, 2006, 20 million shares were available for future grants under the 1993 Stock and Incentive Plan, of which 11 million shares remain available for restricted stock awards. The share amounts and exercise prices discussed in this Note have been adjusted for all periods presented to reflect the impact of Halliburton s two-for-one common stock split, in the form of a stock dividend, paid on July 14, 2006 to Halliburton stockholders of record as of June 23, 2006.

Once Halliburton s ownership interest in KBR is 20% or less, outstanding awards to KBR employees of options to purchase Halliburton stock and unvested Halliburton restricted stock under the Halliburton 1993 Plan will be converted into similar KBR awards under its new Transitional Stock Adjustment Plan, with the intention of preserving approximately the equivalent value of the previous awards under the Halliburton 1993 Plan.

Each of the active stock-based compensation arrangements is discussed below.

Halliburton Stock options

All stock options under Halliburton s 1993 Plan are granted at the fair market value of the common stock at the grant date. Employee stock options vest ratably over a three- or four-year period and generally expire 10 years from the grant date.

The following table represents Halliburton s stock options granted to, exercised by, and forfeited by KBR, Inc. s employees during 2006.

Stock Options	**Number of Shares (in millions)**	**Weighted Average Exercise Price per Share**	**Weighted Average Remaining Contractual Term (years)**	**Aggregate Intrinsic Value (in millions)**
Outstanding at January 1, 2006	5.1	$ 15.53		
Granted				
Exercised	(1.6)	16.31		
Forfeited/expired	(0.1)(a)	15.61		
Outstanding at December 31, 2006	3.4	$ 15.16	4.46	$ 54
Exercisable at December 31, 2006	3.0	$ 14.88	4.07	$ 49

(a) Actual expired shares in 2006 were approximately 40,000 shares with a weighted average exercise price per share of $15.42.

The total intrinsic value of options exercised by KBR, Inc. s employees was $31 million in 2006, $52 million in 2005, and $4 million in 2004. As of December 31, 2006, there was $1 million of unrecognized compensation cost, net of estimated forfeitures, related to Halliburton nonvested stock options, which is expected to be recognized over a weighted average period of approximately 0.7 years.

Halliburton Restricted stock

Restricted shares issued under Halliburton s 1993 Plan are restricted as to sale or disposition. These restrictions lapse periodically over an extended period of time not exceeding 10 years. Restrictions may also lapse for early retirement and other conditions in accordance with

Halliburton s established policies. Upon termination of employment, shares on which restrictions have not lapsed must be returned to Halliburton,

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

resulting in restricted stock forfeitures. The fair market value of the stock on the date of grant is amortized and ratably charged to income over the period during which the restrictions lapse.

The following table represents Halliburton s 1993 Plan restricted stock for our employees during 2006.

Restricted Stock	Number of Shares (in millions)	Weighted Average Grant-Date Fair Value per Share
Nonvested shares at January 1, 2006	1.4	$ 16.12
Granted	(a)	33.77
Vested	(0.4)	16.71
Forfeited	(0.1)	16.26
Nonvested shares at December 31, 2006	0.9	$ 16.87

(a) Actual grants for 2006 included approximately 53,000 shares.

The weighted average grant-date fair value of restricted shares granted to our employees during 2005 and 2004 was $22.14 and $14.64. The total fair value of shares vested during 2006 was $12 million, compared to $16 million during 2005 and $9 million during 2004. As of December 31, 2006, there was $10 million of unrecognized compensation cost, net of estimated forfeitures, related to nonvested restricted stock, which is expected to be recognized over a period of 3.3 years.

Halliburton 2002 Employee Stock Purchase Plan

Under the ESPP, eligible employees may have up to 10% of their earnings withheld, subject to some limitations, to be used to purchase shares of Halliburton s common stock. Unless Halliburton s Board of Directors shall determine otherwise, each six-month offering period commences on January 1 and July 1 of each year. The price at which Halliburton s common stock may be purchased under the ESPP is equal to 85% of the lower of the fair market value of Halliburton s common stock on the commencement date or last trading day of each offering period. Under this plan, 24 million shares of Halliburton s common stock have been reserved for issuance, which may be authorized but unissued shares or treasury shares. As of December 31, 2006, 3.7 million shares have been sold to our employees through the ESPP.

Note 19. Financial Instruments and Risk Management

Foreign exchange risk. Techniques in managing foreign exchange risk include, but are not limited to, foreign currency borrowing and investing and the use of currency derivative instruments. We selectively manage significant exposures to potential foreign exchange losses considering current market conditions, future operating activities and the associated cost in relation to the perceived risk of loss. The purpose of our foreign currency risk management activities is to protect us from the risk that the eventual dollar cash flow resulting from the sale and purchase of products and services in foreign currencies will be adversely affected by changes in exchange rates.

We manage our currency exposure through the use of currency derivative instruments as it relates to the major currencies, which are generally the currencies of the countries for which we do the majority of our international business. These contracts generally have an expiration date of two years or less. Forward exchange contracts, which are commitments to buy or sell a specified amount of a foreign currency at a specified price and time, are generally used to manage identifiable foreign currency commitments. Forward exchange contracts and foreign exchange option contracts, which convey the right, but not the obligation, to sell or buy a specified amount of foreign currency at a specified price, are generally used to manage exposures related to assets and liabilities denominated in a foreign currency. None of the forward or option contracts are exchange traded. While

123

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

derivative instruments are subject to fluctuations in value, the fluctuations are generally offset by the value of the underlying exposures being managed. The use of some contracts may limit our ability to benefit from favorable fluctuations in foreign exchange rates.

Foreign currency contracts are not utilized to manage exposures in some currencies due primarily to the lack of available markets or cost considerations (non-traded currencies). We attempt to manage our working capital position to minimize foreign currency commitments in non-traded currencies and recognize that pricing for the services and products offered in these countries should cover the cost of exchange rate devaluations. We have historically incurred transaction losses in non-traded currencies.

Assets, liabilities and forecasted cash flow denominated in foreign currencies. We utilize the derivative instruments described above to manage the foreign currency exposures related to specific assets and liabilities, that are denominated in foreign currencies; however, we have not elected to account for these instruments as hedges for accounting purposes. Additionally, we utilize the derivative instruments described above to manage forecasted cash flow denominated in foreign currencies generally related to long-term engineering and construction projects. Beginning in 2003, we designated these contracts related to engineering and construction projects as cash flow hedges. The ineffective portion of these hedges is included in operating income in the accompanying consolidated statement of operations and was not material in 2006, 2005 or 2004. As of December 31, 2006, we had approximately $1 million in unrealized net gains on these cash flow hedges. As of December 31, 2005, we had approximately $14 million in unrealized net losses on these cash flow hedges and approximately $14 million in unrealized net gains as of December 31, 2004. These unrealized gains and losses include amounts attributable to cash flow hedges placed by our consolidated and unconsolidated subsidiaries and are included in other comprehensive income in the accompanying consolidated balance sheets. Changes in the timing or amount of the future cash flow being hedged could result in hedges becoming ineffective and, as a result, the amount of unrealized gain or loss associated with that hedge would be reclassified from other comprehensive income into earnings. At December 31, 2006 and December 31, 2005, the maximum length of time over which we are hedging our exposure to the variability in future cash flow associated with foreign currency forecasted transactions is 12 months. The fair value of these contracts was less than $1 million as of December 31, 2006 and December 31, 2005. At December 31, 2004 the fair value of these contracts was $28 million.

Notional amounts and fair market values. The notional amounts of open forward contracts and options held by our consolidated subsidiaries was $134 million, $362 million and $483 million at December 31, 2006, 2005 and 2004, respectively. The notional amounts of our foreign exchange contracts do not generally represent amounts exchanged by the parties, and thus, are not a measure of our exposure or of the cash requirements relating to these contracts. The amounts exchanged are calculated by reference to the notional amounts and by other terms of the derivatives, such as exchange rates.

Credit risk. Financial instruments that potentially subject us to concentrations of credit risk are primarily cash equivalents, investments and trade receivables. It is our practice to place our cash equivalents and investments in high-quality securities with various investment institutions. We derive the majority of our revenues from engineering and construction services to the energy industry and services provided to the United States government. There are concentrations of receivables in the United States and the United Kingdom. We maintain an allowance for losses based upon the expected collectibility of all trade accounts receivable. See Note 9 for further discussion of United States government receivables.

There are no significant concentrations of credit risk with any individual counterparty related to our derivative contracts. We select counterparties based on their profitability, balance sheet and a capacity for timely payment of financial commitments which is unlikely to be adversely affected by foreseeable events.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Interest rate risk. We have several debt instruments outstanding with variable interest rates. We may manage our variable-rate debt through the use of different types of debt instruments and derivative instruments. As of December 31, 2006 and December 31, 2005, we held no material interest rate derivative instruments.

Fair market value of financial instruments. The carrying amount of variable rate long-term debt approximates fair market value because these instruments reflect market changes to interest rates. The carrying amount of short-term financial instruments, cash and equivalents, receivables, and accounts payable, as reflected in the consolidated balance sheets, approximates fair market value due to the short maturities of these instruments. The currency derivative instruments are carried on the balance sheet at fair value and are based upon third party quotes.

Note 20. Equity Method Investments and Variable Interest Entities

We conduct some of our operations through joint ventures which are in partnership, corporate, undivided interest and other business forms and are principally accounted for using the equity method of accounting.

The following is a description of our significant unconsolidated subsidiaries that are accounted for using the equity method of accounting:

TSKJ Group is a joint venture consortium consisting of several private limited liability companies registered in Madeira, Portugal. TSKJ Group entered into various contracts to design and construct large-scale projects in Nigeria. KBR has an approximate 25% interest in the TSKJ Group.

Brown & Root-Condor Spa (BRC) is registered in Algiers, Algeria and primarily executes oil and gas production facilities and civil infrastructure projects in Algeria. KBR owns a 49% interest in the joint venture.

TKJ Group is a joint venture consortium consisting of several private limited liability companies registered in Dubai, UAE. The TKJ Group was created for the purpose of trading equipment and the performance of services required for the realization, construction, and modification of maintenance of oil, gas, chemical, or other installations in the Middle East. KBR holds a 33.3% interest in the TKJ Group companies.

JK Group is a joint venture consortium consisting of several private limited liability companies registered in the Cayman Islands. The JK Group was created for the purpose of building two gas processing plants and related pipelines in Algeria. KBR owns a 50% interest in each of the JK Group companies.

ASD is a general partnership registered in Australia and was created for the purpose of operating a railroad between Alice Springs and Darwin in Australia. KBR owns a 36.7% interest in the partnership.

Summarized financial information for the underlying businesses of our significant equity method investments are as follows:

Balance Sheets

	December 31, 2006				
Millions of dollars	**TSKJ Group**	**BRC**	**TKJ**	**JK Group**	**ASD**

Current assets	$ 457	$ 322	$ 650	$ 79	$ 274
Noncurrent assets	$ 23	$ 22	$ 107	$	$ 600
Total assets	$ 480	$ 344	$ 757	$ 79	$ 874
Current liabilities	$ 364	$ 314	$ 654	$ 265	$ 263
Noncurrent liabilities	$ 6	$	$	$	$ 527
Total liabilities	$ 370	$ 314	$ 654	$ 265	$ 790

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Statements of Operations

	For the Year Ended December 31, 2006				
Millions of dollars	**TSKJ Group**	**BRC**	**TKJ**	**JK Group**	**ASD**
Revenue	$ 339	$ 483	$ 943	$ 39	$ 158
Operating income (loss)	$ 20	$ 21	$ 83	$ (36)	$ (13)
Net income (loss)	$ 32	$ 14	$ 96	$ (35)	$ (57)

Balance Sheets

	December 31, 2005				
Millions of dollars	**TSKJ Group**	**BRC**	**TKJ**	**JK Group**	**ASD**
Current assets	$ 434	$ 379	$ 199	$ 154	$ 186
Noncurrent assets	$ 4	$ 27	$ 3	$	$ 610
Total assets	$ 438	$ 406	$ 202	$ 154	$ 796
Current liabilities	$ 394	$ 391	$ 225	$ 211	$ 174
Noncurrent liabilities	$ 3	$	$ 25	$ 2	$ 498
Total liabilities	$ 397	$ 391	$ 250	$ 213	$ 672

Statements of Operations

	For the Year Ended December 31, 2005				
Millions of dollars	**TSKJ Group**	**BRC**	**TKJ**	**JK Group**	**ASD**
Revenue	$ 707	$ 365	$ 37	$ 210	$ 90
Operating income (loss)	$ 2	$ (71)	$	$ (70)	$ (28)
Net income (loss)	$ 11	$ (53)	$ 1	$ (69)	$ (40)

Statements of Operations

	For the Year Ended December 31, 2004			
Millions of dollars	**TSKJ Group**	**BRC**	**JK Group**	**ASD**
Revenue	$ 796	$ 360	$ 153	$ 31
Operating income (loss)	$ 69	$ (31)	$ (105)	$ (29)

Net income (loss)	$ 80	$ (21)	$ (103)	$ (29)

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Consolidated summarized financial information for all other jointly owned operations that are accounted for using the equity method of accounting is as follows:

Balance Sheets

Millions of dollars	December 31, 2006	December 31, 2005
Current assets	$ 4,179	$ 891
Noncurrent assets	2,737	2,489
Total	$ 6,916	$ 3,380
Current liabilities	$ 1,020	$ 888
Noncurrent liabilities	5,481	2,237
Member s equity	415	255
Total	$ 6,916	$ 3,380

Statements of Operations

Millions of dollars	Years ended December 31, 2006	2005	2004
Revenue	$ 2,031	$ 1,335	$ 978
Operating income (loss)	$ 69	$ 15	$ (2)
Net income (loss)	$ 92	$ 26	$ (7)

The FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46), in January 2003. In December 2003, the FASB issued FIN 46R, a revision which supersedes the original interpretation. We adopted FIN 46R effective January 1, 2004. FIN 46R requires the consolidation of entities in which a company absorbs a majority of another entity s expected losses, receives a majority of the other entity s expected residual returns, or both, as a result of ownership, contractual, or other financial interests in the other entity. Previously, entities were generally consolidated based upon a controlling financial interest through ownership of a majority voting interest in the entity.

G&I segment

We have identified the following variable interest entities:

during 2001, we formed a joint venture, in which we own a 50% equity interest with an unrelated partner, that owns and operates heavy equipment transport vehicles in the United Kingdom. This variable interest entity was formed to construct, operate, and service certain assets for a third party, and was funded with third party debt. The construction of the assets was completed in the second quarter of 2004, and the operating and service contract related to the assets extends through 2023. The proceeds from the debt financing were used to construct the assets and will be paid down with cash flow generated during the operation and service phase of the contract. As of December 31, 2006 and 2005, the joint venture had total assets of $161 million and $149 million and total liabilities of $147 million and $154 million, respectively. Our aggregate maximum exposure to loss as a result of our involvement with this joint venture is limited to our investment, which is zero at December 31, 2006, and any future losses related to the operation of the assets. We are not the primary beneficiary. The joint venture is accounted for using the equity method of accounting;

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

we are involved in four privately financed projects, executed through joint ventures, to design, build, operate, and maintain roadways for certain government agencies in the United Kingdom. We have a 25% ownership interest in these joint ventures and account for them using the equity method of accounting. The joint ventures have obtained financing through third parties that is not guaranteed by us. These joint ventures are considered variable interest entities; however, we are not the primary beneficiary of these joint ventures and, therefore, account for them using the equity method of accounting. As of December 31, 2005, these joint ventures had total assets of $1.9 billion and total liabilities of $1.9 billion. As of December 31, 2006, these joint ventures had total assets of $2.2 billion and total liabilities of $2.1 billion. Our maximum exposure to loss was $24 million at December 31, 2006. With respect to one of these roadways, KBR received a revised financial forecast during the second quarter of 2006, which takes into account sustained projected losses due to lower than anticipated long vehicle traffic and higher than forecasted lane availability deductions, which reduce project revenues. Because of this new information, we recorded an impairment charge of $10 million during the second quarter of 2006 in our equity investment in this roadway. As of December 31, 2006, our investment in this joint venture and the related company that performed the construction of the road was zero. In addition, at December 30, 2006, we had no additional funding commitments;

we participate in a privately financed project formed for operating and maintaining a railroad freight business in Australia. We own 36.7% of the joint venture and operating company and we account for these investments using the equity method of accounting. These joint ventures are funded through senior and subordinated debt and equity contributions from the joint ventures partners. This joint venture has sustained losses since commencing operations due to lower than anticipated freight volume and a slowdown in the planned expansion of the Port of Darwin. At the end of the first quarter of 2006, the joint venture s revised financial forecast led us to record a $26 million impairment charge. In October 2006, the joint venture incurred an event of default under its loan agreement by failing to make an interest and principal payment. These loans are non-recourse to us. In light of the default and the realization that the joint venture efforts to raise additional equity from third parties was not successful, we recorded an additional $32 million impairment charge in the third quarter of 2006. We will receive no tax benefit as this impairment charge is not deductible for Australian tax purposes. In December 2006, the senior lenders agreed to waive existing defaults and concede certain rights under the existing indenture. Among these were a reduction in the joint venture s debt service reserve and the relinquishment of the right to receive principal payments for 27 months, through March 2009. In exchange for these concessions, the shareholders of the joint venture committed approximately $12 million of new subordinated financing, of which $6 million was committed by us. These joint ventures are considered variable interest entities; however, we are not the primary beneficiary of the joint ventures. As of December 31, 2005 and 2006, the joint venture had total assets of $796 million and $874 million and total liabilities of $672 million and $790 million, respectively. At December 31, 2006, our maximum exposure to loss totaling $12 million is limited to our equity investments, senior operating notes, and equity owner notes.

we participate in a privately financed project executed through certain joint ventures formed to design, build, operate, and maintain a viaduct and several bridges in southern Ireland. The joint ventures were funded through debt and were formed with minimal equity. These joint ventures are considered variable interest entities; however, we are not the primary beneficiary of the joint ventures. We have up to a 25% ownership interest in the project s joint ventures, and we are accounting for these interests using the equity method of accounting. As of December 31, 2006 and 2005, the joint ventures had total assets of $301 million and $240 million and total liabilities of $293 million and $227 million, respectively. Our maximum exposure to loss was $8 million at December 31, 2006, and our share of any future losses resulting from the project. In addition, at December 31, 2006, we had remaining funding commitments of approximately $4 million.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

in April 2006, Aspire Defence, a joint venture between us, Mowlem Plc. and a financial investor, was awarded a privately financed project contract, the Allenby & Connaught project, by the MoD to upgrade and provide a range of services to the British Army s garrisons at Aldershot and around Salisbury Plain in the United Kingdom. In addition to a package of ongoing services to be delivered over 35 years, the project includes a nine-year construction program to improve soldiers single living, technical and administrative accommodations, along with leisure and recreational facilities. Aspire Defence will manage the existing properties and will be responsible for design, refurbishment, construction and integration of new and modernized facilities. We indirectly own a 45% interest in Aspire Defence, the project company that is the holder of the 35-year concession contract. In addition, we own a 50% interest in each of two joint ventures that provide the construction and the related support services to Aspire Defence. Our performance through the construction phase is supported by $159 million in letters of credit and surety bonds totaling approximately $209 million as of December 31, 2006, both of which have been guaranteed by Halliburton. Furthermore, our financial and performance guarantees are joint and several, subject to certain limitations, with our joint venture partners. The project is funded through equity and subordinated debt provided by the project sponsors and the issuance of publicly held senior bonds. The entities we hold an interest in are considered variable interest entities; however, we are not the primary beneficiary of these entities. We account for our interests in each of the entities using the equity method of accounting. As of December 31, 2006, the aggregate total assets and total liabilities of the variable interest entities were $3.2 billion and $3.3 billion, respectively. Our maximum exposure to project company losses as of December 31, 2006 was $59 million. Our maximum exposure to construction and operating joint venture losses is limited to the funding of any future losses incurred by those entities.

E&C segment

We perform many of our long-term energy-related construction projects through incorporated or unincorporated joint ventures. Typically, these ventures are dissolved upon completion of the project. Many of these ventures are funded by advances from the project owner, and accordingly, require no equity investment by the joint venture partners or shareholders. Occasionally, a venture incurs losses, which then requires funding by the joint venture partners or shareholders in proportion to their interest percentages. The ventures that have little or no initial equity investment are variable interest entities. Our significant variable interest entities are:

during 2005, we formed a joint venture to engineer and construct a gas monetization facility. We own 50% equity interest and determined that we are the primary beneficiary of the joint venture which is consolidated for financial reporting purposes. At December 31, 2006 and December 31, 2005, the joint venture had $756 million and $324 million in total assets and $877 million and $311 million in total liabilities, respectively. There are no consolidated assets that collateralize the joint venture s obligations. However, at December 31, 2006 and December 31, 2005, the joint venture had approximately $413 million and $173 million of cash, respectively, which mainly relate to advanced billings in connection with the joint venture s obligations under the EPC contract;

we have equity ownership in three joint ventures to execute EPC projects. Our equity ownership ranges from 33% to 50%, and these joint ventures are considered variable interest entities. We are not the primary beneficiary and thus account for these joint ventures using the equity method of accounting. At December 31, 2006 and December 31, 2005, these joint ventures had aggregate assets of $1 billion and $863 million and aggregate liabilities of $1.1 billion and $914 million, respectively. Our aggregate, maximum exposure to loss related to these entities was $77 million and $28 at December 31, 2006 and 2005, respectively, and is comprised of our equity investments in and advances to the joint ventures in addition to our commitment to fund any future losses; and

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

we have an investment in a development corporation that has an indirect interest in the new Egypt Basic Industries Corporation (EBIC) ammonia plant project located in Egypt. We are performing the engineering, procurement and construction (EPC) work for the project and operations and maintenance services for the facility. We own 60% of this development company and consolidate it for financial reporting purposes within our E&C segment. The development corporation owns a 25% ownership interest in a company that consolidates the ammonia plant which is considered a variable interest entity. The development corporation accounts for its investment in the company using the equity method of accounting. The variable interest entity is funded through debt and equity. We are not the primary beneficiary of the variable interest entity. As of December 31, 2006, the variable interest entity had total assets of $347 million and total liabilities of $199 million. Our maximum exposure to loss on our equity investments at December 31, 2006 is limited to our investment of $15 million and our commitment to fund an additional $3 million of stand-by equity. In August 2006, the lenders providing the construction financing notified EBIC that it was in default of the terms of its debt agreement, which effectively prevented the project from making additional borrowings until such time as certain security interests in the ammonia plant assets related to the export facilities could be perfected. This default was cured on December 8, 2006 subject to submitting the remaining documentation in March 2007. Indebtedness under the debt agreement is non-recourse to us. No event of default has occurred pursuant to our EPC contract and we have been paid all amounts due from EBIC. In September 2006, we were instructed by EBIC to cease work on one location of the project on which the ammonia storage tanks were originally planned to be constructed due to a decision to relocate the tanks. The new location has been selected and the client and its lenders have agreed to compensate KBR for approximately $6 million in costs resulting from relocation of the storage tanks. We resumed work on the ammonia tanks in February 2007.

In July 2006, we were awarded, through a 50%-owned joint venture, a contract with Qatar Shell GTL Limited to provide project management and cost-reimbursable engineering, procurement and construction management services for the Pearl GTL project in Ras Laffan, Qatar. The project, which is expected to be completed by 2011, consists of gas production facilities and a GTL plant. The joint venture is considered a variable interest entity. We consolidate the joint venture for financial reporting purposes within our E&C segment because we are the primary beneficiary. As of December 31, 2006, the Pearl joint venture had total assets of $66 million and total liabilities of $56 million.

Note 21. Related Party Transactions

Historically, all transactions between Halliburton and KBR were recorded as an intercompany payable or receivable. At December 31, 2004, KBR had an outstanding intercompany payable to Halliburton of $1.2 billion. In October 2005, Halliburton contributed $300 million of the intercompany balance to KBR equity in the form of a capital contribution. On December 1, 2005, the remaining intercompany balance was converted to two long-term notes payable to Halliburton subsidiaries (Subordinated Intercompany Notes). At December 31, 2005, the outstanding aggregate principal balance of the Subordinated Intercompany Notes was $774 million and was to be paid on or before December 31, 2010. Interest on both notes, which accrued at 7.5% per annum, was payable semi-annually beginning June 30, 2006. The notes were subordinated to the Revolving Credit Facility. At December 31, 2005, the amount of $774 million is shown in the Consolidated Financial Statements as Notes Payable to Related Party. During the fourth quarter of 2006, we paid in full the $774 million of Subordinated Intercompany Notes.

In addition, Halliburton, through the date of our initial public offering in November 2006, continued to provide daily cash management services. Accordingly, we invested surplus cash with Halliburton on a daily basis, which will be returned as needed for operations. A Halliburton subsidiary executed a demand note payable (Halliburton

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Cash Management Note) for amounts outstanding under these arrangements. Annual interest on the Halliburton Cash Management Note has been based on the closing rate of overnight Federal Funds rate determined on the first business day of each month. Similarly, from time to time, borrowed funds from Halliburton, subject to limitations provided under the Revolving Credit Facility, on a daily basis pursuant to a note payable (KBR Cash Management Note). Annual interest on the KBR Cash Management Note is based on the six-month Eurodollar Rate plus 1.00%. In connection with our initial public offering in November of 2006, Halliburton repaid to us the $387 million balance in the Halliburton Cash Management note. At December 31, 2006, KBR has a $152 million balance payable to Halliburton which consists of amounts KBR owes Halliburton for estimated current year outstanding income taxes, amounts owed pursuant to our transition services agreement and other amounts.

We conduct business with other Halliburton entities on a commercial basis, and we recognize revenues as services are rendered and costs as they are incurred. Amounts billed to us by Halliburton were primarily for services provided by Halliburton s Energy Services Group on projects in the Middle East and were $0, $0 and $18 million for the years ended December 31, 2006, 2005 and 2004, respectively, and are included in cost of services in the consolidated statements of operations. Amounts we billed to Halliburton s Energy Services Group were $2 million, $1 million and $4 million for the years ended December 31, 2006, 2005 and 2004, respectively.

In addition to the transactions described above, Halliburton and certain of its subsidiaries provide various support services to KBR, including information technology, legal and internal audit. Costs for information technology, including payroll processing services, which totaled $11 million , $20 million and $19 million for the years ended December 31, 2006, 2005 and 2004, respectively, are allocated to KBR based on a combination of factors of Halliburton and KBR, including relative revenues, assets and payroll, and negotiation of the reasonableness of the charge. Costs for other services allocated to us were $23 million, $20 million and $20 million for the years ended December 31, 2006, 2005 and 2004, respectively. Costs for these other services, including legal services and audit services, are primarily charged to us based on direct usage of the service. Costs allocated to KBR using a method other than direct usage are not significant individually or in the aggregate. We believe the allocation methods are reasonable. In addition, KBR leases office space to Halliburton at its Leatherhead, U.K. location.

Historically, Halliburton has centrally developed, negotiated and administered our risk management process. This insurance program has included broad, all-risk coverage of worldwide property locations, excess worker s compensation, general, automobile and employer liability, director s and officer s and fiduciary liability, global cargo coverage and other standard business coverages. Net expenses of $17 million, $17 million and $20 million, representing our share of these risk management coverages and related administrative costs, have been allocated to us for the years ended December 31, 2006, 2005 and 2004, respectively. These expenses are included in cost of services in the consolidated statements of operations. Historically, we have been self insured, or have participated in a Halliburton self-insured plan, for certain insurable risks, such as general liability, property damage and workers compensation. However, subject to specific limitations, Halliburton has had umbrella insurance coverage for some of these risk exposures. In anticipation of our complete separation from Halliburton, we are developing our own stand-alone insurance and risk management policies that will provide substantially the same coverage. In connection with our initial public offering we obtained a stand-alone director and officer liability insurance policy. The insurance policies covering primary liability and marine cargo were separated between us and Halliburton in 2007. At the time of our complete separation from Halliburton certain other policies will be separated. We are also in the process of obtaining certain stand-alone insurance policies, including property coverage. Our property coverage will differ from prior coverage as appropriate to reflect the nature of our properties, as compared to Halliburton s properties.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

The balances for the related party transactions described above are reflected in the consolidated financial statements as due from parent or due to parent, as appropriate. The average intercompany balance for 2006 was $348 million. For 2005 and 2004, the average intercompany balance was $921 million and $1.2 billion respectively.

In connection with certain projects, we are required to provide letters of credit and guarantees to our customers. As of December 31, 2006, in addition to the $55 million of letters of credit outstanding under our Revolving Credit Facility, we had additional letters of credit and financial guarantees totaled approximately $621 million, of which approximately $516 million related to our joint venture operations, including $159 million issued in connection with the Allenby & Connaught project. The remaining $160 million of outstanding letters of credit relate to various other projects. Of the $676 million in letters of credit outstanding at December 31, 2006, $597 million are irrevocably and unconditionally guaranteed by Halliburton. In addition, Halliburton has guaranteed surety bonds and provided direct guarantees primarily related to our performance. Under certain reimbursement agreements, if we were unable to reimburse a bank under a paid letter of credit and the amount due is paid by Halliburton, we would be required to reimburse Halliburton for any amounts drawn on those letters of credit or guarantees in the future. We expect to cancel these letters of credit, surety bonds and other guarantees as we complete the underlying projects. (See Note 15.)

All of the charges described above have been included as costs of our operation in these consolidated financial statements. It is possible that the terms of these transactions may differ from those that would result from transactions among third parties.

Halliburton has incurred $14 million , $9 million and $8 million for the years ended December 31, 2006, 2005 and 2004, respectively, for expenses relating to the FCPA and bidding practices investigations described in Note 14. In 2004, $1.5 million of the $8 million incurred was charged to us. Except for this $1.5 million, Halliburton has not charged these costs to us. These expenses were incurred for the benefit of both Halliburton and us, and we and Halliburton have no reasonable basis for allocating these costs between Halliburton and us.

In connection with our initial public offering in November 2006, we entered into various agreements to complete the separation of our business from Halliburton, including, among others, a master separation agreement, transition services agreements and a tax sharing agreement. The master separation agreement provides for, among other things, our responsibility for liabilities relating to our business and the responsibility of Halliburton for liabilities unrelated to our business. Pursuant to our master separation agreement, we agreed to indemnify Halliburton for, among other matters, all past, present and future liabilities related to our business and operations. We agreed to indemnify Halliburton for liabilities under various outstanding and certain additional credit support instruments relating to our businesses and for liabilities under litigation matters related to our business. Halliburton agreed to indemnify us for, among other things, liabilities unrelated to our business, for certain other agreed matters relating to the FCPA investigations and the Barracuda-Caratinga project and for other litigation matters related to Halliburton s business. In connection with Halliburton s anticipated exchange offer, at Halliburton s request KBR and Halliburton amended the tax sharing agreement to clarify that the terms of the tax sharing agreement are applicable to the anticipated exchange offer and amended the registration rights agreement to contemplate that KBR will file a registration statement on Form S-4 with the SEC relating to the anticipated exchange offer sooner than 180 days after the completion of KBR s initial public offering. KBR s board of directors appointed a special committee, consisting of KBR s independent directors, which reviewed and approved these amendments. The special committee retained an independent financial advisor and independent legal counsel to assist it in connection with its review.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Under the transition services agreements, Halliburton is expected to continue providing various interim corporate support services to us and we will continue to provide various interim corporate support services to Halliburton. The tax sharing agreement provides for certain allocations of U.S. income tax liabilities and other agreements between us and Halliburton with respect to tax matters. The services provided under the transition services agreement between Halliburton and KBR are substantially the same as the services historically provided. Similarly, the related costs of such services will be substantially the same as the costs incurred and recorded in our historical financial statements. Further, the tax sharing agreement contains substantially the same tax sharing provisions as included in our previous tax sharing agreements.

On April 1, 2006, Halliburton contributed to us its interest in three joint ventures, which are accounted for using the equity method of accounting. These joint ventures own and operate offshore vessels equipped to provide various services, including accommodations, catering and other services to sea-based oil and gas platforms and rigs off the coast of Mexico. At March 31, 2006, the contributed interest in the three joint ventures had a book value of approximately $26 million.

We perform many of our projects through incorporated and unincorporated joint ventures. In addition to participating as a joint venture partner, we often provide engineering, procurement, construction, operations or maintenance services to the joint venture as a subcontractor. Where we provide services to a joint venture that we control and therefore consolidate for financial reporting purposes, we eliminate intercompany revenues and expenses on such transactions. In situations where we account for our interest in the joint venture under the equity method of accounting, we do not eliminate any portion of our revenues or expenses. We recognize the profit on our services provided to joint ventures that we consolidate and joint ventures that we record under the equity method of accounting primarily using the percentage-of-completion method. Total revenue from services provided to our unconsolidated joint ventures recorded in our consolidated statements of operations were $450 million, $249 million and $519 million for the years ended December 31, 2006, 2005 and 2004, respectively. Profit on transactions with our joint ventures recognized in our consolidated statements of operations were $62 million, $21 million and $50 million for the years ended December 31, 2006, 2005 and 2004, respectively.

Note 22. Retirement Plans

We have various plans that cover a significant number of our employees. These plans include defined contribution plans, defined benefit plans, and other postretirement plans:

- Our defined contribution plans provide retirement benefits in return for services rendered. These plans provide an individual account for each participant and have terms that specify how contributions to the participant s account are to be determined rather than the amount of pension benefits the participant is to receive. Contributions to these plans are based on pretax income and/or discretionary amounts determined on an annual basis. Our expense for the defined contribution plans totaled $46 million in 2006, $48 million in 2005, and $40 million in 2004. Additionally, we participate in a Canadian multi-employer plan to which we contributed $7 million, $24 million, and $20 million in 2006, 2005, and 2004, respectively;

- Our defined benefit plans are funded pension plans, which define an amount of pension benefit to be provided, usually as a function of age, years of service, or compensation; and

- Our postretirement medical plan is offered to specific eligible employees. This plan is contributory. Our liability is limited to a fixed contribution amount for each participant or dependent. The plan participants share the total cost for all benefits provided above our fixed contributions. Participants contributions are adjusted as required to cover benefit payments. We have made no commitment to

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

adjust the amount of our contributions; therefore, the computed accumulated postretirement benefit obligation amount is not affected by the expected future health care cost inflation rate.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires an employer to:

- recognize on its balance sheet the funded status (measured as the difference between the fair value of plan assets and the benefit obligation) of pension and other postretirement benefit plans;
- recognize, through comprehensive income, certain changes in the funded status of a defined benefit and postretirement plan in the year in which the changes occur;
- measure plan assets and benefit obligations as of the end of the employer s fiscal year; and
- disclose additional information.

The requirement to recognize the funded status of a benefit plan and the additional disclosure requirements are effective for fiscal years ending after December 15, 2006. Accordingly, we adopted SFAS No. 158 requirements for our fiscal year ending December 31, 2006.

The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end is effective for fiscal years ending after December 15, 2008. We will not elect early adoption of these additional SFAS No. 158 requirements and will adopt these requirements for our fiscal year ending December 31, 2008.

Benefit obligation and plan assets

We use a September 30 measurement date for our international plans and an October 31 measurement date for our domestic plans. Plan asset, expenses, and obligation for retirement plans are presented in the following tables.

	Pension Benefits				Other	
Benefit obligation	**United States**	**Int l**	**United States**	**Int l**	**Postretirement Benefits**	
Millions of dollars	**2006**		**2005**		**2006**	**2005**
Change in benefit obligation						
Benefit obligation at beginning of period	$ 46	$ 2,919	$ 45	$ 2,552	$ 1	$ 1
Service cost		50		50		
Interest cost	3	147	2	138		
Plan participants contributions		6		12	1	1
Settlements/curtailments				(59)		
Currency fluctuations		166		(35)		
Actuarial (gain) loss	1	206	1	341		
Transfers		11				
Benefits paid	(2)	(88)	(2)	(80)	(1)	(1)

Benefit obligation at end of period	$ 48	$ 3,417	$ 46	$ 2,919	$ 1	$ 1
Accumulated benefit obligation at end of period	$ 48	$ 2,925	$ 46	$ 2,453	$	$

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

	Pension Benefits				Other	
Plan assets	**United States**	**Int l**	**United States**	**Int l**	**Postretirement Benefits**	
Millions of dollars	**2006**		**2005**		**2006**	**2005**
Change in plan assets						
Fair value of plan assets at beginning of period	$ 38	$ 2,598	$ 33	$ 2,188	$	$
Actual return on plan assets	5	249	3	467		
Employer contributions		115	4	43		
Settlements and transfers		13				
Plan participants contributions		6		12	1	1
Currency fluctuations		148		(32)		
Benefits paid	(2)	(88)	(2)	(80)	(1)	(1)
Fair value of plan assets at end of period	$ 41	$ 3,041	$ 38	$ 2,598	$	$
Funded status	$ (7)	$ (376)	$ (8)	$ (321)	$ (1)	$ (1)
Amounts not yet recognized						
Employer contribution		22		8		
Unrecognized transition asset			(1)			
Unrecognized actuarial loss (gain)			20	475		(2)
Unrecognized prior service benefit				(10)		(2)
Net amount recognized	$ (7)	$ (354)	$ 11	$ 152	$ (1)	$ (5)
Amounts recognized on the consolidated balance sheet						
Prepaid benefit cost	$	$	$ 11	$ 152	$	$
Accrued benefit liability, including additional minimum liability			(19)	(163)		(5)
Accumulated other comprehensive income, net of tax			12	114		
Deferred tax asset			7	49		
Net amount recognized	$	$	$ 11	$ 152	$	$ (5)
Noncurrent assets	$	$	$ 11	$ 152	$	$
Current liabilities						
Noncurrent liabilities	(7)	(354)			(1)	(5)
Pension plans in which accumulated benefit obligation exceeds plan assets at December 31						
Projected benefit obligation	$ 48	$ 1,657	$ 46	$ 1,395		
Accumulated benefit obligation	48	1,558	46	1,283		
Fair value of plan assets	41	1,491	38	1,209		
Weighted-average assumptions used to determine benefit obligations at measurement date						
Discount rate	5.75%	5.00%	5.75%	5.00%	5.50%	5.75%
Rate of compensation increase	N/A	3.75%	N/A	3.5 -4.0%	N/A	N/A
Assumed health care cost trend rates at December 31						
Health care cost trend rate assumed for next year	N/A	N/A	N/A	N/A	10.0%	10.0%

Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	N/A	N/A	N/A	N/A	5.0%	5.0%
Year that the rate reached the ultimate trend rate	N/A	N/A	N/A	N/A	2011	2008

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Plan assets		Pension Benefits			
		United States	Int l	United States	Int l
Millions of dollars		2006		2005	
Asset allocation at December 31					
Asset category	**(target allocation 2007)**				
Equity securities	(50% 70%)	63%	63%	63%	62%
Debt securities	(30% 50%)	36%	35%	36%	30%
Other	(0% 5%)	1%	2%	1%	8%
Total	(100%)	100%	100%	100%	100%

Assumed long-term rates of return on plan assets, discount rates for estimating benefit obligations, and rates of compensation increases vary for the different plans according to the local economic conditions. The discount rate was determined based on the rates of return of high-quality fixed income investments as of the measurement date. For our United Kingdom pension plans, which constitute all of our international pension plans projected benefit obligation, the discount rate was determined by comparing the terms of the plans to the yield curve of a portfolio of high quality debt instruments at the measurement date, and was 5.0% at September 30, 2006. The discount rate for 2005 was based on the annualized yield of the iBoxx AA corporate bonds, and was 5.0% at September 30, 2005.

The overall expected long-term rate of return on assets was determined based upon an evaluation of our plan assets, historical trends, and experience, taking into account current and expected market conditions.

Our investment strategy varies by country depending on the circumstances of the underlying plan. Typically, less mature plan benefit obligations are funded by using more equity securities, as they are expected to achieve long-term growth while exceeding inflation. More mature plan benefit obligations are funded using more fixed income securities, as they are expected to produce current income with limited volatility. Risk management practices include the use of multiple asset classes and investment managers within each asset class for diversification purposes. Specific guidelines for each asset class and investment manager are implemented and monitored.

In accordance with SFAS 87, in 2006 we recognized a $77 million increase in additional minimum pension liability and a $9 million decrease in net deferred income taxes. We also recognized $57 million of other comprehensive income.

There was an additional charge to accumulated other comprehensive income of $152 million recognized with the adoption of SFAS 158 for a total net reduction to equity of $209 million.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

The incremental effect of applying SFAS No. 158 on individual line items in the consolidated balance sheet was as follows:

Millions of dollars	December 31, 2006 Before Adoption of SFAS No. 158	Adjustments	After Adoption of SFAS No. 158
Noncurrent deferred income taxes	$ 24	$ 107	$ 131
Other assets	263	(263)	
Total assets	$ 287	$ (156)	$ 131
Employee compensation and benefits	269	93	362
Total liabilities	$ 269	$ 93	$ 362
Minority interest in consolidated subsidiaries	$ (1)	$ (97)	$ (98)
Accumulated other comprehensive loss	(183)	(152)	(335)
Total liabilities and shareholders equity	$ 85	$ (156)	$ (71)

Amounts recognized in accumulated other comprehensive income were as follows:

Millions of dollars	Pension Benefits United States 2006	Int l	Other Postretirement Benefits 2006
Net actuarial loss (gain)	$ 11	$ 330	$ (2)
Prior service cost (benefit)		(3)	(1)
Total recognized in accumulated other comprehensive income	$ 11	$ 327	$ (3)

Expected cash flows

Contributions. Funding requirements for each plan are determined based on the local laws of the country where such plan resides. In certain countries the funding requirements are mandatory while in other countries they are discretionary. We currently expect to contribute $57 million to our international pension plans in 2007. We do not have a required minimum contribution for our domestic plans; however, we may make additional discretionary contributions, which will be determined after the actuarial valuations are complete.

Benefit payments. The following table presents the expected benefit payments over the next 10 years.

Millions of dollars	Pension Benefits United	Int l

	States	
2007	$ 2	$ 95
2008	2	97
2009	3	100
2010	3	105
2011	3	108
Years 2012 2016	16	613

Expected benefit payments for other postretirement benefits are immaterial.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Net periodic cost

	Pension Benefits					
	United States	**Int l**	**United States**	**Int l**	**United States**	**Int l**
Millions of dollars	**2006**		**2005**		**2004**	
Components of net periodic benefit cost						
Service cost	$	$ 50	$	$ 50	$	$ 68
Interest cost	2	147	2	138	2	123
Expected return on plan assets	(3)	(177)	(3)	(158)	(3)	(147)
Transition amount						(1)
Amortization of prior service cost		(1)		(1)		
Settlements/curtailments				5		
Recognized actuarial loss	1	20	1	14	1	15
Net periodic benefit cost	$	$ 39	$	$ 48	$	$ 58

For other postretirement plans, net periodic cost was immaterial for the years ended December 31, 2006, 2005, and 2004.

Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31	**Pension Benefits**						**Other Postretirement Benefits**		
	United States	**Int l**	**United States**	**Int l**	**United States**	**Int l**			
	2006		**2005**		**2004**		**2006**	**2005**	**2004**
Discount rate	5.75%	5.00%	5.75%	5.50%	6.25%	5.30%	5.75%	5.75%	6.25%
Expected return on plan assets	8.25%	7.00%	8.50%	7.00%	8.50%	7.00%	N/A	N/A	N/A
Rate of compensation increase	N/A	3.5 4.0%	N/A	4.00%	N/A	3.75%	N/A	N/A	N/A

Estimated amounts that will be amortized from accumulated other comprehensive income, net of tax, into net periodic benefit cost in 2007 are as follows:

	Pension Benefits	
Millions of dollars	**United States**	**International**

Actuarial (gain) loss	$	$	17
Prior service (benefit) cost			
Total	$	$	17

The majority of our postretirement benefit plans are not subjected to risk associated with fluctuations in the medical trend rates because the company subsidy is capped. We expect the amortization from other comprehensive income to be immaterial. Assumed health care cost trend rates are not expected to have a significant impact on the amounts reported for the total of the health care plans. A one-percentage-point change in assumed health care cost trend rates would not have a material impact on total of service and interest cost components or the postretirement benefit obligation.

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 23. Reorganization of Business Operations

In the fourth quarter of 2006, we committed to a restructuring plan that included broad based headcount reductions deemed necessary to reduce overhead and better position us for the future. In connection with this reorganization, we recorded restructuring charges totaling $5 million for severance, incentives, and other employee benefit costs for personnel whose employment was involuntarily terminated. Of this amount, $3 million relates to our Energy and Chemicals segment and $2 million relates to our Government and Infrastructure segment. The entire $5 million was included in General and administrative in the statements of operations as of December 31, 2006. These termination benefits were offered to approximately 139 personnel, with 66 receiving enhanced termination benefits. The terminated personnel located in the United States and United Kingdom. As of December 31, 2006, $5 million had not been paid. This amount is included in Accounts payable on the consolidated balance sheets.

Effective October 1, 2004, we restructured our business into two segments, G&I and E&C. In 2004, we recorded restructuring and related costs of $40 million related to the reorganization. The total restructuring charges consisted of $31 million in personnel termination benefits and $9 million in impairment charges on technology-related assets. For the year-ended December 31, 2004, $32 million of the restructuring charge was included in Cost of services and $8 million was included in General and administrative on the consolidated statements of operations. As of December 31, 2005, all amounts related to the 2004 restructuring had been paid and the balance in the restructuring reserve account was zero.

Table of Contents

KBR, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 24. Quarterly Data and Market Price Information *(Unaudited)*

Summarized quarterly financial data for the years ended December 31, 2006 and 2005 are as follows

(in millions, except per share amounts)	First	Second	Quarter Third	Fourth	Year
2006					
Revenue	$ 2,246	$ 2,439	$ 2,439	$ 2,509	$ 9,633
Operating income	60	(30)	95	121	246
Income from continuing operations	20	9	9	43	81
Income (loss) from discontinued operations	6	83	(2)		87
Net income	$ 26	$ 92	$ 7	$ 43	$ 168
Earnings per share:					
Basic and diluted income (loss) per share:					
Income from continuing operations(2)	$ 0.15	$ 0.07	$ 0.07	$ 0.28	$ 0.58
Income (loss) from discontinued operations(2)	0.04	0.61	(0.02)		0.62
Net income	$ 0.19	$ 0.68	$ 0.05	$ 0.28	$ 1.20
Common stock prices(1)					
High				$ 27.01	$ 27.01
Low				$ 20.75	$ 20.75
2005					
Revenue	$ 2,591	$ 2,512	$ 2,319	$ 2,724	$ 10,146
Operating income	95	109	143	108	455
Income from continuing operations	40				