

KBR, INC.
Form 10-K
February 26, 2008

Table of Contents

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

FORM 10-K

(Mark One)

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2007**

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
(State or other jurisdiction of
incorporation or organization)

20-4536774
(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 | |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark 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.

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting stock held by non-affiliates on June 29, 2007, was approximately \$3,907,000,000, determined using the closing price of shares of common stock on the New York Stock Exchange on that date of \$26.23.

As of February 21, 2008, there were 169,736,998 shares of KBR, Inc. Common Stock, \$0.001 par value per share, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the KBR, Inc. Company Proxy Statement for our 2008 Annual Meeting of Stockholders are incorporated by reference into Part III of this report.

TABLE OF CONTENTS

| | Page |
|---|-------------|
| <u>PART I</u> | 4 |
| <u>Item 1. Business</u> | 4 |
| <u>Item 1A. Risk Factors</u> | 14 |
| <u>Item 1B. Unresolved Staff Comments</u> | 27 |
| <u>Item 2. Properties</u> | 28 |
| <u>Item 3. Legal Proceedings</u> | 28 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 28 |
| <u>PART II</u> | 29 |
| <u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> | 29 |
| <u>Item 6. Selected Financial Data</u> | 31 |
| <u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 33 |
| <u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u> | 62 |
| <u>Item 8. Financial Statements and Supplementary Data</u> | 62 |
| <u>Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosures</u> | 117 |
| <u>Item 9A. Controls and Procedures</u> | 117 |
| <u>Item 9B. Other Information</u> | 118 |
| FINANCIAL STATEMENTS | |
| <u>Report of Independent Registered Public Accounting Firm</u> | 63 |
| <u>Consolidated Statements of Income</u> | 64 |
| <u>Consolidated Balance Sheets</u> | 65 |
| <u>Consolidated Statements of Shareholders' Equity</u> | 66 |
| <u>Consolidated Statements of Cash Flows</u> | 67 |
| <u>Notes to Consolidated Financial Statements</u> | 68 |
| <u>PART III</u> | 119 |
| <u>Item 10. Directors, Executive Officers and Corporate Governance</u> | 119 |
| <u>Item 11. Executive Compensation</u> | 119 |
| <u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> | 119 |
| <u>Item 13. Certain Relationships and Related Transactions, and Director Independence</u> | 119 |
| <u>Item 14. Principal Accounting Fees and Services</u> | 119 |
| <u>PART IV</u> | 119 |
| <u>Item 15. Exhibits and Financial Statement Schedules</u> | 119 |
| SIGNATURES | 159 |
| <u>List of Subsidiaries</u> | |
| <u>Consent of KPMG LLP - Houston, Texas</u> | |
| <u>Consent of KPMG - Adelaide, South Australia</u> | |
| <u>Certification of CEO Pursuant to Rule 13a-14(a)</u> | |
| <u>Certification of CFO Pursuant to Rule 13a-14(a)</u> | |
| <u>Certification Furnished Pursuant to Section 1350</u> | |
| <u>Certification Furnished Pursuant to Section 1350</u> | |

Table of Contents

Forward-Looking and Cautionary Statements

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** contained in Part I of this Annual Report on Form 10-K.*

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.

Table of Contents**PART I****Item 1. Business****General**

KBR, Inc. (KBR) is a leading global engineering, construction and services company supporting the energy, petrochemicals, government services and civil infrastructure sectors. We offer a wide range of services. Our business however, 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. We provide our wide range of services through six business units; Government and Infrastructure (G&I), Upstream, Services, Downstream, Technology and Ventures. During the third quarter of 2007, we announced the reorganization of our operations into six business units as a result of a change in operational and market strategies in order to maximize KBR's resources for future opportunities. During the fourth quarter of 2007, we revised our internal reporting structure which resulted in changes in the monthly financial and operating information provided to our chief operating decision maker. Prior to the reorganization, the business activities included in the Upstream, Services, Downstream and Technology business units had previously been reported as part of the Energy and Chemicals segment. Prior period information has been reclassified to conform with the new segment reporting structure. See Note 10 to the consolidated financial statements for financial information about our reportable business segments.

KBR, Inc. 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. 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 retained all of the KBR shares owned prior to the Offering and, as a result of the Offering, its 135,627,000 shares of common stock represented 81% of the outstanding common stock of KBR, Inc. after the Offering.

On February 26, 2007, Halliburton's board of directors approved a plan under which Halliburton would dispose of its remaining interest in KBR through a tax-free exchange with Halliburton's stockholders pursuant to an exchange offer. On April 5, 2007, Halliburton completed the separation of KBR by exchanging the 135,627,000 shares of KBR owned by Halliburton for publicly held shares of Halliburton common stock pursuant to the terms of the exchange offer (the Exchange Offer) commenced by Halliburton on March 2, 2007.

In connection with the Offering in November 2006 and the separation of our business from Halliburton, we entered into various agreements with Halliburton including, among others, a master separation agreement, tax sharing agreement, transition services agreements and an employee matters agreement. Refer to Separation from Halliburton in Management's Discussion and Analysis of Financial Condition and Results of Operation and Notes 2 and 20 to the consolidated financial statements for further discussion of the above agreements and other related party transactions with Halliburton.

On June 28, 2007, we completed the disposition of our 51% interest in Devonport Management Limited (DML) to Babcock International Group plc. DML owns and operates Devonport Royal Dockyard, one of Western Europe's largest naval dockyard complexes. Our DML operations, which was part of our G&I business unit, primarily involved refueling nuclear submarines and performing maintenance on surface vessels for the U.K. Ministry of Defence as well as limited commercial projects. In connection with the sale of our 51% interest in DML, we received \$345 million in cash proceeds, net of direct transaction costs, resulting in a gain of approximately \$101 million, net of tax of \$115 million.

In May 2006, we completed the sale of our Production Services group, which was part of our Services business unit. The Production Services group delivers a range of support services, including asset management and

optimization; brownfield projects; engineering; hook-up, commissioning and start-up; maintenance management and execution; and long-term production operations, to oil and gas exploration and production customers. 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 in the year ended December 31, 2006.

Table of Contents

In accordance with the provisions of Statement of Financial Accounting Standards No. 144 Accounting for Impairment or Disposal of Long-Lived Assets, the results of operations of the Production Services group and DML for the current and prior periods have been reported as discontinued operations in our consolidated statements of income. See Note 25 to the consolidated financial statements for information about discontinued operations.

Our Business Units

Government and Infrastructure. Our G&I business unit provides 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 deliver on-demand support services across the full military mission cycle from contingency logistics and field support to operations and maintenance on military bases. A significant portion of our G&I business unit's current operations relate to the support of the United States government operations in the Middle East, which we refer to as our Middle East operations, one of the largest U.S. military deployments since World War II. In the civil infrastructure market, we operate in diverse sectors, including transportation, waste and water treatment and facilities maintenance. We design, construct, maintain and operate and manage civil infrastructure projects ranging from airport, rail, highway, water and wastewater facilities, and mining and mineral processing to regional development programs and major events. We provide many of these services to foreign governments such as the United Kingdom and Australia.

Upstream. Our Upstream business unit provides a full range of services for large, complex upstream projects, including liquefied natural gas (LNG), gas-to-liquids (GTL), onshore oil and gas production facilities, offshore oil and gas production facilities, including platforms, floating production and subsea facilities, and onshore and offshore pipelines. In gas-to-liquids, we are leading the construction of two of the world's three gas-to-liquids projects under construction or start-up, the size of which exceeds that of almost any other in the industry. Our Upstream business unit has designed and constructed some of the world's most complex onshore facility and pipeline projects and, in the last 30 years, more than half of the world's operating LNG liquefaction capacity. In oil & gas, we provide integrated engineering and program management solutions for offshore production facilities and subsea developments, including the design of the largest floating production facility in the world to date.

Services. Our Services business unit provides construction and industrial services built on the legacy established by the founders Brown & Root almost 100 years ago. Our construction services include major project construction, construction management and module and pipe fabrication services. Our industrial services include routine maintenance, small capital and turnaround services as well as the full range of high value services including startup commissioning, procurement support, facility services, supply chain solutions, and electrical and instrumentation solutions. We also provide offshore maintenance and construction services to oil and gas facilities using semisubmersible vessels in the Bay of Campeche through a jointly held venture. Our services are delivered to customers in variety of industries including the petrochemical, refining, pulp and paper, and energy industries.

Downstream. Our Downstream business unit serves clients in the petrochemical, refining, coal gasification and syngas markets, executing projects throughout the world. We leverage our differentiated process technologies, some of which are the most efficient ones available in the market today, and also execute projects using non-KBR technologies, either alone or with joint venture or alliance partners to a wide variety of customers. Downstream's work with KBR's Ventures business unit has resulted in creative equity participation structures such as our Egypt Basic Industries Corporation Ammonia plant which offers our customers unique solutions to meet their project development needs. We are a leading contractor in the markets that we serve delivering projects through a variety of service offerings including front end engineering design (FEED), detailed engineering, EPC, EPCM and Program Management. We are dedicated to providing life cycle value to our customers.

Technology. Our Technology business unit offers differentiated process technologies, some of which are the most efficient ones available in the market today, including value-added technologies in the coal monetization, petrochemical, refining and syngas markets. We offer technology licenses, and, in conjunction with our Downstream business unit, offer project management and engineering, procurement and construction for integrated solutions worldwide. We are one of a few engineering and construction companies to possess a technology center, with 80 years of experience in technology research and development.

Ventures. Our Ventures business unit develops, provides assistance in arranging financing for, makes equity and/or debt investments in and participates in managing entities owning assets generally from projects in which one of our other business units has a direct role in engineering, construction, and/or operations and maintenance. The creation of the Ventures business unit provides management focus on our investments in the entities that own the assets. Projects developed and under

Table of Contents

current management include government services, such as defense procurement and operations and maintenance services for equipment, military infrastructure construction and program management, toll roads and railroads, and energy and chemical plants.

Our Significant Projects

The following table summarizes several significant contracts under which our business units are currently providing or have recently provided services.

G&I-Middle East

| Project Name | Customer Name | Location | Contract Type | Description |
|---------------------|----------------------|-----------------|----------------------|-------------------------------|
| LogCAP III | U.S. Army | Worldwide | Cost-reimbursable | Contingency support services. |

G&I-Americas

| Project Name | Customer Name | Location | Contract Type | Description |
|-----------------------------------|--|-----------------|--|--|
| Los Alamos National Security, LLC | University of California for the U.S. Department of Energy | New Mexico | Cost-reimbursable | Site support 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. |
| DOCCC-Office of Space Launch | NRO Office of Space Launch | USA | Fixed-price plus award fee | Provide on call project management, construction management and related support for mission critical facilities at Cape Canaveral and other locations. |

G&I-International

| Project Name | Customer Name | Location | Contract Type | Description |
|--|---|-----------------|-----------------------------------|---|
| Aspire Defence-Allenby & Connaught Accommodation Project | Aspire Defence U.K. Ministry of Defence | U.K. | Fixed-price and cost-reimbursable | Design, build and finance the upgrade and service of army facilities. |
| Temporary Deployable Accommodations (TDA) | U.K. Ministry of Defence | Worldwide | Fixed-price | Battlefield infrastructure support. |

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|----------------|--|-----------|--|--|
| CONLOG | U.K. Ministry of Defence | Worldwide | Combination of fixed-price and cost-reimbursable | Provide contingency support services to MOD. |
| Scottish Water | Scottish Water | Scotland | Cost-reimbursable | Program management of water assets renewal. |
| Palm Island | Nakheel-Dubai | Dubai | Cost-plus | Program management for Palm Island facilities development. |
| Hope Downs DES | Rio Tinto for Hope Downs joint venture | Australia | Cost-reimbursable | EPCM services supporting mine development. |
| Air 87 | Australian Aerospace for the Australian Army | Australia | Fixed-price | Helicopter training services to support the acquisition of a new helicopter. |

Table of Contents**Upstream- Gas Monetization**

| 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 Pertamina 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 Train 6 | Nigeria LNG Ltd. | Nigeria | Fixed-price | EPC-CS services for one LNG liquefaction train; working through TSKJ joint venture. |
| Skikda LNG | Sonatrach | Algeria | Fixed-price and cost-reimbursable | EPC-CS services for one LNG liquefaction train. |
| Escravos GTL | Chevron Nigeria Ltd & Nigeria National Petroleum Corp. | Nigeria | Cost-reimbursable | 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 (FEED) work and project management for the overall complex and EPCm for the GTL synthesis and utilities portions of the complex; joint venture with JGC. |

Upstream-Offshore

| 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. |
| Block 18 Greater Plutonio | British Petroleum Angola | Angola | Cost-reimbursable | EPCm services for a floating production storage and offloading unit and subsea facilities. |

| | | | | |
|----------|------|------------|-------------------|--|
| Kashagan | AGIP | Kazakhstan | Cost-reimbursable | Project management services for the development of multiple facilities in the Caspian Sea. |
|----------|------|------------|-------------------|--|

Upstream-Other

| Project Name | Customer Name | Location | Contract Type | Description |
|---------------------|----------------------|-----------------|----------------------|---|
| KEP2010 | Statoil Hydro | Norway | Cost-reimbursable | Engineering and support services for the overall construction for the upgrade of a gas plant. |

Table of Contents**Services**

| Project Name | Customer Name | Location | Contract Type | Description |
|---------------------|---------------------------|-----------------|----------------------|--|
| Hydrogen Project | Air Products | Canada | Cost-reimbursable | Mechanical services for hydrogen production facility. |
| Texas Instruments | Texas Instruments | Texas | Cost-reimbursable | Maintenance operations and small capital projects at multiple campuses. |
| Bassell | Bassell | Texas | Cost-reimbursable | Direct hire, maintenance and other services for chemical plants. |
| Scotford ASOP | Shell Canada | Canada | Cost-reimbursable | Provision of direct hire construction services for oil sands upgrader project. |
| NWU/Lurgi Gassifier | Northwest Upgrader/ Lurgi | Canada | Cost-reimbursable | Provision of direct hire construction services for oil sands upgrader project. |

Downstream

| 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. |
| 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 |
| Ras Tanura Integrated Project | Dow and Saudi Aramco | Saudi Arabia | Cost-reimbursable | FEED and PM/CM of an integrated refinery and Petrochemical complex. |
| Yanbu Export Refinery Project | Aramco Services Co. and ConocoPhillips Yanbu Ltd. | Saudi Arabia | Cost-reimbursable | Program management services including FEED for a new 400,000 barrels per day green field export refinery. |
| Ammonia Plant | Egypt Basic Industries Corporation | Egypt | Fixed-price | EPC-CS services for an ammonia plant based on KBR Advanced Ammonia Process |

technology.

Technology

| Project Name | Customer Name | Location | Contract Type | Description |
|---------------------|----------------------|-----------------|----------------------|--|
| Moron Ammonia Plant | Ferrostaal | Venezuela | Fixed-price | Technology license and engineering services. |

Ventures

| Project Name | Customer Name | Location | Contract Type | Description |
|--|--------------------------|-----------------|-----------------------------------|---|
| APT/ FreightLink Alice Springs-Darwin Railway | Various | Australia | Fixed-price and market rates | Design, build, own, finance and operate railway/freight services. |
| Egypt Basic Industries (EBIC)-Ammonia Project | Various | Egypt | Market rates | Design, build, own, finance and operate ammonia projection plant. |
| Aspire Defence-Allenby & Connaught Defence Accommodation Project | U.K. Ministry of Defence | U.K. | Fixed-price and cost-reimbursable | Design, build and finance the upgrade and service of army facilities. |

See Note 10 to the consolidated financial statements for financial information about our reportable business segments.

Table of Contents

Our Business Strategy

Our business strategy is to increase shareholder value by delivering consistent, predictable financial results in growth markets. We will also pursue targeted merger and acquisition activity to complement organic growth and accelerate implementation of individual Business Unit strategies. Key features of our business unit strategies include:

The Government and Infrastructure business unit will broaden its service offerings to existing customers and cross-sell to adjacent markets.

The Upstream business unit will build on its world-class strength in gas monetization and regain its leading position in offshore oil and gas services.

The Services business unit will grow organically by expanding existing operations while pursuing new offerings that capitalize on our brand reputation and legacy core competencies.

The Downstream business unit will grow its business by leveraging our leading technologies and execution excellence to provide life-cycle value to customers.

The Technology business unit will expand its range of differentiated process technologies and increase its proprietary equipment and catalyst offerings.

The Ventures business unit will differentiate the offerings of our business units by investing capital and arranging project finance.

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;

technical excellence or differentiation;

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 89% of our consolidated revenue during 2007, 85% of our consolidated revenue during 2006 and 86% of our consolidated revenue during 2005. Revenue from our operations in Iraq, primarily related to our work for the U.S. government was 50% of our consolidated revenue in 2007, 49% of our consolidated revenue in 2006 and 55% in 2005.

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.

Table of Contents

Please read Management's Discussion and Analysis of Financial Condition and Results of Operations, Financial Instruments Market Risk, and Note 18 to our consolidated financial statements for information regarding our exposures to foreign currency fluctuations, risk concentration, and financial instruments used to manage our risks.

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 of our significant joint ventures and alliances are described below. All joint venture ownership percentages presented are as of December 31, 2007.

We began working with JGC Corporation (JGC) 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. KBR and JGC have been awarded 24 FEED and/or EPC-CS contracts for LNG and GTL facilities, and have completed over 35 million metric tons per annum of LNG capacity between 2000 and 2007. We operate this alliance through global hubs in Houston, Yokohama and London.

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 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 Group 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 nearing completion on a sixth such facility. We account for this investment using the equity method of accounting.

KSL is a joint venture with Shaw Group and Los Alamos Technical, formed to provide support services to the Los Alamos National Security, LLC in New Mexico. We are a 55% owner and the managing partner of KSL. The joint venture serves as subcontractor to Los Alamos National Security (LANS), which in December 2005 won a rebid for laboratory operatorship. As part of the rebid, LANS 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.

APT/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, Carillion Plc. and a financial investor formed to contract with the U.K. Ministry of Defence 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 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 our investments in these entities using the equity method of accounting.

MMM is a joint venture formed under a Partners Agreement with Grupo R affiliated entities. The principal Grupo R entity is Corporative Grupo R, S.A. de C.V. and Discoverer ASA, Ltd a Cayman Islands company. The partners agreement covers five joint venture entities related to the Mexico contract with PEMEX. The MMM joint venture was set up under Mexican maritime law in order to hold navigation permits to operate in Mexican waters. The scope of the business is to render services of maintenance, repair and restoration of offshore oil and gas platforms and provisions of quartering in the territorial waters of Mexico. We own a 50% interest in MMM and in each of the four other joint ventures. We account for our investment in these entities using the equity method of accounting.

Table of Contents**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 \$3.1 billion and \$4.4 billion at December 31, 2007 and 2006, 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 \$3.2 billion at December 31, 2007 and \$2.9 billion at December 31, 2006.

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.

Backlog⁽¹⁾⁽²⁾

| (in millions) | December 31, | |
|--|---------------------|-----------------|
| | 2007 | 2006 |
| G&I: | | |
| U.S. Government Middle East Operations | \$ 1,361 | \$ 2,969 |
| U.S. Government Americas Operations | 548 | 715 |
| International Operations | 2,339 | 2,380 |
| Total G&I | \$ 4,248 | \$ 6,064 |
| Upstream: | | |
| Gas Monetization | 6,606 | 3,908 |
| Offshore Projects | 173 | 157 |
| Other | 118 | 698 |
| Total Upstream | \$ 6,897 | \$ 4,763 |
| Services | 765 | 277 |
| Downstream | 313 | 578 |
| Technology | 128 | 95 |
| Ventures | 700 | 660 |

| | | |
|---|-----------|-----------|
| Total backlog for continuing operations | \$ 13,051 | \$ 12,437 |
|---|-----------|-----------|

(1) Our backlog for continuing operations does not include backlog associated with DML, which was sold in the second quarter of 2007 and is accounted for as discontinued operations. Backlog for DML was \$1.1 billion as of December 31, 2006.

(2) Our G&I business unit's total backlog from continuing operations attributable to firm orders was \$4.0 billion as of December 31, 2007 and 2006. Our G&I business unit's total backlog from continuing operations attributable to unfunded orders was \$0.2 billion and \$2.1 billion as of December 31, 2007 and 2006, respectively.

We estimate that as of December 31, 2007, 45% of our backlog will be complete within one year. As of December 31, 2007, 28% of our backlog for continuing operations was attributable to fixed-price contracts and 72% was attributable to

Table of Contents

cost-reimbursable contracts. For contracts that contain both fixed-price and cost-reimbursable components, we classify the components as either fixed-price or cost-reimbursable according to the composition of the contract except for smaller contracts where 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 the third quarter of 2008 under the LogCAP III contract in our G&I-Middle East operations. As of December 31, 2007, our backlog under the LogCAP III contract was \$1.4 billion. In July 2007, we were awarded the EPC contract for the Skikda LNG project for approximately \$2.8 billion. As of December 31, 2007, the Skikda backlog was \$2.7 billion and was included in our Upstream-Gas Monetization operations.

Contracts

Our contracts can be broadly categorized as either cost-reimbursable or fixed-price, the latter sometimes being 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 business unit provides substantial work under government contracts with the Department of Defense (DoD), the Ministry of Defense (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 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 business unit, represented 62% of our 2007 consolidated revenue, 66% of our 2006 consolidated revenue, and 71% of our 2005 consolidated revenue. 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, *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

Table of Contents

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 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.

Technology Development

We own and operate a technology center in Houston, Texas, where we collaborate 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 CO₂ sequestration to reduce CO₂ emissions by capturing and injecting them underground. Our expenditures for research and development activities were \$1 million in 2007, \$2 million in 2006 and \$2 million in 2005, which are classified as a component of general and administrative expenses in our consolidated statements of income. 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, 2007, we had over 52,000 employees in our continuing operations, of which approximately 2.6% 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.

Table of Contents

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.

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 by complying 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 make estimates of the amount of costs associated with known environmental contamination that we will be required to remediate and record accruals to recognize those estimated liabilities. Our estimates are based on the best available information and are updated whenever new information becomes known. For certain locations including our property at Clinton Drive, we have not completed our analysis of the site conditions and until further information is available, we are only able to estimate a possible range of remediation costs. This range of costs could change depending on our ongoing site analysis and the timing and techniques used to implement remediation activities. 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. During 2007, we increased our accrual from approximately \$4 million to \$7 million for the estimated assessment and remediation costs associated with all environmental matters, which represents the low end of the range of possible costs that could be as much as \$15 million.

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

Risks Related to Our Customers and Contracts

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

Our G&I business unit 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 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. 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, under which certain task orders have been extended by the DoD through in the third quarter of 2008. In June 2007, we were selected as one of the executing contractors under the LogCap IV

Table of Contents

contract to provide logistics support to U.S. Forces deployed in the Middle East and elsewhere. Since the award of the LogCAP IV contract, unsuccessful bidders have brought actions at the Government Accountability Office (GAO) protesting the contract award. GAO has rendered a decision upholding portions of the bid protests. Currently, the DoD has implemented a process to reevaluate the previous contract awards in accordance with GAO's decision. We expect DoD's reevaluation will be completed in the first quarter of 2008. Even if our award of a portion of the LOGCAP IV contract is reconfirmed and we are awarded a portion of the LogCAP IV contract, we expect our overall volume of work to decline as our customer scales back its requirement for the types and the amounts of services we provide.

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 62% of our revenues in 2007, 66% in 2006 and 71% in 2005. 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.

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.

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 Upstream, Services, Downstream, and Technology business units depend 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 our services 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;

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.

Table of Contents

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

Demand for our services 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 these projects, worldwide resource constraints, escalating material and equipment prices, and ongoing supply chain pricing pressures have caused delays in awards of and, in other cases, cancellations of major gas monetization and upstream prospects. Any delays could impact our long term projected results. 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. Prior to the separation from Halliburton we had 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. Since the separation from Halliburton we have been engaged in discussions with surety companies and have arranged lines with multiple firms for our own stand-alone capacity. Since the arrangement of this stand alone capacity we have been sourcing our surety bonds from our own capacity without Halliburton credit support. We continue to engage in discussions with other surety companies about additional stand-alone surety bond capacity. 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. Prior to our initial public offering, Halliburton 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. 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.

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

Table of Contents

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 Relationship 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 has resulted in a more limited use of agents on large-scale international projects than in the past. 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 are 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, 2007, 28% of our backlog for continuing operations was attributable to fixed-price contracts and 72% 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.

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

Table of Contents

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.

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.

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.

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

Table of Contents

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.

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 have identified issues for disclosure, and it is possible that we will identify additional issues for disclosure. Specifically, 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 applicable regulations. Please read *Management's Discussion and Analysis of Financial Condition and Results of Operations - U.S. Government Matters - Investigations Relating to Iraq, Kuwait and Afghanistan* for more information. We expect to incur legal and other costs, which could include penalties, in connection with these export control disclosures and investigations.

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. 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. Although we believe Petrobras is responsible for any maintenance and replacement of the bolts, it is possible that the arbitration panel could find against us on this issue. Consequences of this matter could have a material adverse effect on our results of operations, financial condition and cash flow. Please read *Management's Discussion and Analysis of Financial Condition and Results of Operations - Business Environment and Results of Operations* for further discussion. ***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

Table of Contents

probable unapproved claims. For example, we are involved in several arbitration matters with PEMEX as discussed in Note 6 to our consolidated financial statements.

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, 2007, 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. Please read *Management's Discussion and Analysis of Financial Condition and Results of Operations - Legal Proceedings - FCPA Investigations* for more information.

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.

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.

Table of Contents

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 2007, we had revenue of \$5.4 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 2007, we had revenue of \$224 million 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

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, and the amount of dividends we can declare to pay or equity shares that can be repurchased. 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

Table of Contents

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 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 and other customers to finance large-scale projects, such as railroads, and major military equipment, capital project and service 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 in projects of this type include the Alice Springs-Darwin railroad in Australia and the Egypt Basic Industries Corporation ammonia plant in Egypt. Please read Note 19 to our consolidated financial statements for further discussion of these projects.

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

Table of Contents

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 current business strategy relies on acquisitions. Acquisitions of other companies present certain risks and uncertainties.

We see business merger and acquisition activities as an integral means of achieving our goal of capturing additional market share within our business unit. As a result, we may incur certain additional risks accompanying these activities. These risks include the following:

We may not identify or complete future acquisitions conducive to our current business strategy;

Any future acquisition activities may not be completed successfully as a result of potential strategy changes, competitor activities, and other unforeseen elements associated with merger and acquisition activities;

Valuation methodologies may not accurately capture the value proposition;

Future completed acquisitions may not be integrated within our operations with the efficiency and effectiveness initially expected resulting in a potentially significant detriment to the associated product service line financial results, and pose additional risks to our operations as a whole;

We may have difficulty managing the growth from merger and acquisition activities;

Key personnel within an acquired organization may resign from their related positions resulting in a significant loss to our strategic and operational efficiency associated with the acquired company;

The effectiveness of our daily operations may be reduced by the redirection of employees and other resources to acquisition activities;

We may assume liabilities of an acquired business (e.g. litigation, tax liabilities, contingent liabilities, environmental issues), including liabilities that were unknown at the time the acquisition, that pose future risks to our working capital needs, cash flows and the profitability of related operations;

Business acquisitions often may include unforeseen substantial transactional costs to complete the acquisition that exceed the estimated financial and operational benefits;

We may experience significant difficulties in integrating our current system of internal controls into the acquired operations; and

Future acquisitions may require us to obtain additional equity or debt financing, which may not be available on attractive terms. Moreover, to the extent an acquisition transaction results in additional goodwill, it will reduce our tangible net worth, which might have an adverse effect on our credit capacity.

If we need to sell or issue additional common shares to finance future acquisitions, our existing shareholder ownership could be diluted.

Part of our business strategy is to expand into new markets and enhance our position in existing markets both domestically and internationally through the merging and acquiring of complementary businesses. To successfully fund and complete such identified, potential acquisitions, we may issue additional equity securities that have the potential to dilute our earnings per share and our existing shareholder ownership.

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 89% of our consolidated revenue during 2007, 85% of our consolidated revenue during 2006 and 86% of our consolidated revenue during 2005. Based on the location of services provided, 50% of our consolidated revenue in 2007, 49% in 2006 and 55% in 2005 was from our operations in Iraq, primarily related to our work for the United States government. Operations in countries other than the

Table of Contents

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 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.

Table of Contents

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 does 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, 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 *Risks Related to Our Relationship with Halliburton 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.

As part of the master separation agreement, Halliburton has agreed to indemnify us for certain FCPA Matters, but we had to agree that Halliburton will, 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. 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

Table of Contents

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 Management's Discussion and Analysis of Financial Condition and Results of Operations 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. 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

Table of Contents

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 exchange fails 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 exchange offer, 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 with representations that have been made to the Internal Revenue Service in connection with the private letter ruling that Halliburton has received. If we breach 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 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 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 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. 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 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 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.

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, since our separation from Halliburton, 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 became effective following the exchange offer. 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.

Item 1B. Unresolved Staff Comments

None

27

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 Segment |
|--|-----------------------|---------------------------|-------------------------|
| Houston, Texas | Leased ⁽¹⁾ | High-rise office facility | All and Corporate |
| Arlington, Virginia | Leased | High-rise office facility | G&I |
| Houston, Texas | Owned | Campus facility | All and Corporate |
| Leatherhead, United Kingdom | Owned | Campus facility | All |
| Greenford, Middlesex United Kingdom | Owned ⁽²⁾ | High-rise office facility | All |

(1) At December 31, 2007, we had a 50% interest in a joint venture which owns this office facility.

(2) At December 31, 2007, we had a 55% interest in a joint venture which owns this office 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, which are currently for sale, covering approximately 300 acres in Scotland. 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 **Risk Factors** contained in Part I of this Annual Report on Form 10-K and **Management's Discussion and Analysis of Financial Condition and Results of Operations** and in Notes 8, 13 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 2007.

Table of Contents**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock is traded on the New York Stock Exchange under the symbol KBR. The following table sets forth, on a per share basis for the periods indicated, the high and low sale prices per share for our common stock as reported by the New York Stock Exchange:

| | High | Low |
|--|-------------|------------|
| Fiscal Year 2006 (1) | | |
| First quarter ended March 31, 2006 | \$ | \$ |
| Second quarter ended June 30, 2006 | | |
| Third quarter ended September 30, 2006 | | |
| Fourth quarter ended December 31, 2006 | 27.01 | 20.75 |
| Fiscal Year 2007 | | |
| First quarter ended March 31, 2007 | \$26.10 | \$19.66 |
| Second quarter ended June 30, 2007 | 29.32 | 20.13 |
| Third quarter ended September 30, 2007 | 40.38 | 26.31 |
| Fourth quarter ended December 31, 2007 | 45.24 | 33.76 |

(1) In November 2006, we completed an initial public offering of our common stock at an offering price of \$17.00 per share.

At February 21, 2008, there were 152 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.

We have not paid cash dividends nor repurchased shares of our common stock. Our \$850 million revolving credit facility restricts, among other things, our ability to pay dividends and to engage in equity repurchases of our common stock. On January 17, 2008, we entered into an Agreement and Amendment to the Revolving Credit Facility effective as of January 11, 2008, (the Amendment). The Amendment, among other things, permits us to declare and pay shareholder dividends and/or engage in equity repurchases not to exceed an agreement amount of \$400 million. See Note 12 to the consolidated financial statements. While we have historically not paid cash dividends, we may consider paying dividends on our common stock in the future. The declaration and payment of any future dividends will be at the discretion of our 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.

The information required by this item regarding securities authorized for issuance under equity compensation plans is incorporated by reference to the information set forth in Item 12 of this Form 10-K.

Table of Contents**Performance Graph**

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 | 12/29/2006 | 3/30/2007 | 6/29/2007 | 9/28/2007 | 12/31/2007 |
|---------------------------------|-------------------|-------------------|------------------|------------------|------------------|-------------------|
| KBR | \$ 100.00 | \$ 126.07 | \$ 98.07 | \$ 126.41 | \$ 186.84 | \$ 186.99 |
| Dow Jones Heavy Construction | 100.00 | 103.62 | 110.46 | 153.21 | 182.58 | 196.48 |
| Russell 1000 | 100.00 | 101.31 | 102.08 | 107.64 | 109.27 | 105.22 |

Table of Contents**Item 6. Selected Financial Data**

The following table presents selected financial data for the last five years. 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, (a) (b) | | | | |
|--|--|-------------|-------------|-------------|-------------|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| | (In millions, except for per share amounts) | | | | |
| Statements of Operations Data: | | | | | |
| Total revenue | \$ 8,745 | \$ 8,805 | \$ 9,291 | \$ 11,173 | \$ 8,244 |
| Operating costs and expenses: | | | | | |
| Cost of services | 8,225 | 8,433 | 8,858 | 11,427 | 8,200 |
| General and administrative | 226 | 226 | 158 | 161 | 164 |
| Gain on sale of assets, net | | (6) | (110) | | (4) |
| Operating income (loss) | 294 | 152 | 385 | (415) | (116) |
| Interest expense related party | | (36) | (24) | (15) | (36) |
| Interest income (expense), net | 62 | 27 | (1) | 5 | 1 |
| Foreign currency gains, net related party | | 1 | 3 | (18) | (12) |
| Foreign currency gains (losses), net | (15) | (16) | 2 | 6 | 12 |
| Other, net | 1 | | (1) | (2) | (1) |
| Income (loss) from continuing operations before income taxes and minority interest | 342 | 128 | 364 | (439) | (152) |
| Benefit (provision) for income taxes | (138) | (94) | (160) | 113 | 3 |
| Minority interest in net income of consolidated subsidiaries | (22) | 20 | (19) | (7) | (9) |
| Income (loss) from continuing operations | 182 | 54 | 185 | (333) | (158) |
| Income from discontinued operations, net of tax provisions | 120 | 114 | 55 | 30 | 25 |
| Net income (loss) | \$ 302 | \$ 168 | \$ 240 | \$ (303) | \$ (133) |
| Basic income (loss) per share: | | | | | |
| Continuing operations | \$ 1.08 | \$ 0.39 | \$ 1.36 | \$ (2.45) | \$ (1.16) |
| Discontinued operations | 0.71 | 0.81 | 0.40 | 0.22 | 0.18 |
| Basic income (loss) per share | \$ 1.80 | \$ 1.20 | \$ 1.76 | \$ (2.23) | \$ (0.98) |
| Diluted income (loss) per share: | | | | | |
| Continuing operations | \$ 1.08 | \$ 0.39 | \$ 1.36 | \$ (2.45) | \$ (1.16) |
| Discontinued operations | 0.71 | 0.81 | 0.40 | 0.22 | 0.18 |
| Diluted income (loss) per share | \$ 1.79 | \$ 1.20 | \$ 1.76 | \$ (2.23) | \$ (0.98) |
| Basic weighted average shares outstanding | 168 | 140 | 136 | 136 | 136 |
| Diluted weighted average shares outstanding | 169 | 140 | 136 | 136 | 136 |

Other Financial Data:

| | | | | | | | | | | |
|---|----|----|----|----|----|----|----|----|----|----|
| Capital expenditures (c) | \$ | 36 | \$ | 47 | \$ | 51 | \$ | 56 | \$ | 42 |
| Depreciation and amortization expense (d) | | 31 | | 29 | | 29 | | 28 | | 31 |
| | | 31 | | | | | | | | |

Table of Contents

| | 2007 | 2006 | At December 31, 2005 (In millions) | 2004 | 2003 |
|---|----------|----------|---|--------|--------|
| Balance Sheet Data: | | | | | |
| Cash and equivalents | \$ 1,861 | \$ 1,410 | \$ 362 | \$ 220 | \$ 417 |
| Net working capital | 1,433 | 915 | 944 | 765 | 882 |
| Property, plant and equipment, net | 220 | 211 | 185 | 178 | 181 |
| Total assets | 5,203 | 5,414 | 5,182 | 5,487 | 5,532 |
| Total debt (including due to and notes payable to parent) | | | 774 | 1,189 | 1,242 |
| Shareholders equity | 2,267 | 1,794 | 1,256 | 812 | 944 |

- (a) In May 2006 we completed the sale of our Production Services group and in June 2007 we completed the disposition of our 51% interest in DML. The results of operations of Production Services group and DML for all periods presented have been reported as discontinued operations. See Note 25 to the consolidated financial statements for information about discontinued operations.
- (b) We reclassified certain overhead expenses in our prior period statements of income previously recorded as cost of services to general and administrative expense in our statements of income. These expenses relate to certain overhead expenses and indirect costs that were previously managed and reported within our business units but are now managed and reported at a corporate level. These expenses were reclassified to allow transparency of business unit margins and general and administrative expense consistent with the nature of the underlying costs and the manner in which the costs are managed. See Note 1 to the consolidated financial statements for further discussion of this reclassification.
- (c) Capital expenditures does not include capital expenditures for DML, which was sold in the second quarter of 2007 and is accounted for as discontinued operations. Capital expenditures for DML was \$7 million, \$10 million, \$25 million, \$18 million and \$21 million for the years ended December 31, 2007, 2006, 2005, 2004 and 2003, respectively.
- (d) Depreciation and amortization expense does not include depreciation and amortization expense for DML, which was sold in the second quarter of 2007 and is accounted for as discontinued operations. Depreciation and amortization expense for DML was \$10 million, \$18 million, \$27 million, \$24 million and \$20 million for the years ended December 31, 2007, 2006, 2005, 2004 and 2003, respectively.

Table of Contents**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations****Introduction**

The purpose of management's discussion and analysis (MD&A) is to increase the understanding of the reasons for material changes in our financial condition, results of operations, liquidity and certain other factors that may affect our future results. The MD&A should be read in conjunction with the consolidated financial statements and related notes included in Item 8 of this Annual Report on Form 10-K.

Executive Overview*Summary of Consolidated Results*

Consolidated revenues in 2007 were \$8.7 billion as compared to \$8.8 billion in 2006. Revenue was significantly impacted by our Middle East operations in our G&I business unit where we provide support services to the U.S. military primarily in Iraq. Revenues from our Middle East Operations were down approximately \$480 million in 2007 largely due to the lower volume of activities on our LogCAP III and PCO Oil contracts as our customer continues to scale back the construction and procurement related to military sites in Iraq. We expect overall spending by the U.S. military in Iraq to continue to decline in 2008 and beyond. The decrease in Middle East Operations was partially offset by continued revenue growth on several of our Gas Monetization projects in our Upstream business unit, including our Escravos LNG and Pearl GTL projects.

Consolidated operating income in 2007 was \$294 million as compared to \$152 million in 2006. Operating income in 2007 includes positive contributions from a number of Gas Monetization projects including our Pearl GTL, Yemen LNG, Nigeria LNG and the recently awarded Skikda LNG projects and various offshore projects, including Kashagan, in our Upstream business unit operating income also includes positive contributions from our LOGCAP III contract in our G&I business unit. Our 2006 operating income was negatively impacted by \$157 million in charges related to our Escravos GTL project in Nigeria.

Consolidated revenues in 2006 were \$8.8 billion as compared to \$9.3 billion in 2005. The decrease was largely due to a \$618 million decrease in our military support activities in Iraq in our Middle East operations, a \$184 million decrease in other U.S. government work in our G&I business unit, and other decreases in our Offshore operations in the Upstream business unit primarily related to the completion of the Barracuda-Caratinga and Belanak projects. These decreases were partially offset by increases of approximately \$594 million related to several of our gas monetization projects that were either awarded in late 2005 or early 2006.

Consolidated operating income in 2006 was \$152 million as compared to \$385 million in 2005. Operating income for 2006 included \$157 million in charges related to our Escravos GTL project in Nigeria as well as \$58 million of impairment charges recorded on an equity investment in an Australian railroad project in our Ventures business unit. In 2005, we recognized a gain on sale of a one-time distribution from our interest in the Dulles Greenway Toll Road joint venture in the amount of \$96 million.

Reorganization of Business Units

During the third quarter of 2007, we announced the reorganization of our business into six business units each with its own business unit leader who reports to our chief executive officer (CEO) and chief operating decision maker. The reorganized business units are Government & Infrastructure, Upstream, Services, Downstream, Technology and Ventures. During the fourth quarter of 2007, we completed the reorganization of our monthly financial and operating information provided to our CEO and chief operating decision maker and accordingly, we have redefined our reportable segments consistent with the financial information that our chief operating decision maker reviews to evaluate operating performance and make resource allocation decisions. Our reportable segments are Government and Infrastructure, Upstream and Services. See Note 10 to our consolidated financial statements for further discussion of our reportable segments.

In the fourth quarter of 2007, we initiated a restructuring whereby we committed to a minor headcount reduction and ceased using certain leased office space. In connection with this restructuring we recorded charges totaling approximately \$5 million of which the majority related to a vacated lease, previously utilized by our G&I division in Arlington. This amount is included in Cost of services in our statements of income for the year ended December 31, 2007. Less than \$1 million of the charge consists of standard termination benefits payable to a limited number of corporate and division employees. These termination costs are included in General and Administrative in our statements of income for the year

Table of Contents

ended December 31, 2007. The amounts recorded represent the total amounts expected to be incurred in connection with these activities.

Reclassification

We reclassified certain overhead expenses in our prior period statements of income previously recorded as cost of services to general and administrative expense in our statements of income. These expenses relate to certain overhead expenses and indirect costs that were previously managed and reported within our business units but are now managed and reported at a corporate level. These expenses were reclassified to allow transparency of business unit margins and general and administrative expense consistent with the nature of the underlying costs and the manner in which the costs are managed. See Note 1 to the consolidated financial statements for further discussion of this reclassification.

Separation from Halliburton

On February 26, 2007, Halliburton's board of directors approved a plan under which Halliburton would dispose of its remaining interest in KBR through a tax-free exchange with Halliburton's stockholders pursuant to an exchange offer. On April 5, 2007, Halliburton completed the separation of KBR by exchanging the 135,627,000 shares of KBR owned by Halliburton for publicly held shares of Halliburton common stock pursuant to the terms of the exchange offer (the Exchange Offer) commenced by Halliburton on March 2, 2007.

In connection with the Offering in November 2006 and the separation of our business from Halliburton, we entered into various agreements with Halliburton including, among others, a master separation agreement, tax sharing agreement, transition services agreements and an employee matters agreement.

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, subject to specified exceptions. 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 Foreign Corrupt Practices Act (FCPA) investigations, the Barracuda-Caratinga matters regarding subsea bolts and for other litigation matters related to Halliburton's business. See Note 8 to our consolidated financial statements for further discussion of the FCPA investigations and the Barracuda-Caratinga project.

The tax sharing agreement, as amended, provides for certain allocations of U.S. income tax liabilities and other agreements between us and Halliburton with respect to tax matters. As a result of the Offering, Halliburton is responsible for filing all U.S. income tax returns required to be filed through April 5, 2007, the date KBR ceased to be a member of the Halliburton consolidated tax group. Halliburton is responsible for paying the taxes related to the returns it is responsible for filing. We will pay Halliburton our allocable share of such taxes. We are obligated to pay Halliburton for the utilization of net operating losses, if any, generated by Halliburton prior to the deconsolidation which we may use to offset our future consolidated federal income tax liabilities.

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. These support services relate to, among other things, information technology, legal, human resources and risk management. 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. As of December 31, 2007, most of the corporate service activities have been discontinued and primarily related to human resources and risk management. In 2008, the only significant corporate service activities expected to be incurred relate to fees for ongoing guarantees provided by Halliburton on existing credit support instruments which have not yet expired.

The employee matters agreement provides for the allocation of liabilities and responsibilities to our current and former employees and their participation in certain benefit plans maintained by Halliburton. Among other items, the employee matters agreement and the KBR, Inc. Transitional Stock Adjustment Plan provide for the conversion, upon the complete separation of KBR from Halliburton, of stock options and restricted stock awards (with restrictions that have not yet lapsed as of the final separation date) granted to KBR employees under Halliburton's 1993 Stock and Incentive Plan (1993 Plan) to stock options and restricted stock awards covering KBR common stock. On April 5, 2007, immediately after our separation from Halliburton, the conversion of such stock options and restricted stock

awards occurred. A total of 1,217,095 Halliburton stock options and 612,857 Halliburton restricted stock awards were converted into 1,966,061 KBR

Table of Contents

stock options with a weighted average exercise price per share of \$9.35 and 990,080 million restricted stock awards with a weighted average grant-date fair value per share of \$11.01. The conversion of such stock options and restricted stock was accounted for as a modification in accordance with SFAS No. 123(R) and resulted in an incremental charge to expense of less than \$1 million, recognized in 2007, representing the change in fair value of the converted awards from Halliburton stock options and restricted stock awards to KBR stock options and restricted stock awards. See Notes 3 and 17 to our consolidated financial statements for information regarding stock-based compensation and stock incentive plans.

See Notes 2 and 20 to our consolidated financial statements for further discussion of the above agreements and other related party transactions with Halliburton.

Other Corporate Matters

Share-Based Payment. 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, compensation expense is recognized for all newly granted awards and awards modified, repurchased, or cancelled after January 1, 2006 based on their fair values. 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 was 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. Under APB Opinion No. 25, no compensation expense was recognized for stock options or the ESPP. Compensation expense was recognized for restricted stock awards.

Total stock-based compensation expense, net of related tax effects, was \$7 million in 2007, \$11 million in 2006 and \$8 million in 2005. Total income tax benefit recognized in net income for stock-based compensation arrangements was \$4 million in 2007, \$6 million in 2006, and \$5 million in 2005. Incremental compensation cost resulting from modifications of previously granted stock-based awards which allowed certain employees to retain their awards after leaving the company, was less than a million in 2007, \$6 million in 2006 and \$8 million in 2005. In 2007, we also recognized less than \$1 million in incremental compensation cost from modifications of previously granted stock-awards due to the conversion of Halliburton stock options and restricted stock awards granted to KBR employees to KBR awards of stock options and restricted stock, after our separation from Halliburton on April 5, 2007. Effective upon our complete separation from Halliburton, the Halliburton ESPP plan was terminated to KBR employees. No shares were purchased by KBR employees in 2007 under the Halliburton ESPP plan and therefore no stock-based compensation expense was recorded in 2007. Halliburton shares previously purchased under the ESPP plan remained Halliburton common stock and did not convert to KBR common stock at the date of separation. Refer to Separation from Halliburton.

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 liquefaction capacity over the past 30 years. In addition, we are one of the largest government defense contractors worldwide and we believe we are the world's largest government defense services provider.

We offer our wide range of services through six business units; G&I, Upstream, Services, Downstream, Technology and Ventures. Although we provide a wide range of services, our business 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 benefited 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.

Table of Contents

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.

Contract Structure

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 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 us, 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. 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 to us, since the owner/customer retains many of the risks.

G&I Business Unit Activity

Our G&I business unit provides 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 deliver on-demand support services across the full military mission cycle from contingency logistics and field support to operations and maintenance on military bases. A significant portion of our G&I business unit's current operations relate to the support of the United States government operations in the Middle East, which we refer to as our Middle East operations, one of the largest U.S. military deployments since World War II. In the civil infrastructure market, we operate in diverse sectors, including transportation, waste and water treatment and facilities maintenance. We design, construct, maintain and operate and manage civil infrastructure projects ranging from airport, rail, highway, water and wastewater facilities, and mining and mineral processing to regional development programs and major events. We provide many of these services to foreign governments such as the United Kingdom and Australia.

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.

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.

LogCap Project. 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, 2007 was \$1.4 billion. During the almost six-year period we have worked under the LogCAP III contract, we have been awarded 72 excellent ratings out of 89 total ratings. In addition, based on recent award fee scores, which determined the fees awarded during 2007, we decreased our award fee accrual rate on the LogCAP III contract from 84% to 80%, which resulted in a decrease of \$2 million of award fees being recorded in 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, which has been extended by the DoD through the third quarter of 2008. In June 2007, we were selected as one of the executing contractors under the LogCap IV contract to provide logistics support to U.S. Forces deployed in the Middle East. Since the award of the LogCAP IV contract, unsuccessful bidders have brought actions at the GAO protesting the contract award. The GAO rendered a decision upholding portions of the bid protests.

Currently, the DoD has implemented a process to reevaluate the previous contract awards in accordance with the GAO's decision. We expect the DoD's reevaluation will be completed in the first quarter of 2008. Despite the award of a portion of the LogCAP IV contract and extension of our LogCAP III contract, we expect our overall volume of work to decline as our customer scales back its requirement for the types and the amounts of services we provide. However, as a result of the recently announced

Table of Contents

surge of additional troops and extended tours of duty in Iraq, we expect the decline may occur more slowly than we previously expected.

Allenby & Connaught project. In April 2006, Aspire Defence, a joint venture between us, Carillion 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. Our Venture's business unit manages KBR's equity interest in Aspire Defence, the project company that is the holder of the 35-year concession contract. At December 31, 2007, we indirectly owned a 45% interest in Aspire Defence. In addition, at December 31, 2007, 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, 2007, our performance through the construction phase is supported by \$214 million in letters of credit and surety bonds totaling \$226 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.

Skopje Embassy Project. In 2005, we were awarded a fixed-price contract to design and build a U.S. embassy in Skopje, Macedonia. As a result of a project estimate update and progress achieved on design drawings, we recorded a \$12 million loss in connection with this project during the fourth quarter of 2006. We identified additional increases in cost on this project due to escalating material, labor and other costs including schedule delays. As a result of these cost increases identified in 2007, we recorded an additional loss on this project of approximately \$27 million during 2007 which we believe are not recoverable under the contract. We could incur additional costs and losses on this project if our plan to make up lost schedule is not achieved or if material, labor or other costs incurred exceed the amounts we have estimated. As of December 31, 2007, the project was approximately 45% complete.

Upstream Business Unit Activity

Skikda project. During the third quarter of 2007, we were awarded the engineering, procurement and construction (EPC) contract for the Sonatrach Skikda LNG project, to be constructed at Skikda, Algeria. In addition to performing the EPC work for the 4.5 million metric tons per annum LNG train, we will execute the pre-commissioning and commissioning portion of the contract. The contract has an approximate value of \$2.8 billion. As of December 31, 2007 the Skikda project was approximately 10% complete.

Escravos project. In connection with our review of a consolidated 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, 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.

In the fourth quarter of 2006, we reached agreement with the project owner to settle \$264 million of change orders. We also 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. These services were in excess of the contractual limit to total engineering costs each partner can bill to the joint venture.

During the first half of 2007, we and our joint venture partner negotiated modifications to the contract terms and conditions resulting in an executed contract amendment in July 2007. The contract has been amended to convert from a fixed price to a reimbursable contract whereby we will be paid our actual cost incurred less a credit that approximates the charge we identified in the second quarter of 2006. Also included in the amended contract are client determined incentives that may be earned over the remaining life of the contract. The effect of the modifications resulted in a \$3 million increase to operating income in the second quarter of 2007. In addition, minority interest shareholders' absorption of losses increased by \$15 million resulting in an increase to net income of \$12 million in the

second quarter of 2007. Because our amended agreement with the client provides that we will be reimbursed for our actual costs incurred, as defined, all amounts of probable unapproved change order revenue that were previously included in the project estimated revenues are now considered approved. As of December 31, 2007, our Advanced billings on uncompleted contracts related to this project was

37

Table of Contents

\$236 million.

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 have recorded losses on the project of \$19 million and \$8 million for the years ended December 31, 2006 and 2005, respectively. No losses were recorded on the project in 2007. 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. We funded approximately \$3 million in cash shortfalls during 2007.

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. In November 2007, we executed a settlement agreement with the project owner to settle all outstanding project issues except for the bolts arbitration discussed below. The agreement resulted in the project owner assuming substantially all remaining work on the project and the release of us from any further warranty obligations. The settlement agreement did not have a material impact to our results of operations or financial position.

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 do not believe that it is probable that we have incurred a liability in connection with the claim in the bolt arbitration with Petrobras and therefore, no amounts have been accrued. We disagree with Petrobras' claim since the bolts met the design specification provided by Petrobras. Although we believe Petrobras is responsible for any maintenance and replacement of the bolts, it is possible that the arbitration panel could find against us on this issue. In addition, Petrobras has not provided any evidentiary support or analysis for the amounts claimed as damages. We expect to have a preliminary hearing on legal and factual issues relating to liability with the arbitration panel in April 2008. The actual arbitration hearings have not yet been scheduled. Therefore, at this time, we cannot conclude that the likelihood that a loss has been incurred is remote. Due to the indemnity from Halliburton, we believe any outcome of this matter will not have a material adverse impact to our operating results or financial position. KBR has incurred legal fees and related expenses of \$4 million, \$1 million and \$0 million for the years ended December 31, 2007, 2006 and 2005, respectively, related to this matter.

Under the master separation agreement, Halliburton has agreed to indemnify us and any of our greater than 50%-owned subsidiaries as of November 2006, for all out-of-pocket cash costs and expenses (except for ongoing legal costs), or cash settlements or cash arbitration awards in lieu thereof, we may incur after the effective date of the master separation agreement as a result of the replacement of the subsea flowline bolts installed in connection with the Barracuda-Caratinga project.

Table of Contents**Results of Operations**

For purposes of presenting our results of operations, we supplementally provide financial results for each of our six business units and certain product service lines. The business units presented are consistent with our reportable operating segments discussed in Note 10 (Business Segment Information) to our consolidated financial statements. We also present the results of operations for product service lines (PSL). While certain of the business units and product service lines presented below do not meet the criteria for reportable segments in accordance with SFAS No. 131, we believe this supplemental information is relevant and meaningful to our investors for various reasons including monitoring our progress and growth in certain markets and product lines.

For purposes of reviewing the results of operations, business unit income is calculated as revenue less cost of services managed and reported by the business unit and are directly attributable to the business unit. Business unit income excludes corporate general and administrative expenses and other non-operating income and expense items.

| In millions | Years Ended December 31, | | | | | | |
|--|--------------------------|-----------------|------------------------|----------------------|-----------------|------------------------|----------------------|
| | 2007 | 2006 | Increase (Decrease) | Percentage Change | 2005 | Increase (Decrease) | Percentage Change |
| Revenue (1) | | | | | | | |
| G&I: | | | | | | | |
| U.S. Government Middle East Operations | \$ 4,782 | \$ 5,262 | \$ (480) | (9%) | \$ 5,880 | \$ (618) | (11%) |
| U.S. Government Americas Operations | 721 | 837 | (116) | (14%) | 1,021 | (184) | (18%) |
| International Operations | 590 | 407 | 183 | 45% | 398 | 9 | 2% |
| Total G&I | 6,093 | 6,506 | (413) | (6%) | 7,299 | (793) | (11%) |
| Upstream: | | | | | | | |
| Gas Monetization | 1,402 | 1,012 | 390 | 39% | 392 | 620 | 158% |
| Offshore | 338 | 388 | (50) | (13%) | 541 | (153) | (28%) |
| Other | 147 | 300 | (153) | (51%) | 212 | 88 | 42% |
| Total Upstream | 1,887 | 1,700 | 187 | 11% | 1,145 | 555 | 48% |
| Services | 322 | 314 | 8 | 3% | 280 | 34 | 12% |
| Downstream | 361 | 315 | 46 | 15% | 523 | (208) | (40%) |
| Technology | 90 | 62 | 28 | 45% | 62 | | |
| Ventures | (8) | (92) | 84 | 91% | (18) | (74) | (411%) |
| Total revenue | \$ 8,745 | \$ 8,805 | \$ (60) | \$ (1%) | \$ 9,291 | \$ (486) | \$ (5%) |

(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
(loss) from joint
ventures and
revenue from
services
provided to joint
ventures.

Table of Contents

| In millions | Years Ending December 31, | | | | | | |
|--|---------------------------|--------|------------------------|----------------------|--------|------------------------|----------------------|
| | 2007 | 2006 | Increase (Decrease) | Percentage Change | 2005 | Increase (Decrease) | Percentage Change |
| Business unit income (loss): | | | | | | | |
| G&I: | | | | | | | |
| U.S. Government Middle East Operations | \$ 231 | \$ 350 | \$ (119) | (34%) | \$ 354 | \$ (4) | (1%) |
| U.S. Government Americas Operations | 68 | 83 | (15) | (18%) | 80 | 3 | 4% |
| International Operations | 116 | 73 | 43 | 59% | 60 | 13 | 22% |
| Total job income | 415 | 506 | (91) | (18%) | 494 | 12 | 2% |
| Divisional overhead | (136) | (179) | 43 | 24% | (212) | 33 | 16% |
| Total G&I business unit income | 279 | 327 | (48) | (15%) | 282 | 45 | 16% |
| Upstream: | | | | | | | |
| Gas Monetization | 161 | (4) | 165 | 4,125% | 91 | (95) | (104%) |
| Offshore | 59 | 60 | (1) | (2%) | 93 | (33) | (35%) |
| Other | 22 | 28 | (6) | (21%) | (55) | 83 | 151% |
| Total job income | 242 | 84 | 158 | 188% | 129 | (45) | (35%) |
| Loss on sale of assets | | | | | (2) | 2 | 100% |
| Divisional overhead | (54) | (44) | (10) | (23%) | (27) | (17) | (63%) |
| Total Upstream business unit income | 188 | 40 | 148 | 370% | 100 | (60) | (60%) |
| Services: | | | | | | | |
| Job income | 67 | 50 | 17 | 34% | 35 | 15 | 43% |
| Gain on sale of assets | | | | | 10 | (10) | (100%) |
| Divisional overhead | (11) | (5) | (6) | (120%) | (7) | 2 | 29% |
| Total Services business unit income | 56 | 45 | 11 | 24% | 38 | 7 | 18% |
| Downstream: | | | | | | | |
| Job income | 26 | 54 | (28) | (52%) | 40 | 14 | 35% |
| Gain on sale of assets | | | | | 13 | (13) | (100%) |
| Divisional overhead | (16) | (13) | (3) | (23%) | (13) | | |

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| | | | | | | | |
|--|--------|--------|--------|----------|--------|----------|----------|
| Total Downstream business unit income | 10 | 41 | (31) | (76%) | 40 | 1 | 3% |
| Technology: | | | | | | | |
| Job income | 39 | 28 | 11 | 39% | 18 | 10 | 56% |
| Divisional overhead | (20) | (18) | (2) | (11%) | (18) | | |
| Total Technology business unit income | 19 | 10 | 9 | 90% | | 10 | |
| Ventures: | | | | | | | |
| Job income (loss) | (9) | (91) | 82 | 90% | (5) | (86) | (1,720%) |
| Gain on sale of assets | | 6 | (6) | (100%) | 89 | (83) | (93%) |
| Divisional overhead | (3) | (1) | (2) | (200%) | (2) | 1 | 50% |
| Total Ventures business unit income (loss) | (12) | (86) | 74 | 86% | 82 | (168) | (205%) |
| Total business unit income | 540 | 377 | 163 | 43% | 542 | (165) | (30%) |
| Unallocated amounts: | | | | | | | |
| Labor cost absorption (1) | (20) | 1 | (21) | (2,100%) | 1 | | |
| Corporate general and administrative | (226) | (226) | | | (158) | (68) | (43%) |
| Total operating income | \$ 294 | \$ 152 | \$ 142 | 93% | \$ 385 | \$ (233) | \$ (61%) |

(1) Labor cost absorption represents costs incurred by our central labor and resource groups (above) or under the amounts charged to the operating business units.

Table of Contents

Government and Infrastructure. Revenue from our G&I business unit was \$6.1 billion, \$6.5 billion and \$7.3 billion for the years ended December 31, 2007, 2006 and 2005, respectively. The decline in revenues in 2007 and 2006 is primarily the result of a decrease in U.S. military support activities Iraq under our LogCAP III contract and our oilfield restoration activities under our PCO Oil South contract which is included in U.S. Government Middle East Operations. Revenues under our LogCAP III contract declined by \$293 million in 2007 and \$622 million in 2006. Revenues under our PCO Oil South contract decreased \$185 million in 2007. Although we continue to provide services under the LogCAP III contract through 2008 and expect new work to be awarded to us under the LogCAP IV contract, we expect our overall volume of work to decline as our customer scales back its requirements for the types and the amounts of services we provide. We also experienced a decrease in revenue of \$151 million in 2006 associated with the completion of hurricane repair efforts for U.S. naval facilities under our CONCAP contract included in Americas Operations.

Business unit income was \$279 million, \$327 million and \$282 million for the years ended December 31, 2007, 2006 and 2005, respectively. The decrease in 2007 relates to lower job income on our LogCAP III project. In 2007, we experienced a lower volume of activities and slightly lower award fees as compared to 2006. In addition, we recorded charges in 2007 of approximately \$22 million representing potentially disallowable costs incurred under government contracts for activities dating from 2003. These decreases were partially offset as the result of lower overhead expenses incurred in 2007 by the business unit as a result of G&I's overhead expenses decreased in 2007 primarily as a result of certain office closures in the Middle East and other cost reduction activities.

Upstream. Revenue from our Upstream business unit was \$1.9 billion, \$1.7 billion and \$1.1 billion for the years ended December 21, 2007, 2006 and 2005, respectively. Revenues in 2007 and 2006 increased significantly in 2007 and 2006 as a result of the start-up of several Gas Monetization projects awarded in late 2005 and early 2006, including Escravos LNG and Pearl GTL projects. Revenue on these two projects in addition to the work on the Yemen and Skikda LNG projects increased an aggregate of \$514 million in 2007 and \$561 million in 2006. The increases in 2007 were partially offset by decreases in revenues related to several front-end engineering and design (FEED) and other projects that are now completed.

Business unit income was \$188 million, \$40 million and \$100 million for the years ended December 31, 2007, 2006 and 2005, respectively. The increase in 2007 income is largely due to the \$157 million charge related to our Escravos GTL project in Nigeria in 2006. No further losses have been incurred on the project and in the third quarter of 2007, we executed an amendment with our customer to convert the contract from a fixed price to a cost reimbursable basis. In 2007, business unit income from our gas monetization operation primarily was driven by our Pearl GTL, Skikda LNG, Yemen LNG and Tangguh LNG projects.

Services. Revenue from our Services business unit was \$322 million, \$314 million and \$280 million for the years ended December 31, 2007, 2006 and 2005. Increases in revenue in 2007 and 2006 are primarily related to increases in new awards in our Canadian operations partially offset by decreases in industrial services work. The increase in our Canadian operations has primarily been driven by an increase in demand for direct construction and modular fabrication services.

Business unit income was \$56 million, \$45 million and \$38 million for the years ended December 31, 2007, 2006 and 2005. These increases have primarily been due to the increases related to modular fabrication services in Canada. Job income in 2006 and 2007 has also increased as a result of our MMM joint venture which provides marine vessel support services in the Gulf of Mexico. This joint venture was contributed to us in the second quarter of 2006 by our former parent company, Halliburton. Job income was also positively impacted by actuarially determined insurance adjustments of \$11 million, \$7 million and \$21 million for the years ended December 31, 2007, 2006 and 2005, respectively. These increases were partially offset by decreases in job income from industrial services.

Downstream. Revenue from our Downstream business unit was \$361 million, \$315 million and \$523 million for the years ended December 31, 2007, 2006 and 2005, respectively. For 2007, the increase in revenue is primarily attributable to the Yanbu export refinery and Saudi Kayan olefin projects in Saudi Arabia. Revenue related to these two projects increased an aggregate of \$107 million due to a higher volume of work in 2007. Offsetting these increases were decreases in revenues on various other projects. For 2006, the decrease in revenue is primarily due to the completion of the Syncrude Upgrader Expansion project in Canada which was completed in 2006.

Business unit income was \$10 million, \$41 million and \$40 million for the years ended December 31, 2007, 2006 and 2005, respectively. Business unit income in 2007 includes a \$7 million loss recorded on the Saudi Kayan olefin project in Saudi Arabia. Additionally, job income related to an ammonia plant construction project in Egypt was \$23 million higher in 2006 as a result of higher progress achieved in 2006 and the project was nearing completion in late 2007.

Table of Contents

Technology. Revenue from our Technology business unit was \$90 million, \$62 million and \$62 million for the years ended December 31, 2007, 2006 and 2005, respectively. Business unit income was \$19 million, \$10 million and \$0 million for the years ended December 31, 2007, 2006 and 2005, respectively. The increase in revenues and business unit income in 2007 is largely due to syngas technologies deployed on projects in the South American region and Superflex technology being utilized on a project in China.

Ventures. Revenue from our Ventures business unit was \$(8) million, \$(92) million and \$(18) million for the years ended December 31, 2007, 2006 and 2005, respectively. Business unit income (loss) was \$(12) million, \$(86) million and \$82 million for the years ended December 31, 2007, 2006 and 2005. The loss in 2006 included \$58 million of impairment charges recorded on our equity investment in the Alice Springs-Darwin railroad project and \$17 million in charges recorded on an equity investment in a joint venture road project in the United Kingdom. In addition, the losses in 2007 incurred on the railroad project were partially mitigated by a full year of positive results on our Allenby & Connaught project. In 2005, we recognized an \$85 million gain on the sale of a one-time distribution from our interest in a U.S. toll road. Prior to the sale of our interest in the U.S. toll road, we received a distribution and recorded a corresponding gain of \$11 million.

Labor cost absorption. Labor cost absorption expense was \$20 million, \$1 million and \$1 million for the years ended December 31, 2007, 2006 and 2005, respectively. Labor cost absorption represents costs incurred by our central labor and resource groups (above) or under the amounts charged to the operating business units. The increase in labor cost absorption in 2007 compared to 2006 and 2005 was primarily due to an increase in incentive compensation and the issuance of performance based award units, in 2007.

General and Administrative expense. General and administrative expense was \$226 million, \$226 million and \$158 million for the years ended December 31, 2007, 2006 and 2005, respectively. In 2006, information technology expenses increased approximately \$37 million primarily related to a financial systems implementation project that began in 2005. Also, our general and administrative expenses increased in 2006 as we continued to develop and implement our stand-alone corporate functions prior to our initial public offering in November 2006 and our ultimate separation from Halliburton in early 2007. In 2007, we substantially completed the financial systems implementation project. Costs related to the financial systems implementation project decreased approximately \$17 million in 2007. This decrease was offset by increases in costs from acquisition related activities as well as incentive compensation as we increased the number of participants in and the number of awards issued under our incentive compensation plans.

Non-operating items

Related party interest expense was \$0 million, \$36 million and \$24 million for the years ended December 31, 2007, 2006 and 2005, respectively. The increase in related party interest expense in 2006 compared to 2005 was 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.

Interest income (expense), net was \$62 million, \$27 million and \$(1) million for the years ended December 31, 2007, 2006 and 2005, respectively. The increase in interest income in 2006 is primarily due to interest on excess cash balances resulting from advances from our customers and proceeds from our initial public offering in the fourth quarter of 2006. Our cash and equivalents balance increased from \$394 million at December 31, 2005 to \$1.4 billion at December 31, 2006. In 2007, interest income continued to increase as a result of further increases in our cash and equivalents balance to \$1.9 billion at December 31, 2007.

Foreign currency gains (losses) were \$(15) million, \$(16) million and \$2 million for the years ended December 31, 2007, 2006 and 2005, respectively. The foreign currency losses incurred in 2007 and 2006 primarily related to impact of the weakening of the U.S. dollar against the British Pound on our certain of our U.K. subsidiaries with a British Pound functional currency that hold significant U.S. dollar cash balances related to the proceeds from the sale of our Production Services group in 2006 and sale of DML in 2007.

Provision for income taxes was \$138 million, \$94 million and \$160 million for the years ended December 31, 2007, 2006 and 2005, respectively. Our effective tax rate was 40%, 73% and 44% for the years ended December 31, 2007, 2006 and 2005, respectively. Our U.S. statutory tax rate for all years is 35%. Our 2007 effective tax rate was

higher than the statutory rate primarily as a result of certain non-deductible losses in foreign jurisdictions. Our 2006 effective tax rate was higher than the statutory rate primarily as a result of not receiving a tax benefit for the impairment charges taken on our investment in the Alice Springs-Darwin railroad project in Australia (ASD), non-deductible operations losses from ASD, and tax return-to-accrual adjustments in various tax jurisdictions. Our 2005 effective tax rate was higher than the statutory

Table of Contents

rate primarily due to foreign tax credit displacement resulting from the domestic net operating losses from an asbestos settlement with Halliburton.

Income from discontinued operations was \$120 million, \$114 million and \$55 million for the years ended December 31, 2007, 2006 and 2005, respectively. Discontinued operations represents revenues and gain on the sale of our Productions Services group in May 2006 and the disposition of our 51% interest in DML in June 2007. Revenues from our discontinued operations were \$449 million, \$1.1 billion and \$1.6 billion for 2007, 2006 and 2005, respectively, while income from discontinued operations, net of tax, was \$120 million, \$114 million and \$55 million for the same periods, respectively. Income from discontinued operations included a gain on sale, net of tax, of approximately \$101 million in 2007 and \$77 million in 2006.

Liquidity and Capital Resources

At December 31, 2007 and 2006, cash and equivalents totaled \$1.9 billion and \$1.4 billion, 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 \$483 million at December 31, 2007 and \$527 million at December 31, 2006. 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.

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, 2007 and December 31, 2006, we had zero cash draws and \$508 million and \$55 million, respectively, in letters of credit issued and outstanding, which reduced the availability under the Revolving Credit Facility to \$342 million and \$795 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.

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, 2007, we had approximately \$1 billion in letters of credit and financial guarantees outstanding, of which \$508 million were issued under our Revolving Credit Facility. Approximately \$545 million of these letters of credit were issued under various Halliburton facilities and are irrevocably and unconditionally guaranteed by

Halliburton. Of the total outstanding, \$505 million relate to our joint venture operations, including \$214 million issued in connection with our Allenby & Connaught project. The remaining \$495 million of outstanding letters of credit relate to various other projects. At December 31, 2007, \$605 million of the \$1 billion outstanding letters of credit have triggering events that would entitle a bank to require cash collateralization. Approximately \$381 million of the \$605 million relates to letters of credit issued under our Revolving Credit Facility which have expiry dates close to or beyond the maturity date of the facility. Under the terms of the Revolving Credit Facility, if the original maturity date, of December 16, 2010 is not extended then the issuing banks may require that we provide cash collateral for these extended letters of credit no later than 95 days prior to the original maturity date. Currently,

Table of Contents

our intention is to extend the original maturity date of the Revolving Credit Facility. 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. Prior to the separation from Halliburton we had minimal stand-alone bonding 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 letters of credit, surety bonds and other guarantees. Since the separation from Halliburton we have been engaged in discussions with surety companies and have arranged lines with multiple firms for our own standalone capacity. Since the arrangement of this stand alone capacity we have been primarily sourcing surety bonds from our own capacity without Halliburton credit support. We continue to engage in discussions with other surety companies about additional stand-alone surety bond 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 the separation.

As the need arises, future projects will be supported by letters of credit issued under our Revolving Credit Facility or arranged on a bilateral 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.

During the second quarter of 2007, a £20 million letter of credit was issued on our behalf by a bank in connection with our Allenby & Connaught project. The letter of credit supports a building contract guarantee executed between KBR and certain project joint venture company to provide additional credit support as a result of our separation from Halliburton. The letter of credit issued by the bank is guaranteed by Halliburton.

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. Prior to our Amendment to the Revolving Credit Facility on January 17, 2008 (referred to below), we were generally prohibited from purchasing, redeeming, retiring, or otherwise acquiring any of our common stock unless it was in connection with a compensation plan, program, or practice provided that the aggregate price paid for such transactions did not exceed \$25 million in any fiscal year.

On January 17, 2008, we entered into an Agreement and Amendment to the Revolving Credit Facility effective as of January 11, 2008, (the Amendment). The Amendment (i) permits us to elect whether any increase in the aggregate commitments under the Revolving Credit Facility used solely for the issuance of letters of credit are to be funded from existing banks or from one or more eligible assignees; and (ii) permits us to declare and pay shareholder dividends and/or engage in equity repurchases not to exceed \$400 million.

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 50%; a leverage ratio that does not exceed 3.5; and a fixed charge coverage ratio of at least 3.0. At December 31, 2007 and 2006, we were in compliance with these ratios and other covenants.

| Cash flow activities | Years Ended December 31, | | |
|---|---------------------------------|-------------|-------------|
| | 2007 | 2006 | 2005 |
| | (In millions) | | |
| Cash flows provided by operating activities | \$ 248 | \$ 931 | \$ 527 |
| Cash flows provided by investing activities | 293 | 225 | 20 |
| Cash flows used in financing activities | (150) | (139) | (375) |
| Effect of exchange rate changes on cash | 9 | 50 | (12) |
| Increase in cash and equivalents | \$ 400 | \$ 1,067 | \$ 160 |

Operating activities. Cash provided by operations was \$248 million for the year ended December 31, 2007 compared to cash provided by operations of \$931 million for the year ended December 31, 2006. Operating cash flows in 2007 decreased significantly compared to 2006 due to lower advanced billings on uncompleted contracts and a higher volume of accounts receivable billing on other projects than in 2006. Operating cash flows in 2007 also included tax payments related to the gain on the sale of our 51% interest in DML of approximately \$115 million. Operating cash flows in 2006 includes \$304 million of advanced billings on several consolidated joint venture projects including our Escravos project. Additionally, operating cash flows increased further in 2006 due to a decrease in our Iraq-related working capital which, excluding cash and equivalents, decreased \$247 million from \$495 million at December 31, 2005 to \$248 million at December 31, 2006. Operating cash flows in 2005 included funding of operating cash shortfalls on the Barracuda-Caratinga project of \$169 million, net of revenue received.

Our cash flows from operations can vary significantly from year to year and are affected by the mix, percentage of completion and terms of our engineering and construction projects. We often receive cash through advanced billings on our larger projects and those of our consolidated joint ventures such as Escravos. These cash advances are generally only available for use on a specific project and not available for other purposes. As the advances are used in project execution, our cash position is reduced on the project. In the event the net investment in the operating assets of a project is greater than available project cash balance, we may utilize other cash on hand or availability under our Revolving Credit Facility to satisfy any periodic net operating cash outflows.

Investing activities. Cash provided by investing activities for the year ended December 31, 2007 totaled \$293 million compared to cash provided by investing activities of \$225 million and \$20 million for the years ended December 31, 2006 and 2005, respectively. Capital expenditures in 2007 were \$43 million as compared to \$57 million and \$76 million in 2006 and 2005, respectively. Capital spending in 2005 was primarily directed to our implementation of an enterprise system, SAP. In 2007, we sold our 51% interest in DML for cash proceeds of approximately \$345 million, net of direct transaction costs. In 2006, we completed the sale of our Production Services group, in which we received net proceeds of \$265 million. In 2005, we recognized an \$85 million gain on the sale of a one-time distribution from our interest in a U.S. toll road. Prior to the sale of our interest in the U.S. toll road, we received a distribution and recorded a corresponding gain of \$11 million.

Financing activities. Cash used in financing activities for the year ended December 31, 2007 totaled \$150 million and is primarily related to net payments of \$120 million made to Halliburton, for various support services provided by Halliburton under our transition services agreement and other amounts prior to our separation from Halliburton. Cash flows used in financing activities for the year ended December 31, 2006 were \$139 million and primarily relates to repayment of our borrowings under the Halliburton Cash Management Note as 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 financing activities in 2005 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 had 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, our \$774 million intercompany payable balance was converted into Subordinated Intercompany Notes with Halliburton 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

Table of Contents

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.

In June 2007, our 55%-owned consolidated subsidiary, M.W. Kellogg Limited, entered into a credit facility with Barclays Bank totaling £15 million. This facility replaces a previous facility with Barclays Bank. This facility, which is non-recourse to us, is primarily used for bonding, guarantees, and other purposes. At December 31, 2007, \$20 million of bank guarantees were 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.

Future uses of cash. Future uses of cash will primarily relate to working capital requirements for our operations. In addition, we will use cash to fund capital expenditures, pension obligations, operating leases and various other obligations, including the commitments discussed in the table below, as they arise.

Capital expenditures. Capital spending in 2007 was approximately \$43 million. The capital expenditures budget for 2008 is approximately \$66 million, and primarily relates to information technology and real estate.

Commitments and other contractual obligations. The following table summarizes our significant contractual obligations and other long-term liabilities as of December 31, 2007:

| | Payments Due | | | | | | Total |
|--------------------------------|----------------------|-------------|-------------|-------------|-------------|-------------------|--------------|
| | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter | |
| | (In millions) | | | | | | |
| Operating leases | 49 | 49 | 48 | 44 | 34 | 131 | 355 |
| Purchase obligations(a) | 12 | 2 | 1 | | | | 15 |
| Pension funding obligation (b) | 82 | | | | | | 82 |
| Total (c) | 143 | 51 | 49 | 44 | 34 | 131 | 452 |

(a) 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.

- (b) The pension funding obligation includes an expected payment of approximately \$57 million to be paid in the first quarter of 2008 to the Kellogg, Brown & Root (UK) Limited Pension Plan, related to a February 2008 agreement-in-principle regarding partial deficit funding for this plan. Refer to Note 21 in our consolidated financial statements.
- (c) Excluded from the table is \$77 million which includes, \$14 million in interest and penalties, related to unrecognized tax benefits recorded pursuant to Financial Accounting Standards Board No. 48 Accounting for Uncertainty in Income Taxes. Refer to Note 15 in our consolidated financial statements.

In addition to the commitments above, we had commitments of \$121 million at December 31, 2007 to provide funds to related companies, including \$113 million at December 31, 2007 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 \$21 million of the commitments to be paid during 2008.

Table of Contents***Off balance sheet arrangements***

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 19 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 \$30 million and \$3 million at December 31, 2007 and 2006, respectively. Our equity in earnings (losses) from privately financed project entities totaled \$17 million, \$(77) million and \$18 million for the years ended December 31, 2007, 2006 and 2005, respectively. See Note 19 to our consolidated financial statements.

Other factors affecting liquidity

As of December 31, 2007, we had incurred \$232 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 insufficient funding or had sufficient funding in total, but the funding was not appropriately allocated within the task order. We are in the process of preparing requests 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.

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 *Risk Factors* contained in Part I of this Annual Report on Form 10-K.

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

Table of Contents

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 Risk Factors contained in Part I of this Annual Report on Form 10-K. These factors can affect the accuracy of our estimates and materially impact our future reported earnings.

Accounting for government contracts. Most of the services provided to the United States government are governed by cost-reimbursable contracts. Services under our LogCAP 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, 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. We periodically, receive LogCAP award fee scores and, based on these actual amounts, we adjust our accrual rate for future awards, if necessary. 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

Table of Contents

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 included in the consolidated U.S. federal income tax return of Halliburton up through the date of separation (April 5, 2007). Our income tax expense, prior to the separation from Halliburton, is calculated on a pro rata basis. Under this method, income tax expense is determined based on KBR's operations and its contributions to the income tax expense of the Halliburton consolidated group. For the period post separation from Halliburton, income tax expense is calculated on stand alone basis. Additionally, KBR's U.K.-based subsidiaries and divisions were members of a U.K. tax group, which allowed the sharing of tax losses and other tax attributes among the KBR and Halliburton U.K.-based affiliates up through the date of separation. As part of the separation, KBR and Halliburton entered into a tax sharing agreement, which generally provides that KBR will indemnify Halliburton for any additional taxes attributable to KBR's business for periods prior to the separation.

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 13 and 14 of our consolidated financial statements, as of December 31, 2007 and December 31, 2006, 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

Table of Contents

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 increased from 5.75% at October 31, 2006 to 6.30% at October 31, 2007. 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 97% of all plans increased from 5.00% at September 30, 2006 to 5.70% at September 30, 2007. 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 \$81 million, while a similar increase in the discount rate would reduce our projected benefit obligation by an estimated \$78 million.

Our defined benefit plans reduced pretax earnings by \$18 million, \$16 million and \$13 million for the years ended December 31, 2007, 2006 and 2005, respectively. Included in the amounts were earnings from our expected pension returns of \$100 million, \$82 million and \$79 million for the years ended December 31, 2007, 2006 and 2005, respectively. Unrecognized actuarial gains and losses are being recognized over a period of 10 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 \$133 million, \$148 million and \$214 million for the years ended December 31, 2007, 2006 and 2005, 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, 2007 was \$248 million, of which \$13 million will be recognized as a component of our expected 2008 pension expense. During 2007, we made contributions to fund our defined benefit plans of \$27 million, which included \$11 million contributed in order to mitigate a portion of the projected underfunding of our UK Plans. We currently expect to make contributions in 2008 of approximately \$82 million. This contribution amount includes an expected payment of approximately \$57 million to be paid in the first quarter of 2008 to the Kellogg, Brown & Root (UK) Limited Pension Plan, related to a February 2008 agreement-in-principle regarding partial deficit funding for this Plan.

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.

Table of Contents**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 2007 derivative instruments used to hedge our foreign currency exposure noting the value at risk was immaterial.

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 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 by complying 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 make estimates of the amount of costs associated with known environmental contamination that we will be required to remediate and record accruals to recognize those estimated liabilities. Our estimates are based on the best available information and are updated whenever new information becomes known. For certain locations including our property at Clinton Drive, we have not completed our analysis of the site conditions and until further information is available, we are only able to estimate a possible range of remediation costs. This range of costs could change depending on our ongoing site analysis and the timing and techniques used to implement remediation activities. 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. During 2007, we increased our accrual from approximately \$4 million to \$7 million for the estimated assessment and remediation costs associated with all environmental matters, which represents the low end of the range of possible costs that could be as much as \$15 million.

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 was 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 was 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 was 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.

Halliburton and certain of its subsidiaries provide various support services to KBR pursuant to a transition services agreement, including information technology, legal and internal audit. Costs for these services were \$13 million , \$23 million and \$20 million for the years ended December 31, 2007, 2006 and 2005, respectively. Costs for information technology, including payroll processing services 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,

Table of Contents

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. Subsequent to our separation from Halliburton, costs are no longer allocated but are charged to KBR pursuant to the terms of the transition services agreement.

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, representing our share of these risk management coverages and related administrative costs, have been allocated to us for each of the years ended December 31, 2006 and 2005. These expenses are included in cost of services in the consolidated statements of income for the periods ended December 31, 2006 and 2005. Historically, we have been self insured, or have participated in a Halliburton self-insured plan, for certain insurable risks, such as primary liability and workers compensation. However, subject to specific limitations, Halliburton has had umbrella insurance coverage for some of these risk exposures. As a result of our complete separation from Halliburton, we initially implemented our own stand-alone insurance and risk management programs with policies that provide substantially the same coverage as we had under Halliburton, with the exception of property coverage. Our property coverage differs from prior coverage as appropriate to reflect the nature of our properties, as compared to Halliburton's properties. As of December 31, 2007, we have now implemented insurance and risks management programs more suited to KBR's risk profile.

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, 2007, we had approximately \$1 billion letters of credit and financial guarantees outstanding, of which \$505 million related to our joint venture operations, including \$214 million issued in connection with the Allenby & Connaught project. Of the total \$1 billion, approximately \$545 million in letters of credit were 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. The Halliburton performance guarantees and letter of credit guarantees that are currently in place in favor of KBR's customers or lenders will continue until the earlier of (a) the termination of the underlying project contract or KBR's obligations thereunder or (b) the expiration of the relevant credit support instrument in accordance with its terms or release of such instrument by the customer. 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.

At December 31, 2007 and December 31, 2006, KBR has a \$16 million and \$152 million, respectively, balance payable to Halliburton which consists of amounts KBR owes Halliburton for estimated outstanding income taxes, amounts owed pursuant to our transition services agreement and other amounts.

The balances for these related party transactions are reflected in the consolidated balance sheet as Due to Halliburton, net. The average intercompany balance for 2007 was \$88 million. For 2006 and 2005, the average intercompany balance was \$348 million and \$921million, respectively.

All of the charges described above have been included as costs of our operations 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 incurred approximately \$14 million and \$9 million for the years ended December 31, 2006 and 2005, respectively, for expenses relating to the FCPA and bidding practices investigations. Halliburton incurred \$1 million as such costs for the quarter ended March 31, 2007. We do not know the amount of costs incurred by Halliburton following our separation from Halliburton on April 5, 2007. Halliburton did not charge any of 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 us. Subsequent to our separation from Halliburton and in accordance with the Master Separation Agreement, Halliburton will continue to bear the direct costs associated with overseeing and directing the FCPA and bidding practices investigations. We will bear costs associated with monitoring the continuing investigations as directed by Halliburton which include our own separate legal counsel and advisors. For the year ended December 31, 2007, we incurred approximately \$1 million in expenses related to monitoring these investigations.

Table of Contents

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 income were \$356 million, \$450 million and \$249 million for the years ended December 31, 2007, 2006 and 2005, respectively. Profit on transactions with our joint ventures recognized in our consolidated statements of income were \$30 million, \$62 million and \$21 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) Staff issued FASB Staff Position (FSP) No. AUG AIR-1, Accounting for Planned Major Maintenance Activities. The FSP prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities. The FSP also requires disclosures regarding the method of accounting for planned major maintenance activities and the effects of implementing the FSP. The guidance in this FSP is effective January 1, 2007 and is to be retrospectively applied for all periods presented. The guidance in this FSP affects KBR with regard to a 50%-owned joint venture that leases offshore vessels requiring

periodic major maintenance. This joint venture was contributed to KBR by Halliburton on April 1, 2006. KBR accounts for its investment in this joint venture under the equity method of accounting. As a result, KBR has retroactively applied the required change in accounting, electing the deferral method of accounting for planned major maintenance activities. The deferral method requires the capitalization of planned major maintenance costs at the point they occur and the depreciation of these costs over an estimated period until future maintenance activities are repeated. The result is an increase to KBR's investment in the equity of this joint venture and an increase to additional paid-in capital of approximately \$7 million as of April 1, 2006. The effect of the change in accounting on KBR's operating results for the year ended December 31, 2006 was immaterial.

Table of Contents

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. The statement applies whenever other statements require or permit assets or liabilities to be measured at fair value. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. 157-2 that provides for a one-year deferral for the implementation of SFAS 157 for non-financial assets and liabilities. SFAS 157 does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. Accordingly, the adoption of this Statement will not have a material impact to our financial position, results of operations and cash flows.

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 provides companies with an option to measure certain financial instruments and other items at fair value with changes in fair value reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. Most of the provisions of SFAS 159 apply only to entities that elect the fair value option. However, the amendment to FASB Statement No. 115,

Accounting for Certain Investments in Debt and Equity Securities , applies to all entities with available-for-sale and trading securities. Currently, the adoption of this Statement is not expected to have a material impact on our financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations, (SFAS 141(R)), which replaces FASB Statement No. 141. SFAS 141(R), establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. This Statement also established disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008, early adoption is prohibited. Currently this statement is not expected to have a significant impact to our financial position, results of operations and cash flows. A significant impact may however be realized on any future acquisitions by the company. The amounts of such impact cannot be currently determined and will depend on the nature and terms of such future acquisitions, if any.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statement-amendments of ARB No. 51, (SFAS 160). SFAS 160 states that accounting and reporting for minority interests will be recharacterized as noncontrolling interests and classified as a component of equity. The Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective for fiscal years beginning after December 15, 2008, early adoption is prohibited. We are currently evaluating the impact the adoption of SFAS 160 will have on our financial position, results of operations and cash flows.

U.S. government Matters***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.

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 would 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 was not necessary to protect the government's interest.

Table of Contents

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, but we believe that they should be less than 6% of the total subcontractor costs. We will continue working with the Army to resolve this issue. In October 2007, we filed a claim to recover the amounts withheld. At this time, the likelihood that a loss related to this matter has been incurred is remote. As of December 31, 2007, we had not adjusted our revenues or accrued any amounts related to this matter.

Dining Facility Support Services. In April 2007, DCAA recommended withholding \$13 million of payments from KBR alleging that Eurest Support Services (Cypress) International Limited (ESS), a subcontractor to KBR providing dining facility services in conjunction with our Logcap III contract in Iraq, over-billed for the cost related to the use of power generators. Payments of \$13 million have been withheld from us. We disagree with the position taken by the DCAA and we are working to resolve this issue. We believe the likelihood that a loss has been incurred related to this matter is remote and accordingly, no amounts have been accrued.

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. During 2006, we resolved approximately \$26 million of the withheld amounts with our contracting officer which was received in the first quarter of 2007. Approximately \$30 million continues to be withheld from us as of December 31, 2007, of which \$17 million was withheld by us from our subcontractor. We will continue working with the government and our subcontractors to resolve the remaining amounts. At this time, the likelihood that the loss is in excess of the amount accrued is remote.

Dining facilities. In the third quarter of 2006, the DCAA raised questions regarding \$95 million of costs related to dining facilities in Iraq. We responded to the DCAA that our costs are reasonable. In the fourth quarter of 2007, the DCAA suspended \$11 million of costs related to these dining facilities until such time we provide documentation to support the price reasonableness of the rates negotiated with our subcontractor and demonstrate that the amounts billed were in accordance with the contract terms. Subsequently, the DCAA suspended an additional \$42 million of costs until such time we provide documentation to support the price reasonableness of the rates negotiated with the subcontractor. We believe the prices obtained for these services were reasonable and intend to vigorously defend ourselves on this matter. We are working with our customer and the DCAA to resolve the issue. As of December 31, 2007, we believe it is reasonably possible that we could incur losses in excess of the amount accrued for possible subcontractor costs billed to the customer that were possibly not in accordance with contract terms. However, we are unable to estimate an amount of possible loss or range of possible loss in excess of the amount accrued related to any costs billed to the customer that were not in accordance with the contract terms.

Kosovo fuel. In April 2007, the Department of Justice (DOJ) issued a letter alleging the theft in 2004 and subsequent sale of diesel fuel by KBR employees assigned to Camp Bondsteel in Kosovo. In addition, the letter alleges that KBR employees falsified records to conceal the thefts from the Army. The total value of the fuel in question is estimated by the DOJ at approximately \$2 million based on an audit report issued by the DCAA. We believe the volume of the misappropriated fuel is significantly less than the amount estimated by the DCAA. We responded to the DOJ that we had maintained adequate programs to control, protect, and preserve the fuel in question.

We further believe that our contract with the Army expressly limits KBR's responsibility for such losses. Our discussions with the DOJ are ongoing and have included items ranging from settlement of this matter for de minimus amounts to the DOJ reserving their rights to litigate. Should litigation occur, we believe we have meritorious defenses and intend to vigorously defend ourselves. Neither our client nor the DCAA has indicated any intent to withhold payments from us relating to this matter. We believe the likelihood that a loss has been incurred related to this matter is remote and accordingly, no amounts have been accrued.

Table of Contents

Transportation costs. The DCAA, in performing its audit activities under the LogCAP III contract, raised a question about our compliance with the provisions of the Fly America Act. Subject to certain exceptions, the Fly America Act requires Federal employees and others performing U.S. Government financed foreign air travel to travel by U.S. flag air carriers. There are times when we transported personnel in connection with our services for the U.S. military where we may not have been in compliance with the Fly America Act and its interpretation through Federal Acquisition Regulations and the Comptroller General. As of December 31, 2007, we have accrued an estimate of the amount related to these non-compliant flights with a corresponding reduction to revenue. At this time, the likelihood that additional loss in excess of the amount accrued is remote. We will continue to work with our customer to resolve this matter.

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 Relating to Iraq, Kuwait and Afghanistan

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. We provided information to the DoD Inspector General's office in February 2004 about other contacts between former employees and our subcontractors. 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.

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.

Various Congressional committees have 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 continue to provide information and testimony with respect to operations in Iraq in these Congressional committees, including the House Armed Services Committee.

We have identified and reported to the US Departments of State and Commerce numerous 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 that possibly were not in accordance with the terms of our export license or applicable regulations. However, we believe that the facts and circumstances leading to our conclusion of possible non-compliance are unique and potentially mitigate any possible fines and penalties because the exported items are the property of the U.S. government and are used or consumed in connection with services rendered to the U.S. government. In addition, we have responded to a March 19, 2007, subpoena from the DoD Inspector General concerning licensing for armor for convoy trucks and antiboycott issues. We continue to comply with the requests to provide information under the subpoena. Whereas it is reasonably possible that we may be subject to fines and penalties for possible acts that are not in compliance with our export license or regulations, at this time it is not possible to estimate an amount of loss or range of losses that may have been incurred. 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. We are in ongoing communications with the appropriate authorities with respect to these matters.

SIGIR Report

The Special Inspector General for Iraq Reconstruction, or SIGIR, was created by Congress to provide oversight of the Iraq Relief and Reconstruction Fund (IRRF) and all obligations, expenditures, and revenues associated with reconstruction and rehabilitation activities in Iraq. SIGIR reports, from time to time, make reference to KBR regarding various matters. We believe we have addressed all issues raised by prior SIGIR reports and we will continue to do so as new issues are raised.

Table of Contents***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.

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. On July 5, 2007, the court granted our motion to dismiss the *qui tam* claims and to compel arbitration of employment claims including a claim that the plaintiff was unlawfully discharged. The majority of the plaintiff's claims were dismissed but the plaintiff was allowed to pursue limited claims pending discovery and future motions. All employment claims were sent to arbitration under the Company's dispute resolution program. We believe the relator's claim is without merit and believe the likelihood that a loss has been incurred is remote. As of December 31, 2007, no amounts have been accrued.

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. The final judgement in our favor was entered on April 30, 2007 and subsequently appealed by the plaintiffs on May 3, 2007. We believe the relators' claims are without merit and believe the likelihood that a loss has been incurred is remote. As of December 31, 2007, no amounts have been accrued.

Godfrey Qui Tam suit

In December 2005, we became aware of a *qui tam* action filed against us and several of our subcontractors by a former employee alleging that we violated the False Claims Act by submitting overcharges to the government for dining facility services provided in Iraq under the LogCAP III contract. As required by the False Claims Act, the lawsuit was filed under seal to permit the government to investigate the allegations. In early April 2007, the court denied the government's motion for the case to remain under seal, and on April 23, 2007, the government filed a notice stating that it was not participating in the suit. In August 2007, the relator filed an amended complaint which added an additional contract to the allegations and added retaliation claims. We have filed motions to dismiss and to compel arbitration on which the court has not yet ruled. Although discovery is just beginning, it is our intention to vigorously defend this claim. This matter is in the early stages of the legal process and therefore, we are unable to determine the

likely outcome at this time. No amounts have been accrued because we cannot determine any reasonable estimate of loss that may have been incurred, if any.

Table of Contents**Legal Proceedings*****FCPA Investigations***

Halliburton provided indemnification in favor of KBR under the master separation agreement for certain contingent liabilities, including Halliburton's indemnification of KBR and any of its greater than 50%-owned subsidiaries as of November 20, 2006, the date of the master separation agreement, for fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of a claim made or assessed by a governmental authority in the United States, the United Kingdom, France, Nigeria, Switzerland and/or Algeria, or a settlement thereof, related to alleged or actual violations occurring prior to November 20, 2006 of the FCPA or particular, analogous applicable foreign statutes, laws, rules, and regulations in connection with investigations pending as of that date including with respect to the construction and subsequent expansion by TSKJ of a natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The following provides a detailed discussion of the FCPA investigation.

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 Halliburton, for itself and all of its subsidiaries, enter into a tolling agreement with respect to its investigation. In October of 2007, after our separation from Halliburton, the SEC and DOJ repeated their request for Halliburton and us to each enter into a tolling agreement. In accordance with the master separation agreement, KBR has requested approval from Halliburton to enter into the appropriate tolling agreements.

In 2007, we and Halliburton each received a grand jury subpoena from the DOJ and subpoenas from the SEC related to the Bonny Island project asking for additional information on the immigration service providers used by TSKJ. We have provided the requested documents to the DOJ and SEC and will continue to provide Halliburton with the requested information in accordance with the master separation agreement.

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, 2007. 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, 2007, 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 and KBR have been cooperating with the SEC and DOJ investigations and with other investigations into the Bonny Island project in France, Nigeria and Switzerland. The Serious Frauds Office in the United Kingdom is conducting an investigation relating to the Bonny Island project and recently made contact with KBR to request limited information. Under the master separation agreement, Halliburton will continue to oversee and direct the investigations.

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.

Table of Contents

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.

Halliburton 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 discovered documents related to KBR activities in countries outside of Nigeria with respect to agents for projects after 1998. Certain of the activities involve current or former employees or persons who were or are consultants to us, and the investigation is continuing.

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. 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. Until such time as the agents' suspensions are favorably resolved, KBR will continue the suspension of its use of both of the referenced agents.

A person or entity found in violation of the FCPA 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 2007, we had revenue of approximately \$5.4 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 2007, we had revenue of approximately \$224 million 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.

Table of Contents

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, our compliance procedures or having a monitor required or agreed to be appointed at our cost as part of the disposition of the investigation have resulted 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. 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 the 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, in which we do not have an interest greater than 50%. Please read *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.

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.

The results of these investigations may have a material adverse effect on our business and results of operations. As of December 31, 2007, we are unable to estimate a range of possible loss relates to these matters.

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

Table of Contents

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. In the fourth quarter of 2007, the class action lawsuit was withdrawn by the plaintiffs.

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" and Note 18 of our consolidated financial statements.

Item 8. Financial Statements and Supplementary Data

| | Page No. |
|--|-----------------|
| <u>Report of Independent Registered Public Accounting Firm</u> | 63 |
| <u>Consolidated Statements of Income for years ended December 31, 2007, 2006, and 2005</u> | 64 |
| <u>Consolidated Balance Sheets at December 31, 2007 and 2006</u> | 65 |
| <u>Consolidated Statements of Shareholders' Equity for the years ended December 31, 2007, 2006, and 2005</u> | 66 |
| <u>Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006, and 2005</u> | 67 |
| <u>Notes to Consolidated Financial Statements</u> | 68 |

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, 2007 and 2006, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2007. 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, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 3, 21, and 15 respectively, to the consolidated financial statements, the Company changed its method of accounting for stock-based compensation plans as of January 1, 2006, its method of accounting for defined benefit and other post retirement plans as of December 31, 2006, and its method of accounting for uncertainty in income taxes as of January 1, 2007.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), KBR, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 26, 2008 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Houston, Texas

February 26, 2008

Table of Contents

KBR, Inc.
Consolidated Statements of Income
(In millions, except for per share data)

| | Years ended December 31 | | |
|---|--------------------------------|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Revenue: | | | |
| Services | \$ 8,642 | \$ 8,798 | \$ 9,351 |
| Equity in earnings (losses) of unconsolidated affiliates, net | 103 | 7 | (60) |
| Total revenue | 8,745 | 8,805 | 9,291 |
| Operating costs and expenses: | | | |
| Cost of services | 8,225 | 8,433 | 8,858 |
| General and administrative | 226 | 226 | 158 |
| Gain on sale of assets, net | | (6) | (110) |
| Total operating costs and expenses | 8,451 | 8,653 | 8,906 |
| Operating income | 294 | 152 | 385 |
| Interest expense related party | | (36) | (24) |
| Interest income (expense), net | 62 | 27 | (1) |
| Foreign currency gains, net related party | | 1 | 3 |
| Foreign currency gains (losses), net | (15) | (16) | 2 |
| Other, net | 1 | | (1) |
| Income from continuing operations before income taxes and minority interest | 342 | 128 | 364 |
| Provision for income taxes | (138) | (94) | (160) |
| Minority interest in net (income) loss of subsidiaries | (22) | 20 | (19) |
| Income from continuing operations | \$ 182 | \$ 54 | \$ 185 |
| Income from discontinued operations, net of tax provision of \$(109), \$(82) and \$(37) | 120 | 114 | 55 |
| Net income | \$ 302 | \$ 168 | \$ 240 |
| Basic income per share (1): | | | |
| Continuing operations | \$ 1.08 | \$ 0.39 | \$ 1.36 |
| Discontinued operations, net | 0.71 | 0.81 | 0.40 |
| Net income per share | \$ 1.80 | \$ 1.20 | \$ 1.76 |
| Diluted income per share (1): | | | |
| Continuing operations | \$ 1.08 | \$ 0.39 | \$ 1.36 |
| Discontinued operations, net | 0.71 | 0.81 | 0.40 |
| Net income per share | \$ 1.79 | \$ 1.20 | \$ 1.76 |

| | | | |
|--|-----|-----|-----|
| Basic weighted average shares outstanding | 168 | 140 | 136 |
| Diluted weighted average shares outstanding | 169 | 140 | 136 |

(1) Due to the effect of rounding, the sum of the individual per share amounts may not equal the total shown.

See accompany notes to consolidated financial statements.

Table of Contents

KBR, Inc.
Consolidated Balance Sheets
(In millions except share data)

| | December 31 | |
|--|--------------------|-----------------|
| | 2007 | 2006 |
| Assets | | |
| Current assets: | | |
| Cash and equivalents | \$ 1,861 | \$ 1,410 |
| Receivables: | | |
| Notes and accounts receivable (less allowance for bad debts of \$23 and \$57) | 927 | 761 |
| Unbilled receivables on uncompleted contracts | 820 | 1,110 |
| Total receivables | 1,747 | 1,871 |
| Deferred income taxes | 165 | 120 |
| Other current assets | 282 | 240 |
| Current assets related to discontinued operations | 1 | 257 |
| Total current assets | 4,056 | 3,898 |
| Property, plant, and equipment, net of accumulated depreciation of \$227 and \$205 | 220 | 211 |
| Goodwill | 251 | 251 |
| Equity in and advances to related companies | 294 | 296 |
| Noncurrent deferred income taxes | 139 | 156 |
| Unbilled receivables on uncompleted contracts | 196 | 194 |
| Other assets | 47 | 51 |
| Noncurrent assets related to discontinued operations | | 357 |
| Total assets | \$ 5,203 | \$ 5,414 |
| Liabilities, Minority Interest and Shareholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,117 | \$ 1,177 |
| Due to Halliburton, net | 16 | 152 |
| Advance billings on uncompleted contracts | 794 | 767 |
| Reserve for estimated losses on uncompleted contracts | 117 | 180 |
| Employee compensation and benefits | 316 | 259 |
| Other current liabilities | 262 | 174 |
| Current liabilities related to discontinued operations, net | 1 | 274 |
| Total current liabilities | 2,623 | 2,983 |
| Noncurrent employee compensation and benefits | 79 | 221 |
| Other noncurrent liabilities | 151 | 149 |
| Noncurrent income tax payable | 78 | |
| Noncurrent deferred tax liability | 37 | 22 |
| Noncurrent liabilities of discontinued operations, net | | 210 |
| Total liabilities | 2,968 | 3,585 |
| | (32) | 35 |
| Table of Contents | | 121 |

Minority interest in consolidated subsidiaries (including \$0 and \$44 related to discontinued operations)

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, 169,709,601 and 167,643,000 issued and outstanding

| | | |
|--------------------------------------|-------|-------|
| Paid-in capital in excess of par | 2,070 | 2,058 |
| Accumulated other comprehensive loss | (122) | (291) |
| Retained earnings | 319 | 27 |

| | | |
|---|--------------|--------------|
| Total shareholders equity and accumulated other comprehensive loss | 2,267 | 1,794 |
|---|--------------|--------------|

| | | |
|--|-----------------|-----------------|
| Total liabilities, minority interest and shareholders equity and accumulated other comprehensive loss | \$ 5,203 | \$ 5,414 |
|--|-----------------|-----------------|

See accompanying notes to consolidated financial statements.

Table of Contents

KBR, Inc.
Consolidated Statements of Shareholders Equity
(In millions)

| | December 31 | | |
|---|--------------------|-----------------|-----------------|
| | 2007 | 2006 | 2005 |
| Balance at January 1, | \$ 1,794 | \$ 1,256 | \$ 812 |
| Net proceeds from initial public offering | | 511 | |
| Stock-based compensation | 11 | 17 | |
| Intercompany stock-based compensation | 1 | (16) | |
| Contributions from parent and other activities | | 15 | 300 |
| Adoption of FIN No. 48 | (10) | | |
| Adoption of FSP No. AUG AIR-1 | | 7 | |
| Adoption of SFAS No. 158 | | (152) | |
| Common stock issued upon exercise of stock options | 6 | | |
| Tax benefit related to stock-based plans | 11 | | |
| Intercompany settlement of taxes | (17) | (1) | 22 |
| Comprehensive income: | | | |
| Net income | 302 | 168 | 240 |
| Other comprehensive income (loss), net of tax (provision): | | | |
| Cumulative translation adjustments | (5) | 31 | (46) |
| Pension liability adjustments, net of taxes of \$116, \$(24) and \$(19) | 176 | (57) | (44) |
| Other comprehensive gains (losses) on derivatives: | | | |
| Unrealized gains (losses) on derivatives | 1 | 19 | (21) |
| Reclassification adjustments to net income (loss) | (4) | 1 | (21) |
| Income tax benefit (provision) on derivatives | 1 | (5) | 14 |
| Total comprehensive income | 471 | 157 | 122 |
| Balance at December 31, | \$ 2,267 | \$ 1,794 | \$ 1,256 |

See accompanying notes to consolidated financial statements.

Table of Contents

KBR, Inc.
Consolidated Statements of Cash Flows
(In millions)

| | Years ended December 31 | | |
|---|--------------------------------|--------------|--------------|
| | 2007 | 2006 | 2005 |
| Cash flows from operating activities: | | | |
| Net income | \$ 302 | \$ 168 | \$ 240 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 41 | 47 | 56 |
| Distributions from (to) related companies, net of equity in earnings (losses) | (7) | (41) | 40 |
| Deferred income taxes | (27) | 12 | 3 |
| Gain on sale of assets | (216) | (126) | (110) |
| Impairment of equity method investments | | 68 | |
| Other | 61 | 48 | (18) |
| Changes in operating assets and liabilities: | | | |
| Receivables | (143) | 281 | 203 |
| Unbilled receivables on uncompleted contracts | 264 | 232 | 272 |
| Accounts payable | (92) | (187) | (420) |
| Advance billings on uncompleted contracts | 11 | 209 | 120 |
| Accrued employee compensation and benefits | 57 | 19 | 125 |
| Reserve for loss on uncompleted contracts | (62) | 140 | (93) |
| Other assets | (29) | (38) | (35) |
| Other liabilities | 88 | 99 | 144 |
| Total cash flows provided by operating activities | 248 | 931 | 527 |
| Cash flows from investing activities: | | | |
| Capital expenditures | (43) | (57) | (76) |
| Sales of property, plant and equipment | 3 | 6 | 26 |
| Dispositions of businesses, net of cash | 334 | 276 | 87 |
| Other investing activities | (1) | | (17) |
| Total cash flows provided by investing activities | 293 | 225 | 20 |
| Cash flows from financing activities: | | | |
| Payments to Halliburton, net | (120) | (629) | (350) |
| Net repayments of short-term borrowings | | (2) | |
| Proceeds from long-term borrowings | | 8 | |
| Payments on long-term borrowings | (7) | (25) | (21) |
| Net proceeds from issuance of stock | 6 | 512 | |
| Excess tax benefits from stock-based compensation | 6 | | |
| Payments of dividends to minority shareholders | (35) | (3) | (4) |
| Total cash flows used in financing activities | (150) | (139) | (375) |
| Effect of exchange rate changes on cash | 9 | 50 | (12) |

| | | | |
|--|-----------------|-----------------|---------------|
| Increase in cash and equivalents | 400 | 1,067 | 160 |
| Cash and equivalents at beginning of period | 1,461 | 394 | 234 |
| Cash and equivalents at end of period | \$ 1,861 | \$ 1,461 | \$ 394 |

Supplemental disclosure of cash flow information:

Cash payments during the year for:

| | | | |
|------------------------------|--------|-------|-------|
| Interest paid to third party | \$ 4 | \$ 11 | \$ 12 |
| Income taxes | \$ 229 | \$ 57 | \$ 79 |

Noncash financing activities

| | | | |
|---|----|-------|--------|
| Contribution from parent and other activities | \$ | \$ 15 | \$ 300 |
|---|----|-------|--------|

See accompanying notes to consolidated financial statements.

Table of Contents**KBR, Inc.****Notes to Consolidated Financial Statements****Note 1. Description of Business and Basis of Presentation**

KBR, Inc. and its subsidiaries (collectively, KBR) is a global engineering, construction and services company supporting the energy, petrochemicals, government services and civil infrastructure sectors. We offer a wide range of services through six business units; Government and Infrastructure (G&I), Upstream, Services, Downstream, Technology and Ventures. See Note 10 for financial information about our reportable business segments.

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 retained all of the KBR shares owned prior to the Offering and, as a result of the Offering, its 135,627,000 shares of our common stock represented 81% of the outstanding common stock of KBR, Inc. after the Offering. Simultaneous with the Offering, Halliburton contributed 100% of the common stock of KBR Holdings to KBR, Inc. KBR, Inc. had no operations from the date of its formation to the date of the contribution of KBR Holdings. See Note 2 for a discussion concerning the completion of our separation from Halliburton.

Our consolidated financial statements include the accounts of majority-owned, controlled subsidiaries and variable interest entities where we are the primary beneficiary (see Note 19). 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.

Our consolidated financial statements reflect all costs of doing business, including certain costs 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.

Revisions Our prior period consolidated statements of income have been revised to reclassify certain overhead expenses within general and administrative expenses rather than within cost of services to allow transparency of business unit margins and general and administrative expense consistent with the nature of the underlying costs and the manner in which the costs are managed. See Note 10 for financial information about our reportable business segments and how indirect costs are managed. There was no impact on net income as previously reported in the consolidated statements of income, or on the consolidated balance sheets or the consolidated statements of cash flows, as a result of these revisions. A summary of the financial statement line items affected by the revisions is presented below.

| | | For the year ended | |
|--|--|---------------------------|--------------------------|
| | | December 31, 2006 | December 31, 2005 |
| | | As | As |
| | | Previously | Previously |

| In millions | Reported | As Revised | Reported | As Revised |
|----------------------------|-----------------|-------------------|-----------------|-------------------|
| Cost of service | \$8,551 | \$8,433 | \$8,931 | \$8,858 |
| General and administrative | \$ 108 | \$ 226 | \$ 85 | \$ 158 |
| | 68 | | | |

Table of Contents**Note 2. Separation from Halliburton**

On February 26, 2007, Halliburton's board of directors approved a plan under which Halliburton would dispose of its remaining interest in KBR through a tax-free exchange with Halliburton's stockholders pursuant to an exchange offer. On April 5, 2007, Halliburton completed the separation of KBR by exchanging the 135,627,000 shares of KBR owned by Halliburton for publicly held shares of Halliburton common stock pursuant to the terms of the exchange offer (the Exchange Offer) commenced by Halliburton on March 2, 2007.

In connection with the Offering in November 2006 and the separation of our business from Halliburton, we entered into various agreements with Halliburton including, among others, a master separation agreement, tax sharing agreement, transition services agreements and an employee matters agreement.

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, subject to specified exceptions. 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 Foreign Corrupt Practices Act (FCPA) investigations and the Barracuda-Caratinga project and for other litigation matters related to Halliburton's business. See Note 8 for a further discussion of the FCPA investigations and the Barracuda-Caratinga project.

The tax sharing agreement, as amended, provides for certain allocations of U.S. income tax liabilities and other agreements between us and Halliburton with respect to tax matters. As a result of the Offering, Halliburton will be responsible for filing all U.S. income tax returns required to be filed through April 5, 2007, the date KBR ceased to be a member of the Halliburton consolidated tax group. Halliburton will also be responsible for paying the taxes related to the returns it is responsible for filing. We will pay Halliburton our allocable share of such taxes. We are obligated to pay Halliburton for the utilization of net operating losses, if any, generated by Halliburton prior to the deconsolidation which we may use to offset our future consolidated federal income tax liabilities.

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. These support services relate to, among other things, information technology, legal, human resources, risk management and internal audit. 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. As of December 31, 2007, most of the corporate service activities have been discontinued and primarily related to human resources and risk management. In 2008, the only significant corporate service activities expected to be incurred relate to fees for ongoing guarantees provided by Halliburton on existing credit support instruments which have not yet expired.

The employee matters agreement provides for the allocation of liabilities and responsibilities to our current and former employees and their participation in certain benefit plans maintained by Halliburton. Among other items, the employee matters agreement and the KBR, Inc. Transitional Stock Adjustment Plan provide for the conversion, upon the complete separation of KBR from Halliburton, of stock options and restricted stock awards (with restrictions that have not yet lapsed as of the final separation date) granted to KBR employees under Halliburton's 1993 Stock and Incentive Plan (1993 Plan) to stock options and restricted stock awards covering KBR common stock. On April 5, 2007, immediately after our separation from Halliburton, the conversion of such stock options and restricted stock awards occurred. A total of 1,217,095 Halliburton stock options and 612,857 Halliburton restricted stock awards were converted into 1,966,061 KBR stock options with a weighted average exercise price per share of \$9.35 and 990,080 million restricted stock awards with a weighted average grant-date fair value per share of \$11.01. The conversion of such stock options and restricted stock was accounted for as a modification in accordance with SFAS No. 123(R) and resulted in an incremental charge to expense of less than \$1 million, recognized in 2007, representing the change in fair value of the converted awards from Halliburton stock options and restricted stock awards to KBR stock options and restricted stock awards. See Notes 3 and 17 for information regarding stock-based compensation and stock incentive plans.

See Note 20 for a further discussion of the above agreements and other related party transactions with Halliburton.

Table of Contents**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.

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, 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 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, 2007 and 2006, cash and equivalents included approximately \$483 million and \$527 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, 2007,

Table of Contents

2006 and 2005, included \$44 million, \$304 million and \$175 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 in fiscal 2007, 2006 or 2005. During the fourth quarter of 2007, we reorganized our operations resulting in an increase in the number of operating segments as well as the number of reporting units for goodwill impairment testing purposes. As a result of the reorganized operating segments, certain goodwill associated with one of our previous reporting units was allocated among several new reporting units. As such, we performed a goodwill impairment analysis after revising our reporting units which also resulted in no goodwill impairment. See Note 10 for further discussion of our reportable operating segments and related goodwill.

Intangibles assets not subject to amortization totaled \$10 million at December 31, 2007 and 2006, and are included in Other assets on the consolidated balance sheets.

Patents and other intangibles totaled \$39 million at December 31, 2007 and 2006, 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 \$34 million and \$31 million at December 31, 2007 and 2006, respectively. Patent and other intangible amortization expense was \$3 million for the years ended December 31, 2007, 2006 and 2005. Amortization expense is estimated to be approximately \$2 million for each of the years 2008 and 2009, and \$1 million for 2010.

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

For the period prior to the separation from Halliburton, income tax expense for KBR was calculated on a pro rata basis. Under this method, income tax expense was determined based on KBR operations and its contributions to

income tax expense of the Halliburton consolidated group. For the period post separation from Halliburton, income tax expense is calculated solely on KBR's standalone operations.

71

Table of Contents

KBR was included in the consolidated U.S. federal income tax return of Halliburton up through the date of separation. Additionally, KBR's U.K.-based subsidiaries and divisions were members of a U.K. tax group, which allowed the sharing of tax losses and other tax attributes among the KBR and Halliburton U.K.-based affiliates, up through the date of separation. As part of the separation, KBR and Halliburton entered into a tax sharing agreement, which generally provides that KBR will indemnify Halliburton for any additional taxes attributable to KBR's business for periods prior to the separation.

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.

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 such changes are 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 income.

Concentration of credit risk

Revenue from the United States government, which was derived almost entirely from our G&I business unit, totaled \$5.4 billion, or 62% of consolidated revenue, in 2007, \$5.8 billion, or 66% of consolidated revenue, in 2006, and \$6.6 billion, or 71% of consolidated revenue, in 2005. 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, 2007, 64% of our total receivables were related to our United States government contracts. At December 31, 2006, 62% of our total receivables were related to our United States government contracts, primarily for projects in the Middle East.

Minority Interest

Minority interest in consolidated subsidiaries in our consolidated balance sheets principally represents minority shareholders' proportionate share of the equity in our consolidated subsidiaries. Minority interest in consolidated subsidiaries is adjusted each period to reflect the minority shareholders' allocation of income, or the absorption of losses by minority shareholders on certain majority-owned, controlled investments where the minority shareholders are obligated to fund the balance of their share of these losses.

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.

Table of Contents***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, compensation expense is recognized for all newly granted awards and awards modified, repurchased, or cancelled after January 1, 2006 based on their fair values. 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 was 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. Under APB Opinion No. 25, no compensation expense was recognized for stock options or the ESPP. Compensation expense was recognized for restricted stock awards.

Total stock-based compensation expense, net of related tax effects, was \$7 million in 2007, \$11 million in 2006 and \$8 million in 2005. Total income tax benefit recognized in net income for stock-based compensation arrangements was \$4 million in 2007, \$6 million in 2006, and \$5 million in 2005. Incremental compensation cost resulting from modifications of previously granted stock-based awards which allowed certain employees to retain their awards after leaving the company, was less than \$1 million in 2007, \$6 million in 2006 and \$8 million in 2005. In 2007, we also recognized less than \$1 million in incremental compensation cost from modifications of previously granted stock-awards due to the conversion of Halliburton stock options and restricted stock awards granted to KBR employees to KBR awards of stock options and restricted stock, after our separation from Halliburton on April 5, 2007. Effective upon our complete separation from Halliburton, the Halliburton ESPP plan was terminated to KBR employees. No shares were purchased by KBR employees in 2007 under the Halliburton ESPP plan and therefore, no stock-based compensation expense was recorded in 2007. Halliburton shares previously purchased under the ESPP plan remained Halliburton common stock and did not convert to KBR common stock at the date of separation. See Note 2 Separation from Halliburton.

SFAS No. 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. For 2007, excess tax benefits realized from the exercise of stock-based compensation awards was \$6 million. The exercise of stock-based compensation awards resulted in a tax benefit to us of \$6 million, which has been recognized as paid-in capital in excess of par.

Previously under APB No. 25, Accounting for Stock Issued to Employees, no compensation expense was recognized for unvested stock options where the grant price was equal to market price on the date of grant and the vesting provisions were based only on the passage of time. The following table summarizes the pro forma effect on net income and income per share for 2005 as if we had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

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

Stock Options

There were no Halliburton stock options granted to our employees in 2006 or 2007. For Halliburton stock options granted in 2005, the fair value of options at the date of grant was estimated using the Black-Scholes Merton option pricing model. The expected volatility of Halliburton stock options granted to our employees in 2005 is based upon the historical volatility of Halliburton's common stock.

For KBR stock options granted in 2006, the fair value of options at the date of grant was estimated using the Black-Scholes Merton option pricing model. No KBR stock options were granted in 2007. 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

Table of Contents

peers. The expected term of Halliburton stock options in 2005 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 simplified estimate of expected term is utilized as we lack sufficient history to estimate an expected term for KBR options. The assumptions and resulting fair values of options granted were as follows:

| | Years ended December 31 | | |
|--|--------------------------------|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Halliburton Options | | | |
| Expected term (in years) | N/A | N/A | 5.00 |
| Expected volatility | N/A | N/A | 51% |
| Expected dividend yield | N/A | N/A | 0.8% |
| Risk-free interest rate | N/A | N/A | 4.3% |
| Weighted average grant-date fair value per share | N/A | N/A | \$9.97 |
| KBR Options | | | |
| Expected term (in years) | N/A | 6.00 | N/A |
| Expected volatility | N/A | 35% | N/A |
| Expected dividend yield | N/A | 0% | N/A |
| Risk-free interest rate | N/A | 4.6% | N/A |
| Weighted average grant-date fair value per share | N/A | \$9.34 | N/A |

Conversion of shares from Halliburton common stock awards to KBR common stock awards

Upon our separation from Halliburton, our Transitional Stock Adjustment Plan provided for the conversion of stock options and restricted stock awards (with restrictions that have not yet lapsed as of the final separation date) granted to KBR employees under Halliburton's 1993 Stock and Incentive Plan to stock options and restricted stock awards covering KBR common stock. On April 5, 2007, immediately after our separation from Halliburton, the conversion of such stock options and restricted stock awards occurred. A total of 1,217,095 Halliburton stock options and 612,857 Halliburton restricted stock awards were converted into 1,966,061 KBR stock options with a weighted average exercise price per share of \$9.35 and 990,080 restricted stock awards with a weighted average grant-date fair value per share of \$11.01. The conversion of such stock options and restricted stock was accounted for as a modification in accordance with SFAS No. 123(R) and resulted in an incremental charge to expense of less than \$1 million, recognized in 2007, representing the change in fair value of the converted awards from Halliburton stock options and restricted stock awards to KBR stock options and restricted stock awards. See Note 17 for information regarding stock incentive plans.

In accordance with SFAS 123(R), in the event of an option modification, the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award, and both awards are remeasured based on the share price and other pertinent factors at the modification date. The fair value of each option was estimated based on the date of grant using the Black-Scholes Merton option pricing model. The following assumptions were used in estimating the fair value of the Halliburton stock options exchanged for KBR stock options for KBR employees at the date of modification:

Halliburton Options

| | | |
|---------------------------|-------|--------|
| Expected term (in years) | 0.25 | 4.5 |
| Expected volatility range | 21.06 | 30.63% |

| | |
|-------------------------|-----------|
| Expected dividend yield | 0.96% |
| Risk-free interest rate | 4.5 5.07% |

KBR Options

| | |
|---------------------------|--------------|
| Expected term (in years) | 0.25 5.5 |
| Expected volatility range | 29.03 37.43% |
| Expected dividend yield | 0.00% |
| Risk-free interest rate | 4.5 5.07% |

Table of Contents

The expected term of Halliburton options is based on the historical exercise data of Halliburton and KBR employees and the various original grant dates. Volatility is based on the historical and implied volatility of Halliburton common stock. Expected dividend yield is based on cash dividends paid by Halliburton in 2006 divided by the closing share price at December 31, 2006. The expected term of KBR options is based upon the average of the life of the option and the vesting period of the option. The simplified estimate of expected term is utilized as we lack sufficient history to estimate an expected term for KBR options. Volatility for KBR options is based upon a blended rate that uses the historical and implied volatility of common stock for KBR and selected peers. The risk-free interest rate applied to both Halliburton and KBR options is based on the U.S. Treasury yield curve in effect at the date of modification.

The conversion ratio for restricted stock was calculated under the Transitional Stock Adjustment Plan (refer to Note 17) and was based on comparative KBR and Halliburton share prices. The conversion ratio was based upon the volume weighted average stock price of KBR and Halliburton shares for a three-day average.

Halliburton ESPP Plan

The fair value of Halliburton's ESPP shares for 2006 and 2005 was estimated using the Black-Scholes Merton 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 | | |
|--|--|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Expected term (in years) | N/A | 0.5 | 0.5 |
| Expected volatility | N/A | 37.77% | 30.46% |
| Expected dividend yield | N/A | 0.80% | 0.73% |
| Risk-free interest rate | N/A | 5.29% | 3.89% |
| Weighted average grant-date fair value per share | N/A | \$ 9.32 | \$ 5.50 |

| | Offering Period January 1 to June 30 | | |
|--|---|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Expected term (in years) | N/A | 0.5 | 0.5 |
| Expected volatility | N/A | 35.65% | 26.93% |
| Expected dividend yield | N/A | 0.75% | 1.16% |
| Risk-free interest rate | N/A | 4.38% | 3.15% |
| Weighted average grant-date fair value per share | N/A | \$ 7.91 | \$ 4.15 |

Performance Award Units

In 2007 we granted 24,549,000 performance based award units (Performance Awards) with a performance period from July 1, 2007 to December 31, 2009. Performance is based 50% on Total Shareholder Return (TSR), as compared to our peer group and 50% on KBR's Return on Capital (ROC). The performance award units may only be paid in cash. In accordance with the provisions of SFAS No. 123(R), the TSR portion of the performance award units are classified as liability awards and remeasured at the end of each reporting period at fair value until settlement. The fair value approach uses the Monte Carlo valuation method which analyzes the companies comprising KBR's peer group, considering volatility, interest rate, stock beta and TSR through the grant date. The ROC calculation is based on the company's weighted average net income from continuing operations plus (interest expense x (1-effective tax rate)), divided by average monthly capital from continuing operations. The ROC portion of the Performance Award is also classified as a liability award and remeasured at the end of each reporting period based on our estimate of the amount to be paid at the end of the vesting period.

Cost for the Performance Awards is accrued over the requisite service period. At December 31, 2007 we recognized \$5 million in expense for the Performance Awards. The expense associated with these options is included in cost of services and general and administrative expense in our consolidated statements of income. The liability

awards are included in Employee compensation and benefits on the consolidated balance sheet at December 31, 2007. See Note 17 for further detail on stock incentive plans.

Table of Contents**Note 4. Income per Share**

Basic income per share is based upon the weighted average number of common shares outstanding during the period. Dilutive income per share includes additional common shares that would have been outstanding if potential common shares with a dilutive effect had been issued, using the treasury stock method. A reconciliation of the number of shares used for the basic and diluted income per share calculations is as follows:

| <i>Millions of Shares</i> | 2007 | 2006 | 2005 |
|---|-------------|-------------|-------------|
| Basic weighted average common shares outstanding | 168 | 140 | 136 |
| Dilutive effect of: | | | |
| Stock options and restricted shares | 1 | | |
| Diluted weighted average common shares outstanding | 169 | 140 | 136 |

No adjustments to net income were made in calculating diluted earnings per share for the fiscal years 2007, 2006 and 2005.

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 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.

Table of Contents

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. The amounts of unapproved claims and change orders recorded as Unbilled work on uncompleted contracts or Other assets for each period are as follows:

| Millions of dollars | Years ended December 31 | | |
|--|-------------------------|-------|-------|
| | 2007 | 2006 | 2005 |
| Probable unapproved claims | \$178 | \$178 | \$175 |
| Probable unapproved change orders | 4 | 54 | 5 |
| Probable unapproved claims related to unconsolidated subsidiaries | 36 | 78 | 92 |
| Probable unapproved change orders related to unconsolidated subsidiaries | 15 | 3 | 5 |

As of December 31, 2007, the probable unapproved claims, including those from unconsolidated subsidiaries, related to five contracts, most of which are complete or substantially complete. See Note 13 for a discussion of U.S. government contract claims, which are not included in the table above.

We have contracts with probable unapproved claims that will likely not be settled within one year totaling \$178 million, \$175 million and \$172 million at December 31, 2007, 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, have been recorded as a current asset in Unbilled receivables on uncompleted contracts on the consolidated balance sheets.

Note 6. PEMEX

In 1997 and 1998 we entered into three contracts with PEMEX, the project owner, to build offshore platforms, pipelines and related structures in the Bay of Campeche offshore Mexico. The three contracts are known as EPC 1, EPC 22 and EPC 28, respectively. All three projects encountered significant schedule delays and increased costs due to problems with design work that was the contractual responsibility of PEMEX, late delivery and defects in equipment provided by PEMEX, increases in scope and other changes made by PEMEX. We completed work on EPC 28 and EPC 22 in August 2002 and March 2004 respectively. PEMEX took possession of the offshore facilities of EPC 1 in March 2004 after having achieved oil production and prior to our completion of our scope of work pursuant to the contract.

In accordance with the terms of each of the contracts, we filed for arbitration with the International Chamber of Commerce (ICC) in 2004 and 2005 claiming recovery of damages of \$323 million, \$215 million and \$142 million for EPC 1, 22 and 28, respectively. PEMEX subsequently filed counterclaims totaling \$157 million, \$42 million and \$2 million for EPC 1, 22 and 28, respectively.

The arbitration hearings for EPC 28 and EPC 1 were held in June 2006 and November 2007, respectively. We estimate that the EPC 1 award will be made in the fourth quarter of 2008. In January 2008, we received payment from PEMEX related to the EPC 22 arbitration award of the ICC panel which was sufficient for recovery of our investment in the note receivable for this contract, as well as \$4 million in interest income. Also, we received notice in February 2008, that the ICC approved the arbitration panel's decision to award in favor of KBR on the EPC 28 arbitration. While we are awaiting an official translation of the award, we understand that the net award in our favor exceeds \$70 million plus accrued interest since 2002 which exceeds the book value of our claim of \$61 million.

The amounts of probable claims receivable and previously approved items represent costs that we incurred that as of December 31, 2007 are at least three years old. We have not made any significant adjustments to the recorded amount of probable claims and previously approved items during the years 2005, 2006 or 2007. We recorded legal expenses of \$11 million, \$8 million and \$6 million for the years ended December 31, 2005, 2006, and 2007, respectively, related to these matters.

We believe that the counterclaims referred to above filed by PEMEX are without merit and have concluded there is no reasonable possibility that a loss has been incurred. No amounts have been accrued for these counterclaims at December 31, 2007.

Table of Contents**Note 7. Escravos Project**

In connection with our review of a consolidated 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, 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.

In the fourth quarter of 2006, we reached agreement with the project owner to settle \$264 million of change orders. We also 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. These services were in excess of the contractual limit to total engineering costs each partner can bill to the joint venture.

During the first half of 2007, we and our joint venture partner negotiated modifications to the contract terms and conditions resulting in an executed contract amendment in July 2007. The contract has been amended to convert from a fixed price to a reimbursable contract whereby we will be paid our actual cost incurred less a credit that approximates the charge we identified in the second quarter of 2006. Also included in the amended contract are client determined incentives that may be earned over the remaining life of the contract. The effect of the modifications resulted in a \$3 million increase to operating income in the second quarter of 2007. In addition, minority interest shareholders' absorption of losses increased by \$15 million resulting in an increase to net income of \$12 million in the second quarter of 2007. Because our amended agreement with the client provides that we will be reimbursed for our actual costs incurred, as defined, all amounts of probable unapproved change order revenue that were previously included in the project estimated revenues are now considered approved. As of December 31, 2007, our Advanced billings on uncompleted contracts related to this project was \$236 million.

Note 8. 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 and \$8 million for 2006 and 2005, respectively. No losses were recorded on the project in 2007. 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. We funded approximately \$3 million in cash shortfalls during 2007.

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. In November 2007, we executed a settlement agreement with the project owner to settle all outstanding project issues except for the bolts arbitration discussed below. The agreement resulted in the project owner assuming substantially all remaining work on the project and the release of us from any further warranty obligations. The settlement agreement did not have a material impact to our results of operations or financial position.

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 do not believe that it is probable that we have incurred a liability in connection with the claim in the bolt arbitration with Petrobras and therefore, no amounts have been accrued. We disagree with Petrobras' claim since the bolts met the design specification provided by Petrobras. Although we believe Petrobras is responsible for any maintenance and replacement of the bolts, it is possible that the arbitration panel could find against us on this issue. In addition, Petrobras has not provided any evidentiary support or analysis for the amounts claimed as damages. We expect to have a preliminary hearing on legal and factual issues relating to liability with the arbitration panel in April 2008. The

actual arbitration hearings have not yet been scheduled. Therefore, at this time, we cannot conclude that the likelihood that a loss has been incurred is remote. Due to the indemnity from Halliburton, we believe any outcome of this matter will not have a material adverse impact to our operating results or financial position. KBR has incurred legal fees and related expenses of \$4 million, \$1 million and \$0 million for the years ended December 31, 2007, 2006 and 2005, respectively, related to this matter.

Table of Contents

Under the master separation agreement, Halliburton has agreed to indemnify us and any of our greater than 50%-owned subsidiaries as of November 2006, for all out-of-pocket cash costs and expenses (except for ongoing legal costs), or cash settlements or cash arbitration awards in lieu thereof, we may incur after the effective date of the master separation agreement as a result of the replacement of the subsea flowline bolts installed in connection with the Barracuda-Caratinga project.

Note 9. Dispositions

Devonport Management Limited. On June 28, 2007, we consummated the sale of our 51% ownership interest in DML for cash proceeds of approximately \$345 million, net of direct transaction costs, resulting in a gain of approximately \$101 million, net of tax of \$115 million. Our DML operations were part of our G&I business unit. See Note 25 (Discontinued Operations).

Production Services. In May 2006, we completed the sale of our Production Services group, which was part of our Services business unit. 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 25 (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 Ventures business unit.

Note 10. 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 ventures represent a substantial part of our operations.

During the third quarter of 2007, we announced the reorganization of our operations into six business units as a result of a change in operational and market strategies in order to maximize KBR's resources for future opportunities. Each business unit has its own leader who reports to our chief executive officer (CEO) who is also our chief operating decision maker. During the fourth quarter of 2007, we completed the reorganization of our monthly financial and operating information provided to our chief operating decision maker and accordingly, we have redefined our reportable segments consistent with the financial information that our chief operating decision maker reviews to evaluate operating performance and make resource allocation decisions. Our reportable segments are Government and Infrastructure, Upstream and Services. Our segment information has been prepared in accordance SFAS No. 131

Disclosures About Segments of an Enterprise and Related Information and all prior period amounts have been restated to conform to the current presentation.

We have reorganized our internal reporting structure based on similar products and services. The following is a description of our three reportable segments:

Government and Infrastructure. Our G&I reportable 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.

Upstream. Our Upstream reportable segment designs and constructs energy and petrochemical projects, including large, technically complex projects in remote locations around the world. Our expertise includes LNG and GTL gas monetization facilities, refineries, petrochemical plants, onshore and offshore oil and gas production facilities (including platforms, floating production and subsea facilities), onshore and offshore pipelines. We provide a

complete range of EPC-CS services, as well as program and project management, consulting and technology services.

Services. Our Services reportable segment provides construction and industrial services built on the legacy established by the founders Brown & Root almost 100 years ago. Our construction services include major project construction, construction management and module and pipe fabrication services. Our industrial services include routine maintenance small capital and turnaround services as well as the full range of high value services including startup commissioning ,

Table of Contents

procurement support, facility services, supply chain solutions, and electrical and instrumentation solutions. We also provide offshore maintenance and construction services to oil and gas facilities using semisubmersible vessels in the Bay of Campeche through a jointly held venture. Our services are delivered to customers in variety of industries including the petrochemical, refining, pulp and paper, and energy industries.

Certain of our operating segments do not individually meet the quantitative thresholds as a reportable segment nor do they share a majority of the aggregation criteria with another operating segment. These operating segments are reported on a combined basis as Other and include our Downstream, Technology, and Ventures operating segments as well as corporate expenses not included in the operating segments results.

Our reportable segments follow the same accounting policies as those described in Note 3 (Significant Accounting Policies). 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.

The tables below present information on our business segments.

Operations by Business Segment

| Millions of dollars | Years ended December 31 | | |
|---|-------------------------|----------|----------|
| | 2007 | 2006 | 2005 |
| Revenue: | | | |
| Government and Infrastructure | \$ 6,093 | \$ 6,506 | \$ 7,299 |
| Upstream | 1,887 | 1,700 | 1,145 |
| Services | 322 | 314 | 280 |
| Other | 443 | 285 | 567 |
| Total | \$ 8,745 | \$ 8,805 | \$ 9,291 |
| Operating segment income (loss): | | | |
| Government and Infrastructure | \$ 279 | \$ 327 | \$ 282 |
| Upstream | 188 | 40 | 100 |
| Services | 56 | 45 | 38 |
| Other | 17 | (35) | 122 |
| Operating segment income (a) | 540 | 377 | 542 |
| Unallocated amounts: | | | |
| Labor cost absorption (b) | (20) | 1 | 1 |
| Corporate general and administrative | (226) | (226) | (158) |
| Total | \$ 294 | \$ 152 | \$ 385 |
| Capital Expenditures: | | | |
| Government and Infrastructure | \$ 3 | \$ 9 | \$ 8 |
| Upstream | 4 | 4 | 2 |
| Services | | 1 | 1 |
| Other | | | |
| General corporate | 29 | 33 | 40 |
| Total (c) | \$ 36 | \$ 47 | \$ 51 |

Equity in earnings (losses) of unconsolidated affiliates, net:

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| | | | |
|-------------------------------|--------|-------|---------|
| Government and Infrastructure | \$ 47 | \$ 21 | \$ (8) |
| Upstream | 49 | 59 | (43) |
| Services | 18 | 13 | |
| Other | (11) | (86) | (9) |
| Total | \$ 103 | \$ 7 | \$ (60) |

Depreciation and amortization:

| | | | |
|-------------------------------|-------|-------|-------|
| Government and Infrastructure | \$ 3 | \$ 3 | \$ 5 |
| Upstream | 1 | | |
| Services | 1 | 1 | 2 |
| Other | 2 | 3 | 2 |
| General corporate (d) | 24 | 22 | 20 |
| Total (e) | \$ 31 | \$ 29 | \$ 29 |

Table of Contents

| Millions of dollars | Years ended December 31 | | |
|--|-------------------------|------|------|
| | 2007 | 2006 | 2005 |
| Restructuring charge (Note 22): | | | |
| Government and Infrastructure | \$ 5 | \$ 1 | \$ |
| Upstream | | 1 | 1 |
| Services | | | |
| General corporate | | 3 | |
| Total | \$ 5 | \$ 5 | \$ 1 |

- (a) Operating segment performance is evaluated by our chief operating decision maker using operating segment income which is defined as operating segment revenue less the cost of services and segment overhead directly attributable to the operating segment. Operating segment income excludes certain cost of services and general and administrative expenses directly attributable to the operating segment that is managed and reported at the corporate level, and corporate general and administrative expenses. We

believe this is the most accurate measure of the ongoing profitability of our operating segments.

(b) Labor cost absorption represents costs incurred by our central service labor and resource groups (above) or under the amounts charged to the operating segments.

(c) Capital expenditures does not include capital expenditures for DML, which was sold in the second quarter of 2007 and is accounted for as discontinued operations. Capital expenditures for DML was \$7 million, \$10 million and \$25 million for the year ended December 31, 2007, 2006 and 2005, respectively.

(d) Depreciation and amortization associated with corporate assets

is allocated to our six operating segments for determining operating income or loss.

- (e) These amounts do not include depreciation and amortization expense for DML, which was sold in the second quarter of 2007 and is accounted for as discontinued operations. Depreciation and amortization expense for DML was \$10 million, \$18 million and \$27 million for the year ended December 31, 2007, 2006 and 2005, respectively.

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 and are therefore reported as General corporate assets.

Balance Sheet Information by Operating Segment

| Millions of dollars | December 31 | |
|---|--------------------|-----------------|
| | 2007 | 2006 |
| Total assets: | | |
| Government and Infrastructure | \$ 2,347 | \$ 2,227 |
| Upstream | 1,888 | 1,700 |
| Services | 148 | 87 |
| Other | 819 | 786 |
| Assets related to discontinued operations | 1 | 614 |
| Total assets | \$ 5,203 | \$ 5,414 |

Equity in/advances to related companies:

| | | |
|-------------------------------|--------|---------|
| Government and Infrastructure | \$ 21 | \$ (19) |
| Upstream | 158 | 190 |
| Services | 46 | 50 |
| Other | 69 | 75 |
| Total | \$ 294 | \$ 296 |

Table of Contents

| Millions of dollars | December 31 | |
|-------------------------------|-------------|--------|
| | 2007 | 2006 |
| Goodwill: | | |
| Government and Infrastructure | \$ 23 | \$ 23 |
| Upstream | 159 | 159 |
| Services | 23 | 23 |
| Other | 46 | 46 |
| Total | \$ 251 | \$ 251 |

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 | | |
|---------------------|-------------------------|----------|----------|
| | 2007 | 2006 | 2005 |
| Revenue: | | | |
| United States | \$ 961 | \$ 1,351 | \$ 1,273 |
| Iraq | 4,329 | 4,331 | 5,116 |
| Kuwait | 11 | 217 | 320 |
| United Kingdom | 316 | 302 | 287 |
| Other Countries | 3,128 | 2,604 | 2,295 |
| Total | \$ 8,745 | \$ 8,805 | \$ 9,291 |

| Long-Lived Assets: | December 31 | |
|--------------------|-------------|--------|
| | 2007 | 2006 |
| United States | \$ 114 | \$ 112 |
| United Kingdom | 48 | 42 |
| Other Countries | 58 | 57 |
| Total | \$ 220 | \$ 211 |

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:

| Millions of dollars | Estimated Useful Lives in Years | December 31 | |
|---------------------|---------------------------------|-------------|-------|
| | | 2007 | 2006 |
| Land | N/A | \$ 28 | \$ 28 |

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| | | | |
|-------------------------------------|------|--------|--------|
| Buildings and property improvements | 5-44 | 180 | 169 |
| Machinery, equipment and other | 3-20 | 239 | 219 |
| Total | | 447 | 416 |
| Less accumulated depreciation | | (227) | (205) |
| Net property, plant and equipment | | \$ 220 | \$ 211 |

Table of Contents**Note 12. Debt**

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. 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 50%; a leverage ratio that does not exceed 3.5; and a fixed charge coverage ratio of at least 3.0. At December 31, 2007 and December 31, 2006, we were in compliance with these ratios and other covenants. As of December 31, 2007 and December 31, 2006, there were zero borrowings and \$508 million and \$55 million, respectively, in letters of credit issued and outstanding under this facility.

On January 17, 2008, we entered into an Agreement and Amendment to the Revolving Credit Facility effective as of January 11, 2008, (the Amendment). The Amendment (i) permits us to elect whether any increase in the aggregate commitments under the Revolving Credit Facility used solely for the issuance of letters of credit are to be funded from existing banks or from one or more eligible assignees; and (ii) permits us to declare and pay shareholder dividends and/or engage in equity repurchases not to exceed \$400 million.

In June 2007, our 55%-owned consolidated subsidiary, M.W. Kellogg Limited, entered into a credit facility with Barclays Bank totaling £15 million. This facility replaces a previous facility with Barclays Bank. This facility, which is non-recourse to us, is primarily used for bonding, guarantee, and other purposes. At December 31, 2007, \$20 million of bank guarantees were outstanding under the facility.

Note 13. 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).

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.

We have experienced and expect to be a party to various claims against us by employees, third parties, soldiers and others that have arisen out of our work in Iraq such as claims for wrongful termination, assaults against employees,

personal injury claims by third parties and army personnel, and contractor claims. While we believe we conduct our operations safely, the environments in which we operate often lead to these types of claims. We believe the vast majority of these types of claims are governed by the Defense Base Act or precluded by other defenses. We have a dispute resolution program under which most of these employee claims are subject to binding arbitration. However, an unfavorable resolution or disposition of these matters could have a material adverse effect on our business, results of operations, financial condition and cash flow.

Table of Contents***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.

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 would begin making further adjustments equal to 6% of prior and current subcontractor costs unless we provided timely information sufficient to show that such action was not necessary to protect the government's interest.

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, but we believe that they should be less than 6% of the total subcontractor costs. We will continue to work with the Army to resolve this issue. In October 2007, we filed a claim to recover the amounts withheld. At this time, the likelihood that a loss related to this matter has been incurred is remote. As of December 31, 2007, we had not adjusted our revenues or accrued any amounts related to this matter.

Dining Facility Support Services. In April 2007, DCAA recommended withholding \$13 million of payments from KBR alleging that Eurest Support Services (Cypress) International Limited (ESS), a subcontractor to KBR providing dining facility services in conjunction with our Logcap III contract in Iraq, over-billed for the cost related to the use of power generators. Payments of \$13 million have been withheld from us. We disagree with the position taken by the DCAA and we are working to resolve this issue. We believe the likelihood that a loss has been incurred related to this matter is remote and accordingly, no amounts have been accrued.

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. During 2006, we resolved approximately \$26 million of the withheld amounts with our contracting officer which was received in the first quarter of 2007. Approximately \$30 million continues to be withheld from us as of December 31, 2007, of which \$17 million was withheld by us from our subcontractor. We will continue working with the government and our

subcontractors to resolve the remaining amounts. At this time, the likelihood that the loss is in excess of the amount accrued is remote.

Dining facilities. In the third quarter of 2006, the DCAA raised questions regarding \$95 million of costs related to dining facilities in Iraq. We responded to the DCAA that our costs are reasonable. In the fourth quarter of 2007, the DCAA suspended \$11 million of costs related to these dining facilities until such time we provide documentation to support the price reasonableness of the rates negotiated with our subcontractor and demonstrate that the amounts billed were in accordance with the contract terms. Subsequently, the DCAA suspended an additional \$42 million of costs until such time we provide documentation to support the price reasonableness of the rates negotiated with the subcontractor. We believe the

Table of Contents

prices obtained for these services were reasonable and intend to vigorously defend ourselves on this matter. We are working with our customer and the DCAA to resolve the issue. As of December 31, 2007, we believe it is reasonably possible that we could incur losses in excess of the amount accrued for possible subcontractor costs billed to the customer that were possibly not in accordance with contract terms. However, we are unable to estimate an amount of possible loss or range of possible loss in excess of the amount accrued related to any costs billed to the customer that were not in accordance with the contract terms.

Kosovo fuel. In April 2007, the Department of Justice (DOJ) issued a letter alleging the theft in 2004 and subsequent sale of diesel fuel by KBR employees assigned to Camp Bondsteel in Kosovo. In addition, the letter alleges that KBR employees falsified records to conceal the thefts from the Army. The total value of the fuel in question is estimated by the DOJ at approximately \$2 million based on an audit report issued by the DCAA. We believe the volume of the misappropriated fuel is significantly less than the amount estimated by the DCAA. We responded to the DOJ that we had maintained adequate programs to control, protect, and preserve the fuel in question. We further believe that our contract with the Army expressly limits KBR's responsibility for such losses. Our discussions with the DOJ are ongoing and have included items ranging from settlement of this matter for de minimus amounts to the DOJ reserving their rights to litigate. Should litigation occur, we believe we have meritorious defenses and intend to vigorously defend ourselves. Neither our client nor the DCAA has indicated any intent to withhold payments from us relating to this matter. We believe the likelihood that a loss has been incurred related to this matter is remote and accordingly, no amounts have been accrued.

Transportation costs. The DCAA, in performing its audit activities under the LogCAP III contract, raised a question about our compliance with the provisions of the Fly America Act. Subject to certain exceptions, the Fly America Act requires Federal employees and others performing U.S. Government financed foreign air travel to travel by U.S. flag air carriers. There are times when we transported personnel in connection with our services for the U.S. military where we may not have been in compliance with the Fly America Act and its interpretation through Federal Acquisition Regulations and the Comptroller General. As of December 31, 2007, we have accrued an estimate of the amount related to these non-compliant flights with a corresponding reduction to revenue. At this time, the likelihood that additional loss in excess of the amount accrued is remote. We will continue to work with our customer to resolve this matter.

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 relating to Iraq, Kuwait and Afghanistan

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. We provided information to the DoD Inspector General's office in February 2004 about other contacts between former employees and our subcontractors. 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.

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.

Various Congressional committees have 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 continue to provide information and testimony with respect to operations in Iraq in these Congressional committees, including the House Armed Services Committee.

We have identified and reported to the US Departments of State and Commerce numerous 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 that possibly were not in accordance with the terms of our export license or applicable regulations. However, we believe that the facts and circumstances leading to our conclusion of possible non-

Table of Contents

compliance are unique and potentially mitigate any possible fines and penalties because the exported items are the property of the U.S. government and are used or consumed in connection with services rendered to the U.S. government. In addition, we have responded to a March 19, 2007, subpoena from the DoD Inspector General concerning licensing for armor for convoy trucks and antiboycott issues. We continue to comply with the requests to provide information under the subpoena. Whereas it is reasonably possible that we may be subject to fines and penalties for possible acts that are not in compliance with our export license or regulations, at this time it is not possible to estimate an amount of loss or range of losses that may have been incurred. 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. We are in ongoing communications with the appropriate authorities with respect to these matters.

Claims

We had unapproved claims for U.S. government contracts totaling \$82 million, \$36 million and \$57 million at December 31, 2007, 2006 and 2005, respectively. The unapproved claims outstanding at December 31, 2007, 2006 and 2005 are considered to be probable of collection and have been recognized as revenue. These unapproved claims related to contracts where our costs have exceeded the customer's funded value of the task order and therefore could not be billed.

In addition, as of December 31, 2007 and 2006, we had incurred approximately \$156 million and \$159 million, respectively, 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 have submitted requests for reallocations of funding to the U.S. Army and continue to work with them to resolve this matter. 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 have addressed the issues raised by the DCMA. Specifically, based on the unprecedented level of support that our employees are providing the military in Iraq, Kuwait, and Afghanistan, we updated 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. We continue to address new issues as they are raised by the DCAA.

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. KBR's accounting system is currently deemed acceptable for accumulating costs incurred under US Government contracts.

SIGIR Report

The Special Inspector General for Iraq Reconstruction, or SIGIR, was created by Congress to provide oversight of the Iraq Relief and Reconstruction Fund (IRRF) and all obligations, expenditures, and revenues associated with reconstruction and rehabilitation activities in Iraq. SIGIR reports, from time to time, make reference to KBR regarding various matters. We believe we have addressed all issues raised by prior SIGIR reports and we will continue to do so as new issues are raised.

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

Table of Contents

\$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.

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. On July 5, 2007, the court granted our motion to dismiss the *qui tam* claims and to compel arbitration of employment claims including a claim that the plaintiff was unlawfully discharged. The majority of the plaintiff's claims were dismissed but the plaintiff was allowed to pursue limited claims pending discovery and future motions. All employment claims were sent to arbitration under the Company's dispute resolution program. We believe the relator's claim is without merit and believe the likelihood that a loss has been incurred is remote. As of December 31, 2007, no amounts have been accrued.

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. The final judgement in our favor was entered on April 30, 2007 and subsequently appealed by the plaintiffs on May 3, 2007. We believe the relators' claims are without merit and believe the likelihood that a loss has been incurred is remote. As of December 31, 2007, no amounts have been accrued.

Godfrey Qui Tam suit

In December 2005, we became aware of a *qui tam* action filed against us and several of our subcontractors by a former employee alleging that we violated the False Claims Act by submitting overcharges to the government for dining facility services provided in Iraq under the LogCAP III contract. As required by the False Claims Act, the lawsuit was filed under seal to permit the government to investigate the allegations. In early April 2007, the court denied the government's motion for the case to remain under seal, and on April 23, 2007, the government filed a notice stating that it was not participating in the suit. In August 2007, the relator filed an amended complaint which added an additional contract to the allegations and added retaliation claims. We have filed motions to dismiss and to compel arbitration on which the court has not yet ruled. Although discovery is just beginning, it is our intention to vigorously defend this claim. This matter is in the early stages of the legal process and therefore, we are unable to determine the likely outcome at this time. No amounts have been accrued because we cannot determine any reasonable estimate of loss that may have been incurred, if any.

Note 14. Other Commitments and Contingencies***Foreign Corrupt Practices Act investigations***

Halliburton provided indemnification in favor of KBR under the master separation agreement for certain contingent liabilities, including Halliburton's indemnification of KBR and any of its greater than 50%-owned subsidiaries as of November 20, 2006, the date of the master separation agreement, for fines or other monetary

penalties or direct monetary damages, including disgorgement, as a result of a claim made or assessed by a governmental authority in the United States, the United Kingdom, France, Nigeria, Switzerland and/or Algeria, or a settlement thereof, related to alleged or actual violations occurring prior to November 20, 2006 of the FCPA or particular, analogous applicable foreign statutes, laws, rules, and regulations in connection with investigations pending as of that date including with respect to the construction and

Table of Contents

subsequent expansion by TSKJ of a natural gas liquefaction complex and related facilities at Bonny Island in Rivers State, Nigeria. The following provides a detailed discussion of the FCPA investigation.

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 has been furnished 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, Halliburton, 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 Halliburton, for itself and all of its subsidiaries, enter into a tolling agreement on behalf of Halliburton and KBR with respect to its investigation. In October of 2007, after our separation from Halliburton, the SEC repeated its request for Halliburton and us to each enter into a tolling agreement. In accordance with the master separation agreement, KBR has requested approval from Halliburton to enter into the tolling agreement. In October of 2007, after our separation from Halliburton, the SEC and DOJ repeated their request for Halliburton and us to each enter into a tolling agreement. In accordance with the master separation agreement, KBR has requested approval from Halliburton to enter into the appropriate tolling agreements.

In 2007, we and Halliburton each received a grand jury subpoena from the DOJ and subpoenas from the SEC related to the Bonny Island project asking for additional information on the immigration service providers used by TSKJ. We have provided the requested documents to the DOJ and SEC and will continue to provide Halliburton with the requested information in accordance with the master separation agreement.

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, 2007. 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, 2007, 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 and KBR have been cooperating with the SEC and DOJ investigations and with other investigations into the Bonny Island project in France, Nigeria and Switzerland. The Serious Frauds Office in the United Kingdom is conducting an investigation relating to the Bonny Island project and recently made contact with KBR to request limited information. Under the master separation agreement, Halliburton will continue to oversee and direct the investigations.

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.

Table of Contents

Halliburton 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 documents related to KBR activities in countries outside of Nigeria with respect to agents for projects after 1998. Certain of the activities involve current or former employees or persons who were or are consultants to us, and the investigation is continuing.

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. 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. Until such time as the agents' suspensions are favorably resolved, KBR will continue the suspension of its use of both of the referenced agents.

A person or entity found in violation of the FCPA 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 2007, we had revenue of approximately \$5.4 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 2007, we had revenue of approximately \$224 million 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. We are not aware of any further developments with respect to this claim. 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 have resulted 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

Table of Contents

also result in our inability to bid successfully for governmental contracts and adversely affect our prospects in the commercial marketplace. 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 the Offering, Halliburton has agreed to indemnify us, 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, in which we do not have an interest greater than 50%.

Because of the uncertain ultimate resolution of these matters, as of December 31, 2007, we are unable to estimate a range of possible loss related to these matters.

Halliburton incurred approximately \$14 million and \$9 million for the years ended December 31, 2006 and 2005, respectively, for expenses relating to the FCPA and bidding practices investigations. Halliburton incurred \$1 million as such costs for the quarter ended March 31, 2007. We do not know the amount of costs incurred by Halliburton following our separation from Halliburton on April 5, 2007. Halliburton did not charge any of 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 us. Subsequent to our separation from Halliburton and in accordance with the Master Separation Agreement, Halliburton will continue to bear the direct costs associated with overseeing and directing the FCPA and bidding practices investigations. We will bear costs associated with monitoring the continuing investigations as directed by Halliburton which include our own separate legal counsel and advisors. For the year ended December 31, 2007, we incurred approximately \$1 million in expenses related to monitoring these investigations.

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.

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, 2007, we are unable to estimate a range of possible loss related to these matters.

Table of Contents

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. During 2003, we filed all outstanding tax returns and paid the associated taxes.

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, 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. In the fourth quarter of 2007, the class action lawsuit was withdrawn by the plaintiffs.

Tax law changes

On October 1, 2007, Mexico enacted a new tax law. The new tax law introduces a flat tax, which replaces Mexico's asset tax and requires Mexican taxpayers to pay the greater of its flat tax or regular corporation income tax liability. Currently, we do not believe that the expected arbitration awards will be subject to the flat tax. However, in the event the flat tax is later determined to be applicable to the arbitration awards, we believe that the flat tax should not have a material impact on our financial statements after considering the flat tax will be a creditable tax for U.S. foreign tax credit purposes. We are continuing to evaluate the impact that the new tax law in Mexico will have on our financial position, results of operations, and cash flows.

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 by complying 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 make estimates of the amount of costs associated with known environmental contamination that we will be required to remediate and record accruals to recognize those estimated liabilities. Our estimates are based on the best available information and are updated whenever new

information becomes known. For certain locations including our property at Clinton Drive, we have not completed our analysis of the site conditions and until further information is available, we are only able to estimate a possible range of remediation costs. This range of costs could change depending on our ongoing site analysis and the timing and techniques used to implement remediation activities. 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. During 2007, we increased our accrual from approximately \$4 million to \$7 million for the estimated assessment and remediation costs associated with all environmental matters, which represents the low end of the range of possible costs that could be as much as \$15 million.

Table of Contents***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, 2007, we had approximately \$1 billion in letters of credit and financial guarantees outstanding, of which, \$508 million were issued under our Revolving Credit Facility. Approximately \$545 million of these letters of credit were issued under various facilities and are irrevocably and unconditionally guaranteed by Halliburton. Of the total outstanding, approximately \$505 million relate to our joint venture operations, including \$214 million issued in connection with our Allenby & Connaught project. The remaining \$495 million of outstanding letters of credit relate to various other projects. At December 31, 2007, \$605 million of the \$1 billion outstanding letters of credit have triggering events that would entitle a bank to require cash collateralization. Approximately \$381 million of the \$605 million relates to letters of credit issued under our Revolving Credit Facility which have expiry dates close to or beyond the maturity date of the facility. Under the terms of the Revolving Credit Facility, if the original maturity date, of December 16, 2010 is not extended then the issuing banks may require that we provide cash collateral for these extended letters of credit no later than 95 days prior to the original maturity date.

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 November 20, 2006, 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.

During the second quarter of 2007, a £20 million letter of credit was issued on our behalf by a bank in connection with our Allenby & Connaught project. The letter of credit supports a building contract guarantee executed between KBR and certain project joint venture company to provide additional credit support as a result of our separation from Halliburton. The letter of credit issued by the bank is guaranteed by Halliburton.

Other commitments

As of December 31, 2007, we had commitments to provide funds of \$121 million to related companies, including \$113 million to our privately financed projects. As of December 31, 2006, these commitments were approximately \$156 million, including \$119 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. At December 31, 2007, approximately \$21 million of the \$121 million commitments are current. 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 estimated project cost was \$3 million at December 31, 2007.

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 \$28 million and \$38 million at December 31, 2007 and 2006, respectively (including amounts related to our share of unconsolidated subsidiaries), that we could incur based upon completing the projects as forecasted.

Table of Contents**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 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 was \$158 million, \$178 million and \$380 million in 2007, 2006 and 2005, respectively.

Future total rentals on noncancelable operating leases are as follows: \$49 million in 2008; \$49 million in 2009; \$48 million in 2010; \$44 million in 2011; \$34 million in 2012; and \$131 million thereafter.

Note 15. Income Taxes

The components of the provision for income taxes on continuing operations were:

| Millions of dollars | Years ended December 31 | | |
|----------------------------|-------------------------|---------|----------|
| | 2007 | 2006 | 2005 |
| Current income taxes: | | | |
| Federal | \$ (101) | \$ (56) | \$ (118) |
| Foreign | (58) | (54) | (31) |
| State | (6) | (2) | (8) |
| Total current | (165) | (112) | (157) |
| Deferred income taxes: | | | |
| Federal | 30 | 27 | 22 |
| Foreign | (6) | (8) | (24) |
| State | 3 | (1) | (1) |
| Total deferred | 27 | 18 | (3) |
| Provision for income taxes | \$ (138) | \$ (94) | \$ (160) |

Prior to the separation from Halliburton, income tax expense for KBR, Inc. was calculated on a pro rata basis. Under this method, income tax expense was determined based on KBR, Inc. operations and their contributions to income tax expense of the Halliburton consolidated group. For the period post separation from Halliburton, income tax expense is calculated on a stand alone basis. Payments made to or received from Halliburton to settle tax assets and liabilities are classified as contributions to capital in the accompanying financial statements.

As noted above, we have calculated income tax expense based on a pro rata method up through the date of separation. 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 \$73 million resulting in an effective tax rate of 57% under the separate return method. The income tax expense from discontinued operations recorded in 2006 would have been \$80 million resulting in an effective tax rate of 35% under the separate return method.

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

Years ended December 31

| Millions of dollars | 2007 | 2006 | 2005 |
|----------------------------|-------------|-------------|-------------|
| United States | \$ (42) | \$ 59 | \$ 294 |
| Foreign | 384 | 69 | 70 |
| Total | \$ 342 | \$ 128 | \$ 364 |

Table of Contents

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 | | |
|--|--------------------------------|--------------|--------------|
| | 2007 | 2006 | 2005 |
| United States Statutory Rate | 35.0% | 35.0% | 35.0% |
| Rate differentials on foreign earnings | 7.3 | (15.0) | 3.2 |
| Non-deductible loss | | 15.8 | |
| State income taxes | 1.0 | 1.0 | 1.5 |
| Prior year foreign taxes | (1.3) | 16.2 | (1.9) |
| Prior year federal & state taxes | | 13.8 | 1.4 |
| Valuation allowance | (2.3) | (1.8) | 1.0 |
| Foreign tax credit displacement | | 8.3 | 5.2 |
| Other | 0.5 | (0.1) | (1.5) |
| Total effective tax rate on continuing operations | 40.2% | 73.2% | 43.9% |

We generally do not provide U.S. income taxes on the undistributed earnings of non-United States subsidiaries except for certain entities in Mexico that are parties to the PEMEX arbitration and certain joint ventures in Yemen, Egypt, Nigeria and Indonesia. Taxes are provided as necessary with respect to earnings that are not permanently reinvested. For all other non-U.S. subsidiaries, no U.S. taxes are provided because such earnings are intended to be reinvested indefinitely to finance foreign activities. 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.

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 | |
|------------------------------------|--------------------------------|----------------|
| | 2007 | 2006 |
| Gross deferred tax assets: | | |
| Depreciation and amortization | \$ 14 | \$ 10 |
| Employee compensation and benefits | 76 | 119 |
| Foreign tax credit carryforward | | 67 |
| Construction contract accounting | 118 | 92 |
| Loss carryforwards | 94 | 77 |
| Insurance accruals | 18 | 15 |
| Allowance for bad debt | 7 | 14 |
| Accrued liabilities | 17 | 21 |
| Total | \$ 344 | \$ 415 |
| Gross deferred tax liabilities: | | |
| Construction contract accounting | \$ (68) | \$ (58) |
| All other | (1) | |
| Total | \$ (69) | \$ (58) |

| | | |
|---------------------------------|---------|----------|
| Valuation Allowances: | | |
| Foreign tax credit carryforward | \$ | \$ (67) |
| Loss carryforwards | (33) | (43) |
| Total | \$ (33) | \$ (110) |
| Net deferred income tax asset | \$ 242 | \$ 247 |

At December 31, 2007, we had \$251 million of net operating loss carryforwards that expire from 2007 through 2017 and loss carryforwards of \$91 million with indefinite expiration dates.

Table of Contents

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. Upon KBR's separation from the Halliburton U.S. consolidated group in 2007, the amount of foreign tax credit carryforward allocated to KBR will be determined by operation of U.S. tax law. The amount of such carryforward allocated to KBR is not expected to be significant. However, upon completion of the final Halliburton U.S. consolidated tax return in which KBR is included, certain foreign tax credits could be identified as allocable to KBR. At such time, the resulting benefit from these foreign tax credits will be recognized on KBR's books. Prior to December 31, 2007, we had established a valuation allowance for certain foreign tax credit carryforwards on the basis that we believed these assets would not be utilized in the statutory carryover period. These foreign tax credit carryovers of \$67 million have been derecognized as we do not expect them to be available to KBR at the separation date from Halliburton. Consequently, the related valuation allowance of \$67 million has been reversed as well.

KBR is subject to a tax sharing agreement primarily covering periods prior to the separation from Halliburton. The tax sharing agreement provides, in part, that KBR will be responsible for any audit settlements related to its business activity for periods prior to its separation from Halliburton. As a result, KBR recorded a charge to equity of \$17 as of December 31, 2007, a charge to equity of \$1 million in 2006, and a credit to equity of \$22 million in 2005. As of December 31, 2007, KBR has recorded an \$11 million payable to Halliburton for tax related items under the tax sharing agreement. As of December 31, 2006, the amount recorded was \$94 million due to Halliburton under the tax sharing agreement.

KBR is the parent of a group of our domestic companies which are in the U.S. consolidated federal income tax return of Halliburton through April 5, 2007, the date of our separation from Halliburton. We also file income tax returns in various states and foreign jurisdictions. With few exceptions, we are no longer subject to examination by tax authorities for U.S. federal or state and local income tax for years before 2003, or for non-U.S. income tax for years before 1998.

Effective January 1, 2007, KBR adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48 or the Interpretation). The Interpretation prescribes the minimum recognition threshold a tax position taken or expected to be taken in a tax return is required to meet before being recognized in the financial statements. It also provides guidance for derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. As a result of the implementation of FIN 48, we recognized no change in the liability for unrecognized tax benefits and an increase of approximately \$10 million for accrued interest and penalties, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

In millions

| | |
|--|-------|
| Balance at January 1, 2007 | \$ 61 |
| Additions based on tax positions related to the current year | |
| Additions based on tax positions related to prior years | 3 |
| Reductions for tax positions related to the current year | |
| Reductions for tax positions of prior years | (1) |
| Settlements | |
| Reductions related to a lapse of statute of limitations | |
| Balance at December 31, 2007 | \$ 63 |

As of January 1, 2007 and December 31, 2007, KBR estimates that \$24 million in unrecognized tax benefits, if recognized, would affect the effective tax rate.

KBR recognizes interest and penalties related to unrecognized tax benefits within the provision for income taxes in our consolidated statement of income. As of December 31, 2007, we had accrued approximately \$14 million in interest and penalties. During the year ended December 31, 2007, we recognized approximately \$1 million in interest and penalties charges related to unrecognized tax benefits.

As of December 31, 2007, the unrecognized tax benefits and accrued interest and penalties were not expected to be settled within one year and therefore were classified in noncurrent income tax payable.

As of January 1, 2007, we believed that no current tax positions that have resulted in unrecognized tax benefits will significantly increase or decrease within one year. As of December 31, 2007, no material changes have occurred in our estimates or expected events except for an Algeria tax assessment for the years 2003 through 2005. The audit exposure

Table of Contents

relates to the In Salah and In Amenas gas monetization projects, for which KBR has a 50% joint venture interest. The current audit assessment is based, in large part, on what we believe is an erroneous interpretation of the tax law. We will appeal the tax assessment, and we believe, the final amount determined to be owed will be substantially less than the amount that has been assessed. Nevertheless, there is no certainty that KBR will sustain its position on appeal. If the government prevails, there would be a substantial charge to the joint venture. KBR has recorded the amount that it believes the joint venture will have to pay to settle this tax audit. We will continue to evaluate the tax situation in Algeria, and if warranted, adjust the reserve recorded accordingly.

Table of Contents**Note 16. Shareholders' Equity**

The following tables summarize our shareholders' equity activity:

| Millions of dollars | Common Stock | Members' Equity | Parent Net Investment | Paid-in Capital in Excess of par | Retained Earnings | Accumulated Other Comprehensive Income (Loss) |
|---|-----------------|--------------------|-----------------------------|--|----------------------|---|
| 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 | | 149 | 91 | | | (118) |
| Transfer to members' 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 | | | | 17 | | |
| Intercompany stock-based compensation | | | | (16) | | |

| | | | | | | | |
|---|----|----|----|----------|--------|----|-------|
| Unrealized gains (losses) on derivatives | | | | | | | |
| Reclassification adjustments to net income (loss) | | | | | | | (4) |
| Income tax benefit (provision) on derivatives | | | | | | | 1 |
| Total | | | | | 302 | | 169 |
| Balance at December 31, 2007 | \$ | \$ | \$ | \$ 2,070 | \$ 319 | \$ | (122) |

Table of Contents*Accumulated other comprehensive income*

| Millions of dollars | December 31 | | |
|--|-------------|----------|----------|
| | 2007 | 2006 | 2005 |
| Cumulative translation adjustments | \$ 38 | \$ 43 | \$ 12 |
| Pension liability adjustments | (159) | (335) | (126) |
| Unrealized gains (losses) on derivatives | (1) | 1 | (14) |
| Total accumulated other comprehensive income | \$ (122) | \$ (291) | \$ (128) |

Comprehensive income for the year ended December 31, 2007 includes the elimination of net cumulative translation and pension liability adjustments of \$(22) million and \$90 million, respectively, related to the disposition of our 51% interest in DML. See Note 25 for further discussion.

Shares of common stock

| Millions of shares | 2007 |
|----------------------------------|------|
| Balance at December 31, 2005 (a) | |
| Initial public offering | 168 |
| Balance at December 31, 2006 | 168 |
| Common stock issued | 2 |
| Balance at December 31, 2007 | 170 |

(a) No change in shares of common stock during 2005 as our initial public offering occurred in November 2006.

Note 17. Stock Incentive Plans*Stock Plans*

In 2007 and 2006 Stock-based compensation awards were granted to employees under KBR stock-based compensation plans. In addition, in 2005, KBR employees participated in Halliburton compensation plans and received grants under these plans.

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, 2007, approximately 7.7 million shares were available for future grants under the KBR 2006 Plan, of which approximately 2.1 million shares remained available for restricted stock awards or restricted stock unit awards.

KBR Transitional Stock Adjustment Plan

The Transitional Stock Adjustment Plan provides for stock options to purchase the common stock of KBR and restricted shares of the Company's common stock to holders of outstanding options and restricted shares under the Halliburton 1993 Stock and Incentive Plan. The plan was adopted solely for the purpose to convert Halliburton equity

Table of Contents

awards to KBR equity awards. No new awards can be made under the plan. The converted equity awards are subject to substantially the same terms as they were under the Halliburton 1993 Stock and Incentive Plan prior to conversion.

KBR 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. We amortize the fair value of the stock options over the vesting period on a straight-line basis.

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

KBR Stock Options

| | Number of Shares | Weighted Average Exercise Price per Share | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value (in millions) |
|--|---------------------|---|--|---|
| Stock Options Outstanding at December 31, 2006 | 991,093 | \$ 21.81 | | |
| Conversion of shares (a) | 1,966,061 | 9.35 | | |
| Granted | | | | |
| Exercised | (671,363) | 35.15 | | |
| Forfeited | (135,707) | 20.52 | | |
| Expired | (26,790) | 9.53 | | |
| Outstanding at December 31, 2007 | 2,123,294 | \$ 14.49 | 6.19 | \$ 52 |
| Exercisable at December 31, 2007 | 1,457,066 | \$ 11.66 | 5.09 | \$ 40 |

(a) Conversion of Halliburton shares granted to KBR employees to KBR common stock effective immediately after our separation from Halliburton, on April 5, 2007, in accordance with our Transitional Stock Adjustment Plan.

The total intrinsic value of options exercised in 2007 was \$18 million. As of December 31, 2007, there was \$5 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 1.7 years.

KBR 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 on a straight-line basis. For awards with performance conditions, an evaluation is made each quarter as to the likelihood of the performance criteria being met. Stock-based compensation is then adjusted to reflect the number of shares expected to vest and the cumulative vesting period met to date.

The following table presents the restricted stock awards and restricted stock units converted, granted, vested, and forfeited during 2007 under KBR's 2006 Stock and Incentive Plan.

| <i>Restricted Stock</i> | Number of Shares | Weighted Average Grant-Date Fair Value per Share |
|---------------------------------------|-----------------------------|---|
| Nonvested shares at December 31, 2006 | 964,677 | \$ 21.16 |
| Conversion of shares (a) | 990,080 | 11.01 |
| Granted (b) | 590,572 | 29.63 |
| Vested | (376,142) | 16.24 |
| Forfeited | (172,970) | 20.00 |
| Nonvested shares at December 31, 2007 | 1,996,217 | \$ 19.75 |

Table of Contents

- (a) Conversion of Halliburton shares granted to KBR employees to KBR common stock effective immediately after our separation from Halliburton, on April 5, 2007, in accordance with our Transitional Stock Adjustment Plan.

- (b) Includes 55,306 performance based restricted stock granted to our Chief Executive Officer. The vesting of the restricted stock is subject to the company having net income greater than or equal to zero for the calendar year preceding the annual vesting date, over a 5 year period. The determination of net income with respect to our chief executive officer s restricted stock award will not be reduced by the after-tax earnings impact

of: (i) any item that originated, or relates to the period, prior to our chief executive officer's first date of employment with the company, (ii) the negative effect of required changes in accounting principles, or (iii) the negative effect of changes in the tax law.

The weighted average grant-date fair value of restricted KBR shares granted to employees during 2007 and 2006 was \$29.63 and \$21.16, respectively. As of December 31, 2007, there was \$31 million of unrecognized compensation cost, net of estimated forfeitures, related to KBR's nonvested restricted stock and restricted stock units, which is expected to be recognized over a weighted average period of 4.0 years. The total fair value of shares vested during 2007 was \$12 million based on the weighted-average fair value on the vesting date and \$6 million based on the weighted-average fair value on the date of grant.

KBR Performance Award Units

Under KBR's 2006 Plan, in 2007 we granted 24,549,000 performance based award units (Performance Awards) with a performance period from July 1, 2007 to December 31, 2009. During 2007, 696,000 Performance Awards were forfeited. At December 31, 2007 the outstanding balance for performance based award units was 23,853,000. No Performance Awards will vest until such earned Performance Awards, if any, are paid, subject to approval of the performance results by the certification committee. Refer to Note 3 for additional information regarding the performance award units.

Halliburton Awards

Halliburton has stock-based employee compensation plans in which, prior to our separation from Halliburton, on April 5, 2007, certain key employees of KBR participated. In accordance with our Transitional Stock Adjustment Plan and upon our complete separation from Halliburton, stock options and restricted stock awards granted to KBR employees under Halliburton's 1993 Stock and Incentive Plan were converted to stock options and restricted stock awards covering KBR common stock. Refer to Note 3 for additional information regarding the conversion of these awards.

Halliburton Stock options

All stock options under Halliburton's 1993 Stock and Incentive Plan were 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.

There were no Halliburton stock options granted to KBR employees in 2006 or 2007. Refer to Note 3 for additional information regarding 2005 grants to KBR employees. The total intrinsic value of options exercised by KBR, Inc.'s employees in 2006 and 2005 was \$31 million and \$52 million, respectively.

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, 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 weighted average grant-date fair value of restricted shares granted to our employees during 2006 and 2005 was \$33.77 and \$22.14, respectively. There were no Halliburton restricted shares granted to KBR employees in 2007. The total fair value of shares vested during 2006 and 2005 was \$12 million and \$16 million, respectively.

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

Table of Contents

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.

Effective upon our complete separation from Halliburton, the Halliburton ESPP plan was terminated for KBR employees. No shares were purchased by KBR employees in 2007 under the Halliburton ESPP plan. Halliburton shares previously purchased under the ESPP plan remained Halliburton common stock and did not convert to KBR common stock at the date of separation.

Note 18. 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 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. Since 2003, we have 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 statements of income and was not material in 2006 or 2005. During 2007 no hedge ineffectiveness was recognized. As of December 31, 2007, we had less than \$1 million in unrealized net losses on these cash flow hedges. As of December 31, 2006, we had approximately \$1 million in unrealized net gains on these cash flow hedges and approximately \$14 million in unrealized net losses as of December 31, 2005. 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, 2007, 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 25 months. Estimated amounts to be recognized in earnings in 2008 are not significant. The fair value of these contracts was approximately \$1 million as of December 31, 2007. At December 31, 2006 and December 31, 2005, the fair value of these contracts was less than \$1 million.

Notional amounts and fair market values. The notional amounts of open forward contracts and options held by our consolidated subsidiaries was \$332 million, \$134 million and \$362 million at December 31, 2007, 2006 and 2005, 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

Table of Contents

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.

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.

Interest rate risk. Certain of our unconsolidated subsidiaries and joint-ventures are exposed to interest rate risk through their variable rate borrowings. We manage our exposure to this variable-rate debt with interest rate swaps that are jointly owned through our investments. As of December 31, 2007 and December 31, 2006, we had less than \$1 million in unrealized net losses on the interest rate cash flow hedges held by our unconsolidated subsidiaries and joint-ventures.

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 19. 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.

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.

MMM is a joint venture formed under a Partners Agreement related to the Mexico contract with PEMEX. The MMM joint venture was set up under Mexican maritime law in order to hold navigation permits to operate in Mexican waters. The scope of the business is to render services of maintenance, repair and restoration of offshore oil and gas platforms and provisions of quartering in the territorial waters of Mexico. KBR holds a 50% interest in the MMM joint venture.

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.

Brown & Root Condor Spa (BRC) is a joint venture in which we owned 49% interest. During the third quarter of 2007, we sold our 49% interest and other rights in BRC to Sonatrach for approximately \$24 million resulting in a pre-tax gain of approximately \$18 million which is included in Equity in earnings (losses) of unconsolidated affiliates . In the first quarter of 2007, we recorded an \$18 million impairment charge of which \$16 million was classified as Equity in earnings (losses) of unconsolidated affiliates and \$2 million as a component of Cost of services.

Table of Contents

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

Balance Sheets

| | For the Year Ended December 31, 2007 | | | |
|----------------------------|---|----------------------|---------------|---------------|
| Millions of dollars | TSKJ Group | TKJ Group | MMM | ASD |
| Current assets | \$ 255 | \$ 666 | \$ 78 | \$ 33 |
| Noncurrent assets | \$ 30 | \$ 110 | \$ 45 | \$ 640 |
| Total assets | \$ 285 | \$ 776 | \$ 123 | \$ 673 |
| Current liabilities | \$ 177 | \$ 723 | \$ 35 | \$ 69 |
| Noncurrent liabilities | \$ | \$ | \$ | \$ 618 |
| Total liabilities | \$ 177 | \$ 723 | \$ 35 | \$ 687 |

Statements of Operations

| | For the Year Ended December 31, 2007 | | | |
|----------------------------|---|----------------------|------------|------------|
| Millions of dollars | TSKJ Group | TKJ Group | MMM | ASD |
| Revenue | \$ 291 | \$ 844 | \$ 150 | \$ 229 |
| Operating income (loss) | \$ 50 | \$ 63 | \$ 30 | \$ (4) |
| Net income (loss) | \$ 60 | \$ 87 | \$ 32 | \$ (41) |

Balance Sheets

| | For the Year Ended December 31, 2006 | | | |
|----------------------------|---|----------------------|---------------|---------------|
| Millions of dollars | TSKJ Group | TKJ Group | MMM | ASD |
| Current assets | \$ 457 | \$ 650 | \$ 65 | \$ 274 |
| Noncurrent assets | \$ 23 | \$ 107 | \$ 61 | \$ 600 |
| Total assets | \$ 480 | \$ 757 | \$ 126 | \$ 874 |
| Current liabilities | \$ 364 | \$ 654 | \$ 44 | \$ 263 |
| Noncurrent liabilities | \$ 6 | \$ | \$ | \$ 527 |
| Total liabilities | \$ 370 | \$ 654 | \$ 44 | \$ 790 |

Statements of Operations

| | For the Year Ended December 31, 2006 | | | | |
|----------------------------|---|------------|----------------------|------------|------------|
| Millions of dollars | TSKJ Group | BRC | TKJ Group | MMM | ASD |
| Revenue | \$ 339 | \$ 483 | \$ 943 | \$ 172 | \$ 158 |

| | | | | | |
|-------------------------|-------|-------|-------|-------|---------|
| Operating income (loss) | \$ 20 | \$ 21 | \$ 83 | \$ 32 | \$ (13) |
| Net income (loss) | \$ 32 | \$ 14 | \$ 96 | \$ 24 | \$ (57) |

Statements of Operations

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

Table of Contents

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, | |
|----------------------------|---------------------|-------------|
| | 2007 | 2006 |
| Current assets | \$ 4,025 | \$ 4,519 |
| Noncurrent assets | 3,041 | 2,700 |
| Total | \$ 7,066 | \$ 7,219 |
| Current liabilities | \$ 1,273 | \$ 1,561 |
| Noncurrent liabilities | 5,719 | 5,481 |
| Member s equity | 74 | 177 |
| Total | \$ 7,066 | \$ 7,219 |

Statements of Operations

| Millions of dollars | Years ended December 31, | | |
|----------------------------|---------------------------------|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Revenue | \$ 1,912 | \$ 1,898 | \$ 1,544 |
| Operating income (loss) | \$ 204 | \$ 1 | \$ (55) |
| Net income (loss) | \$ 89 | \$ 33 | \$ (42) |

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.

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. The following is a summary of variable interest entities in which we are either the primary beneficiary or in which we have a significant variable interest.

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, 2007 and 2006, the joint venture had total assets of \$158 million and \$161 million and total liabilities of \$167 million and \$147 million, respectively. Our aggregate maximum exposure

to loss as a result of our involvement with this joint venture was zero at December 31, 2007, 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;

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

Table of Contents

them using the equity method of accounting. As of December 31, 2006, these joint ventures had total assets of \$2.2 billion and total liabilities of \$2.1 billion. As of December 31, 2007, these joint ventures had total assets of \$2.2 billion and total liabilities of \$2.2 billion. Our maximum exposure to loss was \$20 million at December 31, 2007;

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. 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. During 2006, we recorded a total of \$58 million in impairment charges on our equity investment as a result of continued losses incurred by the joint venture and its unsuccessful attempts to raise additional equity from third parties. 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, 2007 and 2006, the joint venture had total assets of \$673 million and \$874 million and total liabilities of \$687 million and \$790 million, respectively. At December 31, 2007, our maximum exposure to loss totaled \$5 million;

we participate in a privately financed project executed through certain joint ventures formed to design, build, operate, and maintain a toll road 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, 2007 and 2006, the joint ventures had total assets of \$313 million and \$301 million and total liabilities of \$307 million and \$293 million, respectively. Our maximum exposure to loss was \$3 million at December 31, 2007, and our share of any future losses resulting from the project;

in April 2006, Aspire Defence, a joint venture between us, Carillion 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 \$214 million in letters of credit and surety bonds totaling approximately \$226 million as of December 31, 2007, 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, 2007, the aggregate total assets and total liabilities of the variable interest entities were \$3.5 billion and \$3.5 billion, respectively. 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, 2007 was \$93 million. Our maximum exposure to construction and operating joint venture losses is limited to the funding of any future losses incurred by those entities.

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, 2007 and December 31, 2006, the joint venture had \$428 million and \$756 million in total assets and \$575 million and \$877 million in total liabilities, respectively. There are no consolidated assets that collateralize the joint venture's obligations. However, at December 31, 2007 and December 31, 2006, the joint venture had approximately \$358 million and \$413 million of cash, respectively, which mainly relate to advanced billings in connection with the joint venture's obligations under the EPC contract;

Table of Contents

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, 2007 and December 31, 2006, these joint ventures had aggregate assets of \$1 billion and \$1 billion and aggregate liabilities of \$1.1 billion and \$1.1 billion, respectively. Our aggregate, maximum exposure to loss related to these entities was \$67 million at December 31, 2007, and is comprised of our equity investments in and advances to the joint ventures;

we have an investment in a development corporation that has an indirect interest in the 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 61% of this development corporation and consolidate it for financial reporting purposes. 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, 2007, the variable interest entity had total assets of \$407 million and total liabilities of \$278 million. 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, 2007 was \$24 million, which includes and is limited to our investment of \$21 million and our commitment to fund an additional \$3 million of stand-by equity. In 2007, additional costs to complete the project were identified requiring EBIC to pursue additional funding. EBIC 's existing senior debt providers have received credit committee approvals to lend the company up to an additional \$50 million to cover its increased costs. Final documentation for the additional loan amount is currently being negotiated. The project 's lenders have been providing waivers to allow the company to continue making scheduled drawdowns under its existing debt facilities. 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 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 because we are the primary beneficiary. As of December 31, 2007, the Pearl joint venture had total assets of \$163 million and total liabilities of \$158 million. As of December 31, 2006, the Pearl joint venture had total assets of \$66 million and total liabilities of \$56 million.

Note 20. 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 was 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 was 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 was 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.

Halliburton and certain of its subsidiaries provide various support services to KBR pursuant to a transition services agreement, including information technology, legal and internal audit. Costs for these services were \$13 million , \$23 million

Table of Contents

and \$20 million for the years ended December 31, 2007, 2006 and 2005, respectively. Costs for information technology, including payroll processing services 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, 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. Subsequent to our separation from Halliburton, costs are no longer allocated but are charged to KBR pursuant to the terms of the transition services agreement.

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, representing our share of these risk management coverages and related administrative costs, have been allocated to us for each of the years ended December 31, 2006 and 2005. These expenses are included in cost of services in the consolidated statements of income for the periods ended December 31, 2006 and 2005. Historically, we have been self insured, or have participated in a Halliburton self-insured plan, for certain insurable risks, such as primary liability and workers compensation. However, subject to specific limitations, Halliburton has had umbrella insurance coverage for some of these risk exposures. As a result of our complete separation from Halliburton, we initially implemented our own stand-alone insurance and risk management programs with policies that provide substantially the same coverage as we had under Halliburton, with the exception of property coverage. Our property coverage differs from prior coverage as appropriate to reflect the nature of our properties, as compared to Halliburton's properties. As of December 31, 2007, we now have implemented insurance and risk management programs more suited to KBR's risk profile.

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, 2007, we had approximately \$1 billion letters of credit and financial guarantees outstanding of which \$505 million related to our joint venture operations, including \$214 million issued in connection with the Allenby & Connaught project. Of the total \$1 billion, approximately \$545 million in letters of credit were 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. The Halliburton performance guarantees and letter of credit guarantees that are currently in place in favor of KBR's customers or lenders will continue until the earlier of (a) the termination of the underlying project contract or KBR's obligations thereunder or (b) the expiration of the relevant credit support instrument in accordance with its terms or release of such instrument by the customer. 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.

At December 31, 2007 and December 31, 2006, KBR has a \$16 million and \$152 million, respectively, balance payable to Halliburton which consists of amounts KBR owes Halliburton for estimated outstanding income taxes, amounts owed pursuant to our transition services agreement and other amounts.

The balances for these related party transactions are reflected in the consolidated balance sheets as Due to Halliburton, net. The average intercompany balance for 2007 was \$88 million. For 2006 and 2005, the average intercompany balance was \$348 million and \$921 million, respectively.

All of the charges described above have been included as costs of our operations 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 incurred approximately \$14 million and \$9 million for the years ended December 31, 2006 and 2005, respectively, for expenses relating to the FCPA and bidding practices investigations. Halliburton incurred \$1 million

as such costs for the quarter ended March 31, 2007. We do not know the amount of costs incurred by Halliburton following our separation from Halliburton on April 5, 2007. Halliburton did not charge any of 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 us. Subsequent to our separation from Halliburton and in accordance with the Master Separation Agreement, Halliburton will continue to bear the direct costs associated with overseeing and directing the FCPA and bidding practices investigations. We will bear costs associated with monitoring the continuing investigations as directed by Halliburton which

Table of Contents

include our own separate legal counsel and advisors. For the year ended December 31, 2007, we incurred approximately \$1 million in expenses related to monitoring these investigations.

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.

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 income were \$356 million, \$450 million and \$249 million for the years ended December 31, 2007, 2006 and 2005, respectively. Profit on transactions with our joint ventures recognized in our consolidated statements of income were \$30 million, \$62 million and \$21 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Note 21. 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 \$44 million in 2007, \$46 million in 2006, and \$48 million in 2005. Additionally, we participate in a Canadian multi-employer plan to which we contributed \$7 million, \$7 million, and \$24 million in 2007, 2006, and 2005, 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

Table of Contents

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 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 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.

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 were effective for fiscal years ending after December 15, 2006. Accordingly, we adopted the recognition and disclosure provisions of SFAS No. 158, prospectively, on December 31, 2006. The adoption of SFAS No. 158 resulted in a decrease to total assets of \$156 million, an increase to total liabilities of \$93 million, a decrease to minority interest in consolidated subsidiaries of \$97 million and a decrease to shareholders' equity of \$152 million. 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 adopt the measurement date change requirements for our fiscal year ending December 31, 2008. The estimated charge to retained earnings due to the elimination of the early measurement date is detailed in the following table.

| <i>Millions of dollars</i> | Pension Obligations | | Other Postretirement Benefits |
|--|----------------------------|--------------|--------------------------------------|
| | United States | Int'l | |
| Change in retained earnings due to elimination of early measurement dates | | | |
| Service cost | \$ | \$ 2 | \$ |
| Interest cost | 1 | 25 | |
| Expected return on plan assets | (1) | (28) | |
| Currency fluctuations | | | |
| (Gain)/ loss amortization | | 3 | |
| Transfers | | | |
| Benefits paid | | | |
| Net pension cost | \$ | \$ 2 | \$ |

Table of Contents**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.

| Benefit obligation <i>Millions of dollars</i> | Pension Benefits | | | | Other Postretirement Benefits | |
|---|-------------------------|--------------|----------------------|--------------|--------------------------------------|-------------|
| | United States | Int 1 | United States | Int 1 | 2007 | 2006 |
| | 2007 | | 2006 | | | |
| Change in benefit obligation | | | | | | |
| Benefit obligation at beginning of period | \$ 48 | \$ 1,657 | \$ 46 | \$ 1,395 | \$ 1 | \$ 1 |
| Service cost | | 9 | | 8 | | |
| Interest cost | 2 | 85 | 3 | 70 | | |
| Plan participants contributions | | | | 1 | 1 | 1 |
| Currency fluctuations | | 73 | | 80 | | |
| Actuarial (gain) loss | (3) | (82) | 1 | 129 | | |
| Transfers | | (7) | | 8 | | |
| Benefits paid | (2) | (46) | (2) | (34) | (2) | (1) |
| Benefit obligation at end of period | \$ 45 | \$ 1,689 | \$ 48 | \$ 1,657 | \$ | \$ 1 |
| Accumulated benefit obligation at end of period | \$ 45 | \$ 1,617 | \$ 48 | \$ 1,558 | \$ | \$ |

| Plan assets <i>Millions of dollars</i> | Pension Benefits | | | | Other Postretirement Benefits | |
|--|-------------------------|--------------|----------------------|--------------|--------------------------------------|-------------|
| | United States | Int 1 | United States | Int 1 | 2007 | 2006 |
| | 2007 | | 2006 | | | |
| Change in plan assets | | | | | | |
| Fair value of plan assets at beginning of period | \$ 41 | \$ 1,490 | \$ 38 | \$ 1,209 | \$ | \$ |
| Actual return on plan assets | 6 | 126 | 5 | 142 | | |
| Employer contributions | | 26 | | 90 | 1 | |
| Settlements and transfers | | (6) | | 10 | | |
| Plan participants contributions | | | | 1 | 1 | 1 |
| Currency fluctuations | | 68 | | 72 | | |
| Benefits paid | (2) | (46) | (2) | (34) | (2) | (1) |
| Fair value of plan assets at end of period | \$ 45 | \$ 1,658 | \$ 41 | \$ 1,490 | \$ | \$ |
| Funded status | \$ | \$ (31) | \$ (7) | \$ (167) | \$ | \$ (1) |
| Amounts not yet recognized | | | | | | |
| Employer contribution | | 6 | | 4 | | |
| Unrecognized transition asset | | | | | | |
| Unrecognized actuarial loss (gain) | | | | | | |

Unrecognized prior service benefit

| | | | | | | |
|-----------------------|----|---------|--------|----------|----|--------|
| Net amount recognized | \$ | \$ (25) | \$ (7) | \$ (163) | \$ | \$ (1) |
|-----------------------|----|---------|--------|----------|----|--------|

Amounts recognized on the consolidated balance sheet

| | | | | | | |
|------------------------|----|------|-----|-------|----|-----|
| Total assets | \$ | \$ | \$ | \$ | \$ | \$ |
| Current liabilities | | | | | | |
| Noncurrent liabilities | | (25) | (7) | (163) | | (1) |

Pension plans in which accumulated benefit obligation exceeds plan assets at December 31

| | | | | |
|--------------------------------|----|----|-------|----------|
| Projected benefit obligation | \$ | \$ | \$ 48 | \$ 1,657 |
| Accumulated benefit obligation | | | 48 | 1,558 |

Table of Contents

| <i>Plan assets</i> <i>Millions of dollars</i> | United States | | Pension Benefits | | Other Postretirement Benefits | |
|---|---------------------------------|--------------|-------------------------|--------------|--------------------------------------|--------------|
| | 2007 | Int 1 | 2006 | Int 1 | 2007 | 2006 |
| Fair value of plan assets | | | 41 | 1,491 | | |
| Weighted-average assumptions used to determine benefit obligations at measurement date | | | | | | |
| Discount rate | 6.30% | 5.70% | 5.75% | 5.00% | 5.75% | 5.50% |
| Rate of compensation increase | N/A | 4.30% | N/A | 3.75% | 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 | N/A | 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 | N/A | 5.0% |
| Year that the rate reached the ultimate trend rate | N/A | N/A | N/A | N/A | N/A | 2011 |
| Asset allocation at December 31 | | | | | | |
| <i>Plan assets</i> <i>Millions of dollars</i> | | | United States | Int 1 | United States | Int 1 |
| | | | 2007 | | 2006 | |
| Asset category | (target allocation 2008) | | | | | |
| Equity securities | (50% | 70%) | 63% | 67% | 63% | 63% |
| Debt securities | (30% | 50%) | 35% | 32% | 36% | 35% |
| Other | (0% | 5%) | 2% | 1% | 1% | 2% |
| 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 based on the annualized yield of the iBoxx AA corporate bonds for both September 30, 2007 and September 30, 2006. The discount rate used for the United Kingdom pension plans was 5.7% at September 30, 2007 and 5.0% at September 30, 2006.

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.

Table of Contents

Amounts recognized in accumulated other comprehensive income were as follows:

| <i>Millions of dollars</i> | Pension Benefits | | Other |
|--|-------------------------|--------------|-----------------------|
| | United | Int 1 | Postretirement |
| | States | | Benefits |
| | | 2007 | 2007 |
| Net actuarial loss (gain) | \$ 7 | \$ 157 | \$ (1) |
| Prior service cost (benefit) | | (3) | (1) |
| Total recognized in accumulated other comprehensive income | \$ 7 | \$ 154 | \$ (2) |

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 \$80 million to our international pension plans. This contribution amount includes an expected payment of approximately \$57 million to be paid in the first quarter of 2008 to the Kellogg, Brown & Root (UK) Limited Pension Plan, related to a February 2008 agreement-in-principle regarding partial deficit funding for this Plan. We currently expect to contribute \$2 million to our domestic plan in 2008. 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.

| <i>Millions of dollars</i> | Pension Benefits | |
|----------------------------|-------------------------|--------------|
| | United States | Int 1 |
| 2008 | \$ 2 | \$ 62 |
| 2009 | 3 | 64 |
| 2010 | 3 | 68 |
| 2011 | 3 | 70 |
| 2012 | 3 | 73 |
| Years 2013 - 2017 | 17 | 406 |

Expected benefit payments for other postretirement benefits are immaterial.

Net periodic cost

| <i>Millions of dollars</i> | Pension Benefits | | | | | |
|--|-------------------------|--------------|----------------------|--------------|----------------------|--------------|
| | United States | Int 1 | United States | Int 1 | United States | Int 1 |
| | 2007 | | 2006 | | 2005 | |
| Components of net periodic benefit cost | | | | | | |
| Service cost | \$ | \$ 9 | \$ | \$ 8 | \$ | \$ 13 |
| Interest cost | 3 | 85 | 2 | 70 | 2 | 65 |
| Expected return on plan assets | (3) | (97) | (3) | (79) | (3) | (76) |
| Transition amount | | | | | | |
| Amortization of prior service cost | | (1) | | (1) | | (1) |
| Settlements/curtailments | | | | | | 5 |
| Recognized actuarial loss | | 22 | 1 | 17 | 1 | 7 |

| | | | | | | |
|---------------------------|----|-------|----|-------|----|-------|
| Net periodic benefit cost | \$ | \$ 18 | \$ | \$ 15 | \$ | \$ 13 |
|---------------------------|----|-------|----|-------|----|-------|

112

Table of Contents

For other postretirement plans, net periodic cost was immaterial for the years ended December 31, 2007, 2006, and 2005.

**Weighted-average
assumptions used to
determine net
periodic benefit cost
for years ended December 31**

| | Pension Benefits | | | | | | | | |
|--------------------------------|-------------------------|--------------|----------------------|--------------|----------------------|--------------|--------------------------------------|-------------|-------------|
| | United States | | United States | | United States | | Other Postretirement Benefits | | |
| | 2007 | Int 1 | 2006 | Int 1 | 2005 | Int 1 | 2007 | 2006 | 2005 |
| Discount rate | 5.75% | 5.00% | 5.75% | 5.00% | 5.75% | 5.50% | 5.75% | 5.75% | 5.75% |
| Expected return on plan assets | 8.25% | 7.00% | 8.25% | 7.00% | 8.50% | 7.00% | N/A | N/A | N/A |
| Rate of compensation increase | N/A | 3.75% | N/A | 3.5% | N/A | 4.00% | 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 2008 are as follows:

| | Pension Benefits | |
|------------------------------|-------------------------|----------------------|
| | United States | International |
| <i>Millions of dollars</i> | | |
| Actuarial (gain) loss | \$ | \$ 9 |
| Prior service (benefit) cost | | (1) |
| Total | \$ | \$ 8 |

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.

Note 22. 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. These termination benefits were offered to 139 personnel, with 66 receiving enhanced termination benefits. The terminated personnel were located in the United States and the United Kingdom. The restructuring charge was included in General and administrative in the statements of income for the year ended December 31, 2006. During 2007, approximately \$4 million of termination benefits were paid. Of this amount, approximately \$1 million relates to our G&I business unit, \$1 million to our Upstream business unit, and \$2 million to general corporate employees. As of December 31, 2007, all amounts related to the 2006 restructuring had been paid and the balance in the restructuring reserve account included in Accounts payable on the consolidated balance sheets was zero.

In the fourth quarter of 2007, we initiated a restructuring whereby we committed to a minor headcount reduction and ceased using certain leased office space. In connection with this restructuring we recorded charges totaling approximately \$5 million of which the majority related to a vacated lease, previously utilized by our G&I division in Arlington. This amount is included in Cost of services in our statements of income for the year ended

December 31, 2007. Less than \$1 million consists of standard termination benefits payable to a limited number of corporate and division employees. These termination costs are included in General and Administrative in our statements of income for the year ended December 31, 2007. The amounts recorded represent the total amounts expected to be incurred in connection with these activities.

Table of Contents**Note 23. Quarterly Data (Unaudited)**

Summarized quarterly financial data for the years ended December 31, 2007 and 2006 are as follows

| (in millions, except per share amounts) | Quarter (1) | | | | |
|---|-------------|----------|-----------|----------|----------|
| | First | Second | Third | Fourth | Year |
| 2007 | | | | | |
| Revenue | \$ 2,027 | \$ 2,152 | \$ 2,177 | \$ 2,389 | \$ 8,745 |
| Operating income | 45 | 65 | 102 | 82 | 294 |
| Income from continuing operations | 24 | 50 | 60 | 48 | 182 |
| Income from discontinued operations | 4 | 90 | 3 | 23 | 120 |
| Net income | \$ 28 | \$ 140 | \$ 63 | \$ 71 | \$ 302 |
| Earnings per share: | | | | | |
| Basic income per share (2) (3): | | | | | |
| Continuing operations | \$ 0.14 | \$ 0.30 | \$ 0.36 | \$ 0.29 | \$ 1.08 |
| Discontinued operations, net | 0.02 | 0.54 | 0.02 | 0.14 | 0.71 |
| Net income per share | \$ 0.17 | \$ 0.83 | \$ 0.38 | \$ 0.42 | \$ 1.80 |
| Diluted income per share (2) (3): | | | | | |
| Continuing operations | \$ 0.14 | \$ 0.30 | \$ 0.35 | \$ 0.28 | \$ 1.08 |
| Discontinued operations, net | 0.02 | 0.53 | 0.02 | 0.14 | 0.71 |
| Net income per share | \$ 0.17 | \$ 0.83 | \$ 0.37 | \$ 0.42 | \$ 1.79 |
| 2006 | | | | | |
| Revenue | \$ 2,056 | \$ 2,236 | \$ 2,222 | \$ 2,291 | \$ 8,805 |
| Operating income (loss) | 43 | (47) | 66 | 90 | 152 |
| Income (loss) from continuing operations | 13 | 4 | (8) | 45 | 54 |
| Income (loss) from discontinued operations | 13 | 88 | 15 | (2) | 114 |
| Net income | \$ 26 | \$ 92 | \$ 7 | \$ 43 | \$ 168 |
| Earnings per share: | | | | | |
| Basic and diluted income (loss) per share (2) (3): | | | | | |
| Continuing operations | \$ 0.10 | \$ 0.03 | \$ (0.06) | \$ 0.30 | \$ 0.39 |
| Discontinued operations, net | 0.10 | 0.65 | 0.11 | (0.01) | 0.81 |
| Net income per share | \$ 0.19 | \$ 0.68 | \$ 0.05 | \$ 0.28 | \$ 1.20 |

(1) In June 2007 we completed the disposition of our 51% interest

in DML. The results of operations of DML for all periods presented have been reported as discontinued operations. See Note 25 to the consolidated financial statements for information about discontinued operations.

- (2) The sum of income (loss) per share for the four quarters may differ from the annual amounts due to the required method of computing weighted average number of shares in the respective periods.
- (3) Due to the effect of rounding, the sum of the individual per share amounts may not equal the total shown.

Note 24. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) Staff issued FASB Staff Position (FSP) No. AUG AIR-1, Accounting for Planned Major Maintenance Activities. The FSP prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities. The FSP also requires disclosures regarding the method of accounting for planned major maintenance activities and the effects of implementing the FSP. The guidance in this FSP is effective January 1, 2007 and is to be retrospectively applied for all periods presented. The guidance in this FSP affects KBR with regard to a 50%-owned joint venture that leases offshore vessels requiring periodic major maintenance. This joint venture was contributed to KBR by Halliburton on April 1, 2006. KBR accounts for its investment in this joint venture under the equity method of accounting. As a result, KBR has retroactively applied the required change in accounting, electing the deferral method of accounting for planned major

maintenance activities. The deferral method requires the capitalization of planned major maintenance costs at the point they occur and the depreciation of these costs over an estimated period until future maintenance activities are repeated. The result is an increase to KBR's investment in the equity of this joint venture and an increase to additional paid-in capital of approximately \$7 million as of April 1, 2006. The effect of the change in accounting on KBR's operating results for the year ended December 31, 2006 was immaterial.

Table of Contents

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. The statement applies whenever other statements require or permit assets or liabilities to be measured at fair value. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. 157-2 that provides for a one-year deferral for the implementation of SFAS 157 for non-financial assets and liabilities. SFAS 157 does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. Accordingly, the adoption of this Statement will not have a material impact to our financial position, results of operations and cash flows.

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 provides companies with an option to measure certain financial instruments and other items at fair value with changes in fair value reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. Most of the provisions of SFAS 159 apply only to entities that elect the fair value option. However, the amendment to FASB Statement No. 115,

Accounting for Certain Investments in Debt and Equity Securities , applies to all entities with available-for-sale and trading securities. Currently, the adoption of this Statement is not expected to have a material impact on our financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations, (SFAS 141(R)), which replaces FASB Statement No. 141. SFAS 141(R), establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. This Statement also established disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008, early adoption is prohibited. Currently this statement is not expected to have a significant impact to our financial position, results of operations and cash flows. A significant impact may however be realized on any future acquisitions by the company. The amounts of such impact cannot be currently determined and will depend on the nature and terms of such future acquisitions, if any.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statement-amendments of ARB No. 51, (SFAS 160). SFAS 160 states that accounting and reporting for minority interests will be recharacterized as noncontrolling interests and classified as a component of equity. The Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective for fiscal years beginning after December 15, 2008, early adoption is prohibited. We are currently evaluating the impact the adoption of SFAS 160 will have on our financial position, results of operations and cash flows.

Note 25. Discontinued Operations

In May 2006, we completed the sale of our Production Services group, which was part of our Services business unit. The Production Services group delivers a range of support services, including asset management and optimization; brownfield projects; engineering; hook-up, commissioning and start-up; maintenance management and execution; and long-term production operations, to oil and gas exploration and production customers. 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 in the year ended December 31, 2006. During 2007, we settled certain claims and provided an allowance against certain receivables from the Production Services group resulting in a charge of approximately \$15 million. In the fourth quarter of 2007, we recognized a tax benefit of \$23 million in discontinued operations primarily related to a previously uncertain tax position associated with the sale of Production Services group.

On June 28, 2007, we completed the disposition of our 51% interest in DML to Babcock International Group plc. DML owns and operates Devonport Royal Dockyard, one of Western Europe s largest naval dockyard complexes. Our DML operations, which was part of our G&I business unit, primarily involved refueling nuclear submarines and performing maintenance on surface vessels for the U.K. Ministry of Defence as well as limited commercial projects. In connection with the sale, we received \$345 million in cash proceeds, net of direct transaction costs for our 51%

interest in DML.

Table of Contents

The sale of DML resulted in a gain of approximately \$101 million, net of tax of \$115 million, calculated as follows:

Millions of dollars

| | |
|---|--------|
| Proceeds, net of direct transaction costs | \$ 345 |
| Less: Net book value of DML | (129) |
| Gain on sale of DML before income tax | 216 |
| Less: Income tax | (115) |
| Gain on sale of DML, net of income tax | \$ 101 |

In accordance with the provisions of SFAS No. 144, Accounting for Impairment or Disposal of Long-Lived Assets, the results of operations of the Production Services group and DML for the current and prior periods have been reported as discontinued operations. The major classes of assets and liabilities of discontinued operations in the consolidated balance sheet at December 31, 2007 and December 31, 2006 are as follows:

| <i>Millions of dollars</i> | December 30, 2007 | December 31, 2006 |
|---|-------------------------|-------------------------|
| Assets: | | |
| Cash and equivalents | \$ | \$ 51 |
| Accounts receivable notes and accounts receivable | 1 | 62 |
| Accounts receivable unbilled receivables on uncompleted contracts | | 112 |
| Other current assets | | 32 |
| Total current assets related to discontinued operations | 1 | 257 |
| Property, plant, and equipment, net | | 281 |
| Goodwill | | 38 |
| Other noncurrent assets | | 38 |
| Total noncurrent assets related to discontinued operations | | 357 |
| Total assets related to discontinued operations | \$ 1 | \$ 614 |
| Liabilities: | | |
| Accounts payable | \$ | \$ 99 |
| Advance billings on incomplete contracts | | 136 |
| Other current liabilities | 1 | 39 |
| Total current liabilities related to discontinued operations | 1 | 274 |
| Employee compensation and benefits | | 191 |
| Long-term debt | | 2 |
| Other long-term liabilities | | 17 |
| Total noncurrent liabilities related to discontinued operations | | 210 |
| Table of Contents | | 223 |

| | | | | |
|--|----|---|----|-----|
| Total liabilities related to discontinued operations | \$ | 1 | \$ | 484 |
| Minority interest in consolidated subsidiaries | \$ | | \$ | 44 |

The consolidated operating results of our Production Services group and DML, which are classified as discontinued operations in our consolidated statements of income, are summarized in the following table:

| Millions of dollars | Years ended December 31 | | |
|----------------------------|--------------------------------|-------------|-------------|
| | 2007 | 2006 | 2005 |
| Revenue | \$ 449 | \$ 1,128 | \$ 1,609 |
| Operating profit | \$ 22 | \$ 109 | \$ 114 |
| Pretax income | \$ 11 | \$ 77 | \$ 91 |

Table of Contents

The operating results of DML, which are classified as discontinued operations, and included in our consolidated operating results table above, are summarized in the following table:

| Millions of dollars | Years ended December 31 | | |
|---------------------|-------------------------|--------|--------|
| | 2007 | 2006 | 2005 |
| Revenue | \$ 449 | \$ 828 | \$ 855 |
| Operating profit | \$ 37 | \$ 94 | \$ 70 |
| Pretax income | \$ 26 | \$ 62 | \$ 47 |

Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosures

None

Item 9A. Controls and Procedures***Managements Evaluation of Disclosure Controls and Procedures***

In accordance with Rules 13a-15 and 15d-15 under the Securities and Exchange Act of 1934 as amended (the Exchange Act), we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2007 to provide reasonable assurance that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Our disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting that occurred during the three months ended December 31, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Managements Annual Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in the Securities Exchange Act Rule 13a-15(f). Internal control over financial reporting, no matter how well designed, has inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation to assess the effectiveness of our internal control over financial reporting as of December 31, 2007, based upon criteria set forth in the Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment, we have concluded that, as of December 31, 2007, our internal control over financial reporting is effective. Our independent registered public accounting firm, KPMG LLP, has issued its report on the effectiveness of our internal control over financial reporting as of December 31, 2007, which follows.

Table of Contents

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

KBR, Inc.

We have audited KBR, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). KBR, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management's Report on Internal Control Over Financial Reporting*. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

In our opinion, KBR, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of KBR, Inc. as of December 31, 2007 and 2006, 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, 2007, and our report dated February 26, 2008 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Houston, TX

February 26, 2008

Item 9B. Other Information

None.

Table of Contents**PART III****Item 10. Directors, Executive Officers and Corporate Governance**

The information required by this Item is incorporated herein by reference to the KBR, Inc. Company Proxy Statement for our 2008 Annual Meeting of Stockholders.

Item 11. Executive Compensation

The information required by this Item is incorporated herein by reference to the KBR, Inc. Company Proxy Statement for our 2008 Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item is incorporated herein by reference to the KBR, Inc. Company Proxy Statement for our 2008 Annual Meeting of Stockholders.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this Item is incorporated herein by reference to the KBR, Inc. Company Proxy Statement for our 2008 Annual Meeting of Stockholders.

Item 14. Principal Accounting Fees and Services

The information required by this Item is incorporated herein by reference to the KBR, Inc. Company Proxy Statement for our 2008 Annual Meeting of Stockholders.

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

1. Financial Statements:
 - (a) The report of the Independent Registered Public Accounting Firm and the financial statements of the Company as required by Part II, Item 8, are included on page 63 and pages 64 through 117 of this annual report. See index on page 62.
2. Financial Statement Schedules:

| | Page No. |
|--|----------|
| <u>(a) KPMG LLP Report on supplemental schedule</u> | 123 |
| <u>(b) Schedule II Valuation and qualifying accounts for the three years ended December 31, 2007</u> | 124 |
| <u>(c) Financial Statements of 50-Percent-Or-Less-Owned Investees</u> | 125 |

Note: All schedules not filed with this report required by Regulations S-X have been omitted as not applicable or not required, or the information required has been included in the notes to financial statements.

3. Exhibits:

Exhibit

| Exhibit Number | Description |
|----------------|--|
| 2.1 | Agreement relating to the sale and purchase of the entire issued share capital of Devonport Management Limited by and among KBR, Inc., Kellogg Brown & Root Holdings (U.K.) Limited, Balfour Beatty plc, The Weir Group plc, and Babcock International Group plc, dated May 10, 2007 (incorporated by reference to Exhibit 10.7 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-3492) |
| 3.1 | KBR Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 3.2 | Amended and Restated Bylaws of KBR, Inc. (incorporated by reference to Exhibit 3.1 to KBR's Form 10-Q for the period ended June 30, 2007; File No. 1-33146) |

Table of Contents**Exhibit**

| Number | Description |
|---------------|---|
| 4.1 | Form of specimen KBR common stock certificate (incorporated by reference to Exhibit 4.1 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.1 | Master Separation Agreement between Halliburton Company and KBR, Inc. dated as of November 20, 2006 (incorporated by reference to Exhibit 10.1 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.2 | Tax Sharing Agreement, dated as of January 1, 2006, by and between Halliburton Company, KBR Holdings, LLC and KBR, Inc., as amended effective February 26, 2007 (incorporated by reference to Exhibit 10.2 to KBR's Annual Report on Form 10-K for the year ended December 31, 2006; File No. 001-33146) |
| 10.3 | Amended and Restated Registration Rights Agreement, dated as of February 26, 2007, between Halliburton Company and KBR, Inc. (incorporated by reference to Exhibit 10.3 to KBR's Annual Report on Form 10-K for the year ended December 31, 2006; File No. 001-33146) |
| 10.4 | Transition Services Agreement dated as of November 20, 2006, by and between Halliburton Energy Services, Inc. and KBR, Inc. (KBR as service provider) (incorporated by reference to Exhibit 10.4 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.5 | Transition Services Agreement dated as of November 20, 2006, by and between Halliburton Energy Services, Inc. and KBR, Inc. (Halliburton as service provider) (incorporated by reference to Exhibit 10.5 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.6 | Employee Matters Agreement dated as of November 20, 2006, by and between Halliburton Company and KBR, Inc. (incorporated by reference to Exhibit 10.6 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.7 | Intellectual Property Matters Agreement dated as of November 20, 2006, by and between Halliburton Company and KBR, Inc. (incorporated by reference to Exhibit 10.7 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.8 | Five Year Revolving Credit Agreement, dated as of December 16, 2005, among KBR Holdings, LLC, a Delaware limited liability company, as Borrower, the Banks and the Issuing Banks party thereto, Citibank, N.A. (Citibank), as Paying Agent, and Citibank and HSBC Bank USA, National Association, as Co-Administrative Agents (Incorporated by reference to Exhibit 10.30 to Halliburton Company's Annual Report on Form 10-K for the year ended December 31, 2005; File No. 001-03492) |
| 10.9 | Amendment No. 1 to the Five Year Revolving Credit Agreement, dated as of April 13, 2006, among KBR Holdings, LLC, a Delaware limited liability company, as Borrower, the Banks and Institutional Banks parties to the Five Year Revolving Credit Agreement, and Citibank, N.A., as paying agent (incorporated by reference to Exhibit 10.9 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.10 | Amendment No. 2 to the Five Year Revolving Credit Agreement, dated as of October 31, 2006, among KBR Holdings, LLC, a Delaware limited liability company, as Borrower, the Banks and Institutional Banks parties to the Five Year Revolving Credit Agreement, and Citibank, N.A., as paying agent |

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(incorporated by reference to Exhibit 10.24 to KBR's registration statement on Form S-1; Registration No. 333-133302)

- 10.11 Amendment No. 3 to the Five Year Revolving Credit Agreement, dated as of January 11, 2008, among KBR Holdings, LLC, a Delaware limited liability company, as Borrower, the Banks and Institutional Banks parties to the Five Year Revolving Credit Agreement, and Citibank, N.A., as paying agent (incorporated by reference to Exhibit 10.1 to KBR's current report on Form 8-K dated January 17, 2008; File No. 1-33146)
- 10.12+ Employment Agreement, dated as of April 3, 2006, between William P. Utt and KBR Technical Services, Inc. (incorporated by reference to Exhibit 10.15 to KBR's registration statement on Form S-1; Registration No. 333-133302)
- 10.13+ Employment Agreement, dated as of November 7, 2005, between Cedric W. Burgher and KBR Technical Services, Inc. (incorporated by reference to Exhibit 10.16 to KBR's registration statement on Form S-1; Registration No. 333-133302)
- 10.14+ Employment Agreement, dated as of August 1, 2004, between Bruce A. Stanski and KBR Technical Services,

Table of Contents

| Exhibit Number | Description |
|---------------------------|--|
| | Inc. (incorporated by reference to Exhibit 10.17 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.15 | Form of Indemnification Agreement between KBR, Inc. and its directors (incorporated by reference to Exhibit 10.18 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.16+ | KBR, Inc. 2006 Stock and Incentive Plan (as amended June 27, 2007) (incorporated by reference to Exhibit 10.1 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146) |
| 10.17+ | KBR, Inc. Senior Executive Performance Pay Plan (incorporated by reference to Exhibit 10.21 to KBR's Form 10-K for the fiscal year ended December 31, 2006; File No. 1-33146) |
| 10.18+ | KBR, Inc. Management Performance Pay Plan (incorporated by reference to Exhibit 10.22 to KBR's Form 10-K for the fiscal year ended December 31, 2006; File No. 1-33146) |
| 10.19+ | KBR, Inc. Transitional Stock Adjustment Plan (incorporated by reference to Exhibit 10.23 to KBR's Form 10-K for the fiscal year ended December 31, 2006; File No. 1-33146) |
| 10.20+ | KBR Dresser Deferred Compensation Plan (incorporated by reference to Exhibit 4.5 to KBR's Registration Statement on Form S-8 filed on April 13, 2007) |
| 10.21+ | KBR Supplemental Executive Retirement Plan (incorporated by reference to Exhibit 10.3 to KBR's current report on Form 8-K dated April 9, 2007; File No. 1-33146). |
| 10.22+ | KBR Benefit Restoration Plan (incorporated by reference to Exhibit 10.4 to KBR's current report on Form 8-K dated April 9, 2007; File No. 1-33146). |
| 10.23+ | KBR Elective Deferral Plan (incorporated by reference to Exhibit 10.5 to KBR's current report on Form 8-K dated April 9, 2007; File No. 1-33146). |
| 10.24+ | Restricted Stock Unit Agreement pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.2 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146) |
| 10.25+ | Stock Option Agreement pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.3 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146) |
| 10.26+ | KBR Restricted Stock Agreement pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.4 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146) |
| 10.27+ | KBR, Inc. Transitional Stock Adjustment Plan Stock Option Award (incorporated by reference to Exhibit 10.5 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146) |
| 10.28+ | KBR, Inc. Transitional Stock Adjustment Plan Restricted Stock Award (incorporated by reference to Exhibit 10.6 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146) |
| 10.29+ | |

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Form of Restricted Stock Agreement between KBR, Inc. and William P. Utt pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.1 to KBR's Form 10-Q for the quarter ended September 30, 2007; File No. 1-33146)

- 10.30+ Form of KBR Performance Award Agreement pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.5 to KBR's Form 10-Q for the quarter ended September 30, 2007; File No. 1-33146)
- 21.1 List of subsidiaries
- 23.1 Consent of KPMG LLP Houston, Texas

Table of Contents

Exhibit

| Number | Description |
|---------------|--|
| 23.2 | Consent of KPMG Adelaide, South Australia |
| 31.1 | Certification by Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a). |
| 31.2 | Certification by Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a). |
| 32.1 | Certification Furnished Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification Furnished Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| + | Management contracts or compensatory plans or arrangements |

Table of Contents

Report of Independent Registered Public Accounting Firm on Supplementary Information
The Board of Directors and Shareholders
KBR, Inc.:

Under the date of February 26, 2008, we reported on the consolidated balance sheets of KBR, Inc. and subsidiaries as of December 31, 2007 and 2006 and the related consolidated statements of income, shareholders' equity, and cash flows, for each of the years in the three-year period ended December 31, 2007, which reports appear in the December 31, 2007, Annual Report on Form 10-K of KBR, Inc. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related consolidated financial statement schedule (Schedule II) included in the Company's Annual Report on Form 10-K. The financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statement schedule based on our audits.

In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Notes 3, 21, and 15, respectively, to the consolidated financial statements, the Company changed its method of accounting for stock-based compensation plans as of January 1, 2006, its method of accounting for defined benefit and other post retirement plans as of December 31, 2006, and its method of accounting for uncertainty in income taxes as of January 1, 2007.

/s/ KPMG LLP

Houston, Texas

February 26, 2008

Table of Contents**KBR, Inc.****Schedule II Valuation and Qualifying Accounts (Millions of Dollars)**

The table below presents valuation and qualifying accounts for continuing operations.

| Descriptions | Balance at Beginning Period | Additions | | Deductions | Balance at End of Period |
|--|--------------------------------------|---|------------------------------------|-------------|-----------------------------------|
| | | Charged to Costs and Expenses | Charged to Other Accounts | | |
| Year ended December 31, 2005: | | | | | |
| Deducted from accounts and notes receivable: | | | | | |
| Allowance for bad debts | \$ 52 | \$ 36 | \$ | \$ (37) (a) | \$ 51 |
| Accrued reorganization charges | \$ 19 | \$ | \$ | \$ (19) | \$ |
| Reserve for losses on uncompleted contracts | \$ 134 | \$ 9 | \$ | \$ (105) | \$ 38 |
| Reserve for potentially disallowable costs incurred under government contracts | \$ 131 | \$ | \$ 11(b) | \$ (9) | \$ 133 |
| Year ended December 31, 2006: | | | | | |
| Deducted from accounts and notes receivable: | | | | | |
| Allowance for bad debts | \$ 51 | \$ 36 | \$ 2 | \$ (32) (a) | \$ 57 |
| Reserve for losses on uncompleted contracts | \$ 38 | \$ 176 | \$ | \$ (34) | \$ 180 |
| Reserve for potentially disallowable costs incurred under government contracts | \$ 133 | \$ | \$ 51(b) | \$ (107) | \$ 77 |
| Year ended December 31, 2007: | | | | | |
| Deducted from accounts and notes receivable: | | | | | |
| Allowance for bad debts | \$ 57 | \$ 19 | \$ 2 | \$ (55) (a) | \$ 23 |
| Reserve for losses on uncompleted contracts | \$ 180 | \$ 26 | \$ | \$ (89) | \$ 117 |
| Reserve for potentially disallowable costs incurred under government contracts | \$ 77 | \$ | \$ 34(b) | \$ (12) | \$ 99 |

- (a) Receivable write-offs, net of recoveries, and reclassifications.
- (b) Reserves have been recorded as reductions of revenue, net of reserves no longer required.

Table of Contents

**Asia Pacific Transport Joint Venture Consortium
Combined Financial Report
30 June 2007**

Draft dated 1 February 2008

125

Table of Contents

Report of Independent Auditors

The Board of Directors
KBR, Inc.

We have audited the accompanying combined balance sheet of Asia Pacific Transport Joint Venture Consortium as of 30 June 2006, and the related combined income statement and statements of changes in equity and cash flows for the year then ended. These combined financial statements are the responsibility of Asia Pacific Joint Venture Consortium's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of Asia Pacific Transport Joint Venture Consortium as of 30 June 2006, and the results of their operations and their cash flows for the year then ended in conformity with Australian equivalents to International Financial Reporting Standards.

As discussed in Note 22 to the combined financial statements, as a result of adopting AASB 132 Financial Instruments: Disclosure and Presentation and AASB 139 Financial Instruments: Recognition and Measurement on 1 July 2005, Asia Pacific Transport Joint Venture Consortium changed its method of accounting for financial instruments. In accordance with an election taken under the relevant transitional provisions, the prior period comparatives have not been restated.

The accompanying combined financial statements have been prepared assuming that Asia Pacific Transport Joint Venture Consortium will continue as a going concern. As discussed in Notes 1 and 16 to the combined financial statements, Asia Pacific Transport Joint Venture Consortium has suffered recurring losses from operations and has a net accumulated deficit that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Notes 1 and 16. The combined financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Australian equivalents to International Financial Reporting Standards vary in certain significant respects from U.S. generally accepted accounting principles. Information relating to the nature of such differences is presented in Note 24 to the combined financial statements.

/s/ KPMG

Adelaide, Australia

26 February 2007

Asia Pacific Transport Joint Venture Consortium Combined Financial Report
 Financial statements for the year ended 30 June 2007

Contents

| | Page |
|---|------|
| <u>Income Statement</u> | 128 |
| <u>Statement of Changes in Equity</u> | 129 |
| <u>Balance Sheet</u> | 130 |
| <u>Statement of cash flows</u> | 131 |
| <u>Note 1: Statement of significant accounting policies</u> | 132 |
| <u>Note 2: Revenue</u> | 139 |
| <u>Note 3: Other Disclosable Expenses</u> | 139 |
| <u>Note 4: Income tax expense</u> | 140 |
| <u>Note 5: Key management personnel disclosures</u> | 140 |
| <u>Note 6: Cash</u> | 141 |
| <u>Note 7: Receivables</u> | 141 |
| <u>Note 8: Other assets</u> | 141 |
| <u>Note 9: Property, plant and equipment</u> | 142 |
| <u>Note 10: Payables and other liabilities</u> | 144 |
| <u>Note 11: Deferred Income</u> | 144 |
| <u>Note 12: Borrowings</u> | 145 |
| <u>Note 13: Reserves and Equity</u> | 146 |
| <u>Note 14: Commitments</u> | 147 |
| <u>Note 15: Contingent liabilities</u> | 148 |
| <u>Note 16: Events subsequent to balance date</u> | 148 |
| <u>Note 17: Related party transactions</u> | 149 |
| <u>Note 18: Segment reporting</u> | 151 |
| <u>Note 19: Cash flow information</u> | 151 |
| <u>Note 20: Financial instruments</u> | 151 |
| <u>Note 21: Entity details</u> | 154 |
| <u>Note 22: Prior Year Changes in Accounting Policies</u> | 154 |
| <u>Note 23: Significant Accounting Policy Differences Between AIFRS and U.S. GAAP</u> | 155 |
| APT JV Consortium Combined Financial Report | |

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Income Statement

| Income Statement | Note | Unaudited June 2007 \$ | June 2006 \$ | Unaudited June 2005 \$ |
|--|------|------------------------------|-----------------|------------------------------|
| Revenue | 2 | 80,196,304 | 61,724,038 | 51,391,580 |
| Linehaul costs | | (42,081,628) | (34,739,070) | (28,360,661) |
| Operating Costs | | (9,176,254) | (5,991,936) | (5,819,415) |
| Depreciation and amortisation expenses | | (18,454,203) | (18,071,565) | (17,202,137) |
| Impairment of property, plant and equipment | 3 | | (87,570,180) | |
| Marketing and administration | | (1,165,789) | (1,035,217) | (1,224,506) |
| Contracts and consultants | | (10,257,994) | (6,946,025) | (8,730,195) |
| Employee benefits expense | | (4,644,511) | (4,197,511) | (3,973,532) |
| Other expenses | | (363,209) | (419,731) | (479,670) |
| Operating loss before finance costs | | (5,947,284) | (97,247,197) | (14,398,536) |
| Financial income | 3 | 1,411,480 | 1,275,453 | 1,118,183 |
| Financial expenses | 3 | (70,409,864) | (60,167,274) | (40,655,408) |
| Net financing costs | | (68,998,384) | (58,891,821) | (39,537,225) |
| Loss before income tax expense | | (74,945,668) | (156,139,018) | (53,935,761) |
| Income tax expense /(benefit) | 4 | | | |
| Net loss after income tax expense/(benefit) | | (74,945,668) | (156,139,018) | (53,935,761) |
| Attributable to members | | (74,945,668) | (156,139,018) | (53,935,761) |

The accompanying notes form part of these financial statements.

128

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Statement of Changes in Equity

| For the year ended 30 June 2005 (unaudited) | Combined Participating Interest and Issued Capital | Retained Earnings / (Accumulated Deficit) | Total |
|--|--|--|--------------|
| Opening balance as at 1 July 2004 | 300,012,158 | (37,248,930) | 262,763,228 |
| Net loss for the period | | (53,935,761) | (53,935,761) |
| Closing balance at 30 June 2005 | 300,012,158 | (91,184,691) | 208,827,467 |

| For the year ended 30 June 2006 | Combined Participating Interest and Issued Capital | Other contributed equity (i) | Retained Earnings / (Accumulated Deficit) | Reserves | Total |
|--|--|------------------------------------|--|-------------|---------------|
| Opening balance as at 1 July 2005 | 300,012,158 | | (91,184,691) | | 208,827,467 |
| Effect of change in accounting policy | | 21,761,379 | (21,761,379) | (6,430,385) | (6,430,385) |
| Net loss for the period | | | (156,139,018) | | (156,139,018) |
| Deemed equity contribution Note 22 | | 14,230,355 | | | 14,230,355 |
| Movement in fair value of hedging instruments | | | | 86,068 | 86,068 |
| Closing balance at 30 June 2006 | 300,012,158 | 35,991,734 | (269,085,088) | (6,344,317) | 60,574,487 |

| For the year ended 30 June 2007 (unaudited) | Combined Participating Interest and Issued Capital | Other contributed equity (i) | Retained Earnings / (Accumulated Deficit) | Reserves | Total |
|--|--|------------------------------------|--|-------------|--------------|
| Opening balance as at 1 July 2006 | 300,012,158 | 35,991,734 | (269,085,088) | (6,344,317) | 60,574,487 |
| Net loss for the period | | | (74,945,668) | | (74,945,668) |
| Deemed equity contribution Note 22 | | 14,230,355 | | | 14,230,355 |

| | | | | | |
|---|-------------|------------|---------------|-----------|-------------|
| Movement in fair value of hedging instruments | | | | 6,911,230 | 6,911,230 |
| Closing balance at 30 June 2007 | 300,012,158 | 50,222,089 | (344,030,756) | 566,913 | (6,770,404) |

Amounts are stated net of tax

- (i) Refer to Note 22 for further detail.

The accompanying notes form part of these financial statements.

129

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Balance Sheet

| | Note | Unaudited June 2007 \$ | June 2006 \$ |
|---|---------|------------------------------|--------------------|
| CURRENT ASSETS | | | |
| Cash | 6 | 20,787,021 | 28,589,938 |
| Receivables | 7 | 9,688,413 | 8,197,268 |
| Materials and supplies | | 2,896,796 | 3,013,539 |
| Other assets | 8 | 4,383,153 | 1,470,663 |
| TOTAL CURRENT ASSETS | | 37,755,383 | 41,271,408 |
| NON-CURRENT ASSETS | | | |
| Property, plant and equipment | 3 & 9 | 683,617,314 | 695,584,818 |
| TOTAL NON-CURRENT ASSETS | | 683,617,314 | 695,584,818 |
| TOTAL ASSETS | | 721,372,697 | 736,856,226 |
| CURRENT LIABILITIES | | | |
| Payables and other liabilities | 10 | 19,648,526 | 15,072,497 |
| Deferred income | 11 | 90,877 | 83,680 |
| Borrowings | 12 | 2,403,000 | 15,856,085 |
| Employee entitlements | 1j | 291,855 | 230,104 |
| TOTAL CURRENT LIABILITIES | | 22,434,258 | 31,242,366 |
| NON-CURRENT LIABILITIES | | | |
| Payables and other liabilities | 10 | 10,268,291 | 16,904,221 |
| Deferred income | 11 | 48,852,394 | 48,943,271 |
| Borrowings | 12 | 633,012,033 | 579,163,557 |
| Employee entitlements | 1j | 35,317 | 28,324 |
| TOTAL NON-CURRENT LIABILITIES | | 692,168,035 | 645,039,373 |
| TOTAL LIABILITIES | | 714,602,293 | 676,281,739 |
| NET ASSETS | | 6,770,404 | 60,574,487 |
| EQUITY | | | |
| Participating Interest and Issued Capital | 13 | 300,012,158 | 300,012,158 |
| Other contributed equity | 13 & 22 | 50,222,089 | 35,991,734 |
| Reserves | 13 | 566,913 | (6,344,317) |
| Retained earnings (accumulated deficit) | | (344,030,756) | (269,085,088) |

| | | |
|--------------|-----------|------------|
| TOTAL EQUITY | 6,770,404 | 60,574,487 |
|--------------|-----------|------------|

| | | |
|---|--|-----|
| The accompanying notes form part of these financial statements. | | 130 |
|---|--|-----|

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Statement of cash flows

| | Note | Unaudited June 2007 \$ | June 2006 \$ | Unaudited June 2005 \$ |
|---|------|------------------------------|-----------------|------------------------------|
| CASH FLOW FROM OPERATING ACTIVITIES | | | | |
| Receipts from customers | | 78,869,327 | 66,277,415 | 49,624,438 |
| Payments to suppliers and employees | | (65,896,969) | (64,153,474) | (42,068,855) |
| Borrowing costs | | (26,851,775) | (24,129,707) | (28,695,956) |
| Net cash provided by (used in) operating activities | 19b | (13,879,417) | (22,005,766) | (21,140,373) |
| CASH FLOW FROM INVESTING ACTIVITIES | | | | |
| Proceeds from sale of property, plant and equipment | | 129,918 | 500 | 151,643 |
| Payment for property, plant and equipment | | (7,433,727) | (9,041,962) | (15,335,424) |
| Net cash provided by (used in) investing activities | | (7,303,809) | (9,041,462) | (15,183,781) |
| CASH FLOW FROM FINANCING ACTIVITIES | | | | |
| Proceeds from borrowings external | | 5,158,000 | 8,171,001 | 14,244,594 |
| Proceeds from borrowings consortium participants | | 11,467,210 | 32,731,316 | 27,922,586 |
| Repayment of borrowings | | (3,244,901) | (3,177,896) | (13,186,335) |
| Net cash provided by (used in) financing activities | | 13,380,309 | 37,724,421 | 28,990,845 |
| Net increase/(decrease) in cash held | | (7,802,917) | 6,677,193 | (7,333,309) |
| Cash at beginning of year | | 28,589,938 | 21,912,745 | 29,246,054 |
| Cash at end of year | 19a | 20,787,021 | 28,589,938 | 21,912,745 |

The accompanying notes form part of these financial statements.

131

APT JV Consortium Combined Financial Report

Table of Contents

Asia Pacific Transport Joint Venture Consortium Combined Financial Report

Financial statements for the year ended 30 June 2007

Notes to the financial statements

Note 1: Statement of significant accounting policies

The Asia Pacific Transport Consortium (Consortium or entity) was established for the purpose of constructing 1,420 kilometres of rail line between Alice Springs and Darwin, the lease and maintenance of the existing 830 kilometre line between Tarcoola and Alice Springs, integration of the railway line with Darwin s East-Arm Port, and operation of the Adelaide to Darwin line for 50 years from January 2004.

The South Australian and Northern Territory governments, through a statutory body, AustralAsia Railway Corporation (AARC), established a legislative framework to co-ordinate and oversee the establishment of the railway. The Concession Deed sets out the fundamental terms between AARC and the Consortium to finance, construct, operate, repair and maintain the railway for a 50 year concession term from the date of completion of construction (2004). Under terms of the Concession Deed, AARC provided the Consortium with leases and subleases providing title to the Corridor for at least the term of the Concession Deed, including leases from the government and various Aboriginal land trusts over lands within the Corridor. The Concession Deed provides certain assurances to the Consortium regarding entitlement to exclusive possession, quiet possession and limited responsibility for certain interests. The Concession Deed also provides that AARC was responsible for procuring and paying for the construction of certain government works as part of the construction of the railway. The government works, which included the construction of certain earthworks, culverts and bridges, were completed during construction of the railway. Refer to note 17 for further discussion of the service concession arrangement.

The Consortium comprises the following entities domiciled in Australia:

Asia Pacific Transport Joint Venture (an unincorporated joint venture);

Freight Link Pty Ltd;

Asia Pacific Transport Pty Ltd (and its controlled entity, Asia Pacific Transport Finance Pty Ltd); and

Asia Pacific Contracting Pty Ltd.

The Consortium performs all rail safety, marketing, operation and asset management functions associated with the business. The Consortium has outsourced a number of activities, including train control, train crewing, terminal loading, port operations and maintenance associated with track and rolling stock, to rail service providers.

The joint venture agreement requires that the joint venture partners of Asia Pacific Transport Joint Venture (APTJV) have identical equity interests in the other group entities. The joint venture partners must at all times act in the best interest of the Consortium.

This Financial Report of the Consortium has been prepared based upon a business combination of APTJV (the deemed parent), its group entities (Freight Link Pty Ltd, Asia Pacific Transport Pty Ltd, Asia Pacific Transport Finance Pty Ltd and Asia Pacific Contracting Pty Ltd) in accordance with UIG 1013 Consolidated Financial Reports in relation to Pre-Date-of-Transition Stapling Arrangements . This financial report is a general purpose report which has been prepared in accordance with the requirements of Australian Accounting standards adopted by the Australian Accounting Standards Board (AASB).

The financial report for the year ended 30 June 2007 is unaudited but has been compiled from the Consortium s audited consolidated financial report for the same period (the year ended 30 June 2007). The 2006 comparatives in this report are audited.

The accompanying notes form part of these financial statements.

132

APT JV Consortium Combined Financial Report

Table of Contents

Asia Pacific Transport Joint Venture Consortium Combined Financial Report

Financial statements for the year ended 30 June 2007

Statement of Compliance

International Financial Reporting Standards (IFRSs) form the basis of Australian Accounting Standards adopted by the AASB, being Australian equivalents to IFRS (AIFRS). The financial report also complies with IFRSs and interpretations adopted by the International Accounting Standards Board.

Basis of preparation

The financial report is presented in Australian dollars. It has been prepared on an accruals basis and is based on historical costs and does not take into account changing money values or, except where stated, current valuations of non-current assets. The entity has not early adopted any of the accounting standards and amendments available for early adoption as none are expected to have a material impact on the financial position of the entity.

Basis of consolidation

This Financial Report of the AsiaPacific Transport Consortium has been prepared based upon a business combination of APTJV (the deemed parent) and its group entities in accordance with UIG 1013 Consolidated Financial Reports in relation to Pre-Date-of-Transition Stapling Arrangements .

Controlled entities are entities controlled by APTJV or its group entities. Control exists when the entity has the power, directly or indirectly, to govern the financial and operating policies of an entity to obtain benefits from its activities. The financial statements of controlled entities are included in the consolidated financial report from the date that control commences until the date that control ceases.

Unrealised gains and losses and inter-entity balances resulting from transactions with or between entities are eliminated in full within the Consortium.

Going concern

The entity has been contracted to the AustralAsia Railway Corporation to undertake, build, own and operate the Adelaide to Darwin Rail Project (the Project). The entity and parties to the Project are confident of the success of the Project (supported by detailed financial modelling) and have undertaken to support each other through the initial stages of the Project. At 30 June 2007, the entity had net assets of \$7m, reflected by participating interests and contributed equity of \$351m, offset by accumulated deficit/reserves of \$344m.

In December 2006 the entity agreed a Standstill Term up to March 2009 with the Senior Banks for a waiver of principal during the Standstill period and Shareholders committed support of \$14.4 million; the shareholders providing the support being KBR, Carillion and GWA. The Consortium believes it will be able to meet its ongoing obligations from operating cash flows under the Standstill Term through 31 March 2009. Accordingly, the financial report has been prepared on a going concern basis which contemplates the continuity of normal business activities and the realisation of assets and settlement of liabilities in the ordinary course of business.

The preparation of a financial report in conformity with AIFRS requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. The estimates and judgements that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year relate to going concern (refer Note 1 previous comments) and impairment (refer Note 1(l)).

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

The accompanying notes form part of these financial statements.

133

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

The accounting policies set out below have been applied consistently to all periods presented in the financial report. None of the standards, amendments to standards and interpretations available for early adoption have been early adopted as none, with the possible exception of Interpretation 12, are expected to have a significant impact on the financial statements of the Consortium. Interpretation 12 Service Concession Arrangements, which is effective in the financial year ended 30 June 2009, addresses the accounting for service concession operators in public to private service concession arrangements. The potential effect of the Interpretation on the Consortium's financial statements has not yet been determined.

a. Revenue

Freight service revenue is recognized when the freight departs from the terminal. This policy results in recognition of revenue in a manner that does not differ materially from proportional revenue recognition as a shipment moves from origin to destination and related expenses are recognised as incurred.

Government grants are recognised in the balance sheet initially as deferred income and then released to income on a systematic basis in the same periods in which the expenses for which the grant was received are incurred. The entity has recognised as a government grant the difference between the present value of the Corporation/government loan and its \$50m face value as outlined in Note 22. Deferred income is being recognised over the loan redemption period to 2054.

Interest revenue is recognised on an accrual basis taking in to account the interest rates applicable to the financial assets.

All revenue is stated net of the amount of goods and services tax (GST).

b. Cash

For the purposes of the statement of cash flows, cash includes cash on hand and at call deposits with banks or financial institutions.

c. Receivables

Receivables are stated at their cost less impairment losses. Debtors to be settled within 30 days are carried at amounts due. The collectability of debts is assessed at balance date and an impairment charge made for any doubtful accounts.

d. Property, Plant and Equipment**Plant and equipment**

Items of property, plant and equipment are stated at cost less accumulated depreciation (see below) and impairment losses (see accounting policy 1). The cost of self-constructed assets includes the cost of materials, direct labour, the initial estimate, where relevant, of the costs of dismantling and removing the items and restoring the site on which they are located, and an appropriate proportion of production overheads. Where parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate items of property, plant and equipment. Preliminary costs associated with the formation of the Project have been capitalised into cost of construction related assets and are amortised over periods (between 5 and 50 years) that reflect the duration of benefit arising from the asset.

Depreciation

The depreciable amount of all fixed assets including buildings and capitalised leased assets, but excluding freehold land, are depreciated on a straight line basis over their useful lives to the joint venture commencing from the time the asset is held ready for use. Leasehold improvements are depreciated over the shorter of either the unexpired period of the lease or the estimated useful lives of the improvements.

The accompanying notes form part of these financial statements.

134

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

The depreciation rates used in the current and comparative periods are:

| <i>Class of Fixed Asset</i> | <i>Depreciation Rate</i> |
|---|--------------------------|
| Buildings (Terminals) | 3%-15% |
| Infrastructure (Track) | 2%-10% |
| Plant & Equipment / Office & Administration | 2%-40% |
| Rolling Stock | 5% |

e. Leases

Leases of fixed assets, where substantially all the risks and benefits incidental to the ownership of the asset, but not legal ownership, are transferred to the entity are classified as finance leases. Finance leases are capitalised recording an asset and a liability equal to the present value of the minimum lease payments, including any guaranteed residual value. Leased assets are depreciated on a straight line basis over their estimated useful lives where it is likely that the economic entity will obtain ownership of the asset or over the term of the lease. Lease payments are allocated between the reduction of the lease liability and the lease interest expense for the period.

Lease payments under operating leases, where substantially all the risks and benefits remain with the lessor, are recognised in the income statement on a straight-line basis over the term of the lease.

The entity was assigned leases at nil cost to enable it to undertake the Project on the rail corridor. No value was assigned to these leases at the time of receipt.

f. Materials and supplies

Materials and supplies, consisting mainly of items for maintenance of property and equipment are stated at the lower of cost or market. The cost of materials and supplies is based on the first-in first-out principle and includes expenditure incurred in acquiring the materials and supplies and bringing them to their existing location and condition.

g. Payables and other liabilities

Liabilities are recognised for amounts to be paid in the future for goods or services received and are stated at cost.

Trade accounts payable are normally settled within 30 days.

Loans received at below-market rates are initially measured at their fair value. Any difference between the fair value of the loan on initial recognition and the amount received is accounted for according to its nature (see accounting policy n).

h. Provisions

A provision is recognised in the balance sheet when the entity has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

i. Income tax

As stated in Note 1 previously, the entity for the purposes of this report comprises one joint venture as deemed parent entity and four companies.

The joint venture is not a taxable entity and lodges a tax return as a Partnership. Accordingly, any tax liabilities are the responsibility of the individual partners and the report does not contain any income tax expense or provision with respect to the joint venture.

The accompanying notes form part of these financial statements.

135

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Income tax on the profit or loss for the year of the other four companies comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

The following temporary differences are not provided for: goodwill, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets or liabilities, using tax rates enacted or substantially enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

j. Employee entitlements

The entity's net obligation in respect of long-term service benefits, other than pension plans, is the amount of future benefit that employees have earned in return for their service in the current and prior periods. The obligation is calculated using expected future increases in wage and salary rates including related on-costs and expected settlement dates and is discounted using the rates attached to the Commonwealth Government bonds at the balance sheet date which have maturity dates approximating to the terms of the entity's obligations.

Liabilities for employee benefits for wages, salaries, annual leave and sick leave that are expected to be settled within 12 months of the reporting date represent present obligations resulting from employees' services provided to reporting date, are calculated at undiscounted amounts based on remuneration wages and salary rates that the entity expects to pay as at reporting date including related on-costs, such as workers compensation insurance and payroll tax.

Non-accumulating non-monetary benefits, such as medical care, housing, cars and free or subsidised goods and services, are expensed based on the net marginal cost to the entity as the benefits are taken by employees.

k. Foreign currency transactions and balances

Foreign currency transactions during the period are converted to Australian currency at the rates of exchange applicable at the dates of the transactions. Amounts receivable and payable in foreign currencies at balance date are converted to the rates of exchange ruling at that date.

The gains and losses from conversion of short-term assets and liabilities, whether realised or unrealised, are included in profit from ordinary activities as they arise.

l. Impairment

The carrying amounts of non-current assets valued on the cost basis are reviewed to determine whether there is any indication of impairment at balance date. If any such indication exists, the asset's recoverable amount is estimated. An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement, unless an asset has previously been revalued, in which case the impairment

The accompanying notes form part of these financial statements.

136

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

loss is recognised as a reversal to the extent of that previous revaluation with any excess recognised through profit or loss.

Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to cash-generating units (group of units) and then, to reduce the carrying amount of the other assets in the unit (group of units) on a pro rata basis.

The recoverable amount of assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

An impairment loss is reversed if there is an indication that the impairment loss may no longer exist and there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

m. Goods and services tax

Revenues, expenses and assets are recognised net of the amount of goods and services tax (GST), except where the amount of GST incurred is not recoverable from the Australian Taxation Office (ATO). In these circumstances the GST is recognised as part of the cost of acquisition of the asset or as part of an item of the expense. Receivables and payables are stated with the amount of GST included. The net amount of GST recoverable from, or payable to, the ATO is included as a current asset or liability in the balance sheet. Cash flows are included in the statement of cash flows on a gross basis. The GST components of cash flows arising from the investing or financing activities which are recoverable from, or payable to, the ATO are classified as operating cash flows.

n. Interest-bearing borrowings

Interest-bearing borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortised cost with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

Net financing costs comprise interest payable on borrowings calculated using the effective interest rate method, interest receivable on funds invested, dividend income, and gains and losses on hedging instruments that are recognised in the income statement (see accounting policy p).

Interest income is recognised in the income statement as it accrues, using the effective interest method. Dividend income is recognised in the income statement on the date the entity's right to receive payments is established. The interest expense component of finance lease payments is recognised in the income statement using the effective interest rate method.

o. Derivatives

The entity uses derivative financial instruments to hedge its exposure to interest rate risks arising from operational and financing activities. In accordance with its treasury policy, the entity does not hold or issue derivative financial instruments for trading purposes.

Derivative financial instruments are recognised initially at cost. Subsequent to initial recognition, derivative financial instruments are stated at fair value. The gain or loss on re-measurement to fair value is recognised immediately in profit or loss. However, where derivatives qualify for hedge

The accompanying notes form part of these financial statements.

137

APT JV Consortium Combined Financial Report

Table of Contents

Asia Pacific Transport Joint Venture Consortium Combined Financial Report

Financial statements for the year ended 30 June 2007

accounting, recognition of any resultant gain or loss depends on the nature of the item being hedged (see accounting policy p).

The fair value of interest rate swaps is the estimated amount that the entity would receive or pay to terminate the swap at the balance sheet date, taking into account current interest rates and the current creditworthiness of the swap counterparties. The fair value of forward exchange contracts is their quoted market price at the balance sheet date, being the present value of the quoted forward price.

p. Cash flow hedges

Where a derivative financial instrument is designated as a hedge of the variability in cash flows of a recognised asset or liability, or a highly probable forecasted transaction, the effective part of any gain or loss on the derivative financial instrument is recognised directly in equity. The ineffective part of any gain or loss is recognised immediately in the income statement. When the forecasted transaction subsequently results in the recognition of a non-financial asset or non-financial liability, the associated cumulative gain or loss is removed from equity and included in the initial cost or other carrying amount of the non-financial asset or liability. If a hedge of a forecasted transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains and losses that were recognised directly in equity are reclassified into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (i.e., when interest income or expense is recognised).

When a hedging instrument expires or is sold, terminated or exercised, or the entity revokes designation of the hedge relationship, but the hedged forecast transaction is still expected to occur, the cumulative gain or loss at that point remains in equity and is recognised in accordance with the above policy when the transaction occurs. If the hedged transaction is no longer expected to take place, the cumulative unrealised gain or loss recognised in equity is recognised immediately in the income statement.

q. Borrowing costs

Borrowing costs incurred in relation to qualifying assets are capitalised into the cost of the asset and amortised over the asset's useful life following completion of the asset's construction. Borrowing costs incurred which are not related to qualifying assets are expensed as incurred.

The accompanying notes form part of these financial statements.

138

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 2: Revenue

| | Unaudited June 2007 \$ | June 2006 \$ | Unaudited June 2005 \$ |
|-------------------------|------------------------------|-----------------|------------------------------|
| Operating activities | | | |
| Freight service revenue | 80,196,304 | 61,724,038 | 51,391,580 |
| Total Revenue | 80,196,304 | 61,724,038 | 51,391,580 |

Note 3: Other Disclosable Expenses

Finance costs:

| | | | |
|--|-------------|-------------|-------------|
| interest income | (1,327,800) | (1,198,399) | (1,118,183) |
| Corporation Loan Grant income | (83,680) | (77,054) | |
| interest expense, OpCo Notes (ii) | 14,230,355 | 14,230,355 | |
| other interest expense | 56,121,391 | 45,799,096 | 40,482,770 |
| borrowing fees | 58,118 | 137,823 | 172,638 |
| | 68,998,384 | 58,891,821 | 39,537,225 |
| Depreciation and amortisation of property, plant and equipment | 18,454,203 | 18,071,565 | 17,202,137 |
| Sale of property, plant and equipment | 817,110 | 1,882 | 7,791 |
| Impairment of property, plant and equipment (i) | | 87,570,180 | |
| Remuneration of auditor: | | | |
| audit or review KPMG | 40,000 | 38,000 | 35,000 |
| other services KPMG | 41,275 | 39,150 | 56,365 |
| other services other auditors | | | 5,560 |

- (i) At June 2007, the present book value of future operating cash flows representing the recoverable amount of PP&E under the value in use assumption was equivalent to the 30 June 2007 \$684m PP&E carrying value, and hence an impairment charge is not required. The discount rate utilised in the financial model was 10.45%.

At June 2006, the present value of future operating cash flows representing the recoverable amount of PP&E under the value in use assumption was below the 30 June 2006 \$783m PP&E carrying value, and hence an impairment charge of \$87,570,180 was recorded. The discount rate utilised in the financial model was 10.44%.

- (ii) Refer to Note 22 for further detail.

The accompanying notes form part of these financial statements.

139

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 4: Income tax expense

| | Unaudited June 2007 \$ | June 2006 \$ | Unaudited June 2005 \$ |
|---|------------------------------|-----------------|------------------------------|
| Recognised in the income statement | | | |
| Current tax expense | | | |
| Deferred tax expense | | | |
| Temporary differences | | | |
| Benefit of tax losses recognised | | | |
| | | | |
| Total income tax expense / (benefit) in income statement | | | |
| | | | |
| All attributable to continuing operations | | | |
| The prima facie tax payable on profit is reconciled to the income tax expense as follows: | | | |
| Prima facie tax payable on loss before income tax at 30% | (22,483,700) | (42,572,598) | (16,180,728) |
| Add tax effect of: | | | |
| Other non-allowable items | (2,444,864) | 8,506 | 6,477 |
| Unrecognised deferred tax asset | 24,928,564 | 42,564,092 | 16,174,251 |

Income Tax Expense

Deferred tax assets have not been recognised in respect of the following items:

| | | | |
|--------------------------------------|------------|------------|------------|
| Tax losses (in Freight Link Pty Ltd) | 60,941,469 | 43,524,285 | 27,269,345 |
|--------------------------------------|------------|------------|------------|

The deductible tax losses do not expire under current tax legislation. No deferred tax assets have been recognised because it is not probable that future taxable profit will be available against which the entity can utilise the benefits there from.

Note 5: Key management personnel disclosures

The key management personnel comprise the directors and CEO of Freight Link Pty Ltd, with remuneration as follows:

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| | | | |
|------------------------------|-----------|---------|-----------|
| Short-term employee benefits | 986,789 | 820,780 | 1,000,616 |
| Other long-term benefits | 88,811 | 73,870 | 62,718 |
| Total | 1,075,600 | 894,650 | 1,063,334 |

Refer to Note 17 for other related party transactions.

The following were key management personnel of the entity at any time during the year:

| | |
|-------------------------|-------------------|
| Mr Nick Bowen | Dr Dan Norton |
| Mr Tim Fischer | Mr Doug Ridley |
| Mr Malcolm Kinnaird, AO | Mr Mark Snape |
| Mr Brett Lazarides | Mr Ron Thomas |
| Mr Brian McGlynn | Mr Bill Woodhead |
| Mr Bruce McGowan | Mr John Fullerton |

The accompanying notes form part of these financial statements.

140

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 6: Cash

| | Note | Unaudited June 2007 \$ | June 2006 \$ |
|--------------|------|------------------------------|-----------------|
| Cash at bank | 6a | 20,786,621 | 28,589,538 |
| Cash on hand | | 400 | 400 |
| | | 20,787,021 | 28,589,938 |

a. Cash available is governed by finance covenants with lenders.

Note 7: Receivables

| | | | |
|---------------|--|-----------|-----------|
| Trade debtors | | 8,905,614 | 7,578,637 |
| Other debtors | | 782,799 | 618,631 |
| | | 9,688,413 | 8,197,268 |

Note 8: Other assets

| | | | |
|-------------|--|-----------|-----------|
| CURRENT | | | |
| Prepayments | | 4,340,552 | 1,360,027 |
| Other | | 42,601 | 110,636 |
| | | 4,383,153 | 1,470,663 |

The accompanying notes form part of these financial statements.

141

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 9: Property, plant and equipment

| | Office & Administration | Plant | Terminals 2007 \$ | Track | Rollingstock | Total |
|---|----------------------------|------------------|-------------------------|----------------------|---------------------|----------------------|
| At cost | 1,409,446 | 1,211,794 | 828,973 | 771,585,682 | 54,298,694 | 829,334,589 |
| Accumulated amortisation/depreciation/impairment | (1,035,493) | (267,335) | (163,921) | (132,062,223) | (12,188,303) | (145,717,275) |
| | 373,953 | 944,459 | 665,052 | 639,523,459 | 42,110,391 | 683,617,314 |
| | | | 2006 \$ | | | |
| At cost | 1,284,653 | 1,189,409 | 775,330 | 769,318,708 | 50,303,118 | 822,871,218 |
| Accumulated amortisation/depreciation | (784,362) | (199,138) | (131,914) | (116,675,919) | (9,495,067) | (127,286,400) |
| | 500,291 | 990,271 | 643,416 | 642,642,789 | 40,808,051 | 695,584,818 |

The accompanying notes form part of these financial statements.

142

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 9: Property, plant and equipment (continued)

Movement in the carrying amounts for each class of property, plant and equipment between the beginning and the end of the current financial year.

| | 2007 | | | | | |
|--------------------------------------|----------------------------|-----------------|-----------------|---------------------|--------------------|---------------------|
| | (Unaudited) | | | | | |
| | \$ | | | | | |
| | Office & Administration | Plant | Terminals | Track | Rollingstock | Total |
| Carrying amount at beginning of year | 500,291 | 990,271 | 643,416 | 652,642,789 | 40,808,051 | 695,584,818 |
| Additions | 124,793 | 22,387 | 53,643 | 2,266,973 | 4,965,931 | 7,433,727 |
| Disposals | | | | | (947,028) | (947,028) |
| Impairment | | | | | | - |
| Depreciation | (251,131) | (68,199) | (32,007) | (15,386,303) | (2,716,563) | (18,454,203) |
| Carrying amount at end of year | 373,953 | 944,459 | 665,052 | 639,523,459 | 42,110,391 | 683,617,314 |

| | 2006 | | | | | |
|--------------------------------------|-------------|-----------|----------|--------------|-------------|--------------|
| | \$ | | | | | |
| Carrying amount at beginning of year | 668,299 | 606,612 | 591,566 | 748,674,315 | 41,572,535 | 792,113,327 |
| Additions | 210,551 | 551,329 | 160,730 | 1,500,421 | 6,618,931 | 9,041,962 |
| Disposals | (2,382) | | | | | (2,382) |
| Impairment | (62,984) | (124,670) | (81,002) | (82,164,023) | (5,137,501) | (87,570,180) |
| Depreciation | (313,193) | (43,000) | (27,878) | (15,367,924) | (2,245,914) | (17,997,909) |
| Carrying amount at end of year | 500,291 | 990,271 | 643,416 | 652,642,789 | 40,808,051 | 695,584,818 |

The accompanying notes form part of these financial statements.

143

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 10: Payables and other liabilities

| | Note | Unaudited June 2007 \$ | June 2006 \$ |
|---|------|------------------------------|-----------------|
| CURRENT | | | |
| Trade creditors | | 13,980,510 | 10,125,976 |
| Sundry creditors | | 5,638,341 | 4,902,765 |
| GST payable | | 29,675 | 43,756 |
| | | 19,648,526 | 15,072,497 |
| NON-CURRENT | | | |
| Fair value swaps (ii) | | (566,913) | 6,344,317 |
| Project contracts (at discount value) (i) | | 10,835,204 | 10,559,904 |
| | | 10,268,291 | 16,904,221 |

(i) Relates to several amounts payable by the entity if funds are available refer Note 17 D&C Contractor paragraph for further detail.

(ii) Refer to note 20(a) for further detail.

Note 11: Deferred income

| | Note | Unaudited June 2007 \$ | June 2006 \$ |
|-------------------------------------|------|------------------------------|-----------------|
| CURRENT | | | |
| Deferred grant Corporation loan (i) | | 90,877 | 83,680 |
| | | 90,877 | 83,680 |
| NON-CURRENT | | | |
| Deferred grant Corporation loan (i) | | 48,852,394 | 48,943,271 |
| | | 48,852,394 | 48,943,271 |

(i) At the outset of the Project, a \$50m loan was received from the AustralAsia Railway Corporation, an entity owned by the South Australian and Northern Territory governments, with repayment required by 2054. Interest payments may be required in certain circumstances based on EBITDA performance against the entity's 2003 Base Case financial model. However, due to the remote likelihood of the entity achieving these results, on adoption of AASB 139 Financial Instruments: Recognition and Measurement effective 1 July 2005 (refer Note 22), the loan has been discounted at the entity's weighted average cost of debt rate and recognised as a component of borrowings at that present value (refer Note 12(b)). The difference between the present value of the loan and the \$50m face value has been accounted for as a deferred government grant, to be amortised to income on the same basis as the loan is accreted to its \$50m face value.

The accompanying notes form part of these financial statements.

144

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 12: Borrowings

| | | Unaudited June 2007 \$ | June 2006 \$ |
|--|-----|------------------------------|-----------------|
| Loan from participating interest holders (e) | | 403,000 | 403,000 |
| Working Capital loan | | 2,000,000 | 2,000,000 |
| Lease liability (d) | | | 52,814 |
| Senior D Amortising | | | 10,033,571 |
| Senior E Rolling Stock | | | 3,366,700 |
| | 12a | 2,403,000 | 15,586,085 |
| NON-CURRENT | | | |
| Senior C Bullet | | 109,020,000 | 109,020,000 |
| Senior D Amortising | | 167,268,639 | 159,663,016 |
| Senior E Rolling Stock | | 53,321,081 | 45,613,334 |
| Tier 1 Mezzanine (c) | | 114,408,242 | 100,017,220 |
| Tier 2 Mezzanine | | 30,008,673 | 26,698,041 |
| Loan Notes-OPCO (c) | | 94,869,031 | 94,869,031 |
| Loan Notes-SON 1 (c) | | 58,847,446 | 38,782,790 |
| Loan Notes-SON 2 (c) | | 4,212,192 | 3,527,076 |
| Corporation loan | 12b | 1,056,729 | 973,049 |
| | | 633,012,033 | 579,163,557 |

a. Refer Note 20d Finance arrangements for terms and conditions of borrowings including covenants. Senior debt is secured under the Security Trust Deed by a charge on all the entity's assets.-refer Note 17 Equity Investors .

b. Fair value of loan (refer Note 11 (i) for detail).

c. Owed either fully or partly to related parties refer Note 17 Equity Investors .

d. Relates to leased software asset, included in Office and Administration assets in Note 9.

e. Loan is non-interest bearing and repayable on demand.

The accompanying notes form part of these financial statements.

145

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 13: Reserves and Equity

| | Unaudited June 2007 \$ | June 2006 \$ |
|--|------------------------------|-----------------|
| Hedging Reserve | | |
| The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred. | | |
| Valuation at the beginning of the financial year | (6,344,317) | |
| Change in accounting policy at 1 July 2005 | | (6,430,385) |
| Movement in fair value of hedging instruments | 6,911,230 | 86,068 |
| Valuation at the end of the financial year | 566,913 | (6,344,317) |
| Equity | | |
| Freight Link Pty Ltd (95,992,500 shares on issue; 2006: 95,992,500) | 959,925 | 959,925 |
| Asia Pacific Transport Joint Venture (participating interest) | 299,048,929 | 299,048,929 |
| Asia Pacific Contracting Pty Ltd (165,200 shares on issue; 2006: 165,200) | 1,652 | 1,652 |
| Asia Pacific Transport Pty Ltd (165,200 shares on issue; 2006: 165,200) | 1,652 | 1,652 |
| Other contributed equity (i) | 50,222,089 | 35,991,734 |
| | 350,234,247 | 336,003,892 |

Voting rights are in proportion to equity interests.

(i) Refer note 22.

The accompanying notes form part of these financial statements.

146

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

Note 14: Commitments

| | Unaudited June 2007 \$ | June 2006 \$ |
|--|------------------------------|-----------------|
| a. Operating lease commitments | | |
| Non-cancellable operating leases contracted for but not capitalised in the financial statements. | | |
| Payable: | | |
| not later than 1 year | 7,873,140 | 2,556,996 |
| later than 1 year but not later than 5 years | 10,481,009 | 3,236,994 |
| later than 5 years | 26,837,343 | |
| | 44,991,492 | 5,793,990 |
| b. Capital Expenditure Commitments | | |
| Contracted for: | | |
| plant and equipment purchases | | 5,145,947 |
| capital expenditure projects | 3,302,000 | |
| | 3,302,000 | 5,145,947 |
| Payable: | | |
| not later than 1 year | 3,302,000 | 5,145,947 |
| later than 1 year and not later than 5 years | | |
| | 3,302,000 | 5,145,947 |
| c. Finance Lease Commitments | | |
| Payable: | | |
| not later than 1 year | | 55,788 |
| later than 1 year but not later than 5 years | | |
| later than 5 years | | |
| | | 55,788 |
| Less: future lease finance charges | | 2,974 |
| | | 52,814 |
| Lease liabilities provided for in the financial statements: | | |
| Current | | 52,814 |

| | | |
|--|------------|------------|
| Non-current | | |
| Total lease liability | | 52,814 |
| d. Other Commitments | | |
| Contracted for: | 43,139,494 | 45,385,613 |
| Payable: | | |
| not later than 1 year | 12,348,387 | 8,026,119 |
| later than 1 year and not later than 5 years | 11,620,308 | 15,079,700 |
| later than 5 years | 19,170,799 | 22,279,794 |
| | 43,139,494 | 45,385,613 |

These include commitments to the Sponsors for professional services which are conditional on funds being available and lapse in 2008.

The accompanying notes form part of these financial statements. 147

APT JV Consortium Combined Financial Report

Table of Contents

Asia Pacific Transport Joint Venture Consortium Combined Financial Report

Financial statements for the year ended 30 June 2007

Note 15: Contingent liabilities

The representatives are not aware of any circumstances or information that would lead them to believe that the entity has a material contingent liability.

Note 16: Events subsequent to balance date

The Consortium will present a plan to the Senior Banks in 2008 to restructure, refinance or sell the business under its obligations in the Standstill Agreement. The Consortium continues to meet all of its obligations under the Standstill Agreement.

Other than noted in this section, there has not arisen in the interval between the end of the financial year and the date of this report any item, transaction or event of a material and unusual nature likely, in the opinion of the representatives of the joint venture and the directors of the companies, to affect significantly the operations of the Consortium, results of those operations, or the state of affairs of the Consortium, at 30 June 2007.

The accompanying notes form part of these financial statements.

148

APT JV Consortium Combined Financial Report

Table of Contents

Asia Pacific Transport Joint Venture Consortium Combined Financial Report

Financial statements for the year ended 30 June 2007

Note 17: Related party transactions

Due to the size and complexity of the Project, there are a large number of parties involved. The following diagram summarises the structure and the significant entities:

Unaudited

Service Concession Arrangement (Concession Deed)

Asia Pacific Transport Joint Venture (APT) is the entity contracted by the AustralAsia Railway Corporation to undertake, build, own and operate the Adelaide to Darwin Rail Project, a 50-year concession on the corridor from Tarcoola to Darwin ending in 2054. Other APT companies are involved in the financing and management of the construction contract. The D&C Contractor, ADrail, was awarded the fixed sum, fixed duration contract to construct the railway and associated infrastructure. Freight Link Pty Ltd operates the railway with many of the activities being sub-contracted to other parties.

The Consortium is required to maintain the railway and hand it over to the AustralAsia Railway Corporation in good working condition at the conclusion of the concession (or surrender the assets earlier if the Project fails), and is otherwise wholly responsible for operations on the corridor during the concession period. There are no service obligations imposed by the concession arrangement apart from track capital expenditure which would be expended if specific financial criteria are met in future years. There is no renewal option.

Equity Investors

Sponsors, comprising subsidiary companies of the following groups:

Kellogg Brown & Root

John Holland Group Pty Ltd *(part of the Leighton Group)

Barclay Mowlem (Asia) Limited *(part of Carillion plc)

Macmahon Holdings Limited *

GWI Holdings Pty Ltd (the owner of Australia Southern Railroad Pty Ltd)

Institutions

MLC Investment Limited

Colonial Investment Services Limited *

Northern Territory Government #

Perpetual Investments

Aboriginal corporations

The accompanying notes form part of these financial statements.

149

APT JV Consortium Combined Financial Report

Table of Contents

Asia Pacific Transport Joint Venture Consortium Combined Financial Report

Financial statements for the year ended 30 June 2007

Northern Aboriginal Investment Corporation Pty Limited

Centrecorp Aboriginal Investment Corporation Pty Ltd

* Also participate in Tier 1 Mezzanine debt on the same terms as other Noteholders.

Also participates in Tier 2 Mezzanine debt on the same terms as other Noteholders.

APT entities

All APT entities are controlled by the Equity Investors:

Asia Pacific Transport Joint Venture: contracted by the AustralAsia Railway Corporation to undertake, build, own and operate the Adelaide to Darwin Rail Project.

Asia Pacific Transport Pty Ltd: The nominee agent and trustee of and for the Asia Pacific Transport Joint Venture.

Asia Pacific Transport Finance Pty Ltd: Responsible for arranging debt finance to fund construction and operation of the railway.

Asia Pacific Contracting Pty Ltd: Responsible for the design and construction of the Government Improvements in relation to the Project.

Freight Link Pty Ltd: Responsible for establishing and operating the integrated rail transport business in South Australia and Northern Territory.

As a result of its first few years of operations Freight Link incurred losses greater than its initial capitalisation, but no more than the guaranteed capital subscription (or the amount as increased due to further subscriptions of capital resulting from amounts being called under the bank letters of credit) received by construction completion (Capitalisation Event). The Capitalisation Event occurred on 31 March 2004. The APT JV could not seek to recover any debts due from Freight Link until after the Capitalisation Event, ensuring that Freight Link maintained net assets available to satisfy other creditors.

D&C Contractor

ADrail Joint Venture comprises Brown & Root Construction Pty Ltd, Barclay Mowlem Construction Pty Ltd, John Holland Pty Ltd and Macmahon Contractors Pty Ltd (with varying levels of participation).

An amount of \$10 million (\$7.4m discounted, part of Project Contracts payable per Note 10) is payable by Asia Pacific Transport JV to ADrail Joint Venture for early completion of the Railway. ADrail Joint venture is a related party of the entity. It is conditional on funds being available for distribution as determined by the project finance documents and D & C contract. It is expected to be payable in the period 2010 to 2011 and has been capitalised into the relevant assets at a discounted value.

Other Contracts

With the exception of a number of the principal contracts that were negotiated at the outset of the Project in conjunction with the formation of the bid syndicate or as subsequently amended, all other contracts have been awarded following competitive tender.

Contracts entered into by this entity and related entities with shareholders as executed in 2001 on commercial terms with review and approval from all shareholders and the Senior Banks are as follows:

GWA/ASR, subsidiary of ARG (GWI)

(Rail Operations & Rolling Stock Services)

2007 expense \$19,617,401 2006 expense \$16,034,544, 2005 expense \$18,990,468

Accrued creditor as at 30 June 2007 of \$338,533

BJB (joint venture of KBR, Laing O'Rourke & John Holland)

(Track Maintenance & Capital Expenditure)

2007 expense \$10,212,413, and accrued creditor as at 30 June 2007 of \$1,055,784

2006 expense \$9,707,046, and accrued creditor as at 30 June 2006 of \$853,553

The accompanying notes form part of these financial statements.

150

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

2005 expense \$8,945,380

KBR *services* 2007 expense \$93,049, and accrued creditor as at 30 June 2007 of \$3,480.**Note 18: Segment reporting**

The entity has been contracted by the AustralAsia Railway Corporation to undertake, build, own and operate the Adelaide to Darwin Rail Project. It therefore operates in one business and one (Australia) geographical segment.

Note 19: Cash flow information

| Note | Unaudited June 2007 \$ | June 2006 \$ | Unaudited June 2005 \$ |
|---|------------------------------|-----------------|------------------------------|
| a. Reconciliation of Cash | | | |
| Cash at the end of the financial year as shown in the Statement of Cash Flows is reconciled to the related items in the balance sheet as follows: | | | |
| Cash on hand | 400 | 400 | |
| At call deposits with financial institutions | 20,786,621 | 28,589,538 | 21,912,745 |
| | 20,787,021 | 28,589,938 | 21,912,745 |
| b. Reconciliation of Cash Flow from Operations with Loss after income tax. | | | |
| Loss after income tax | (74,945,668) | (156,139,018) | (53,935,761) |
| Non-cash flows in profit | | | |
| (Profit)/Loss on sale of non-current assets | 817,110 | 1,882 | 7,791 |
| Depreciation and amortization | 18,454,203 | 18,071,565 | 17,202,137 |
| Impairment of fixed assets | | 87,570,180 | 3,052,049 |
| Accrued interest | 41,161,757 | 29,872,657 | 10,841,269 |
| Changes in assets and liabilities, net of the effects of purchase and disposals of subsidiaries: | | | |
| Decrease/(Increase) in receivables | (1,423,110) | (1,427,654) | (3,687,166) |
| Decrease/(Increase) in materials and supplies | 116,743 | 338,272 | (3,687,166) |
| Decrease/(Increase) in prepayments | (2,980,525) | (727,565) | 865,560 |
| (Decrease)/Increase in payables | 4,851,329 | 305,924 | 4,601,873 |
| (Decrease)/Increase in provisions | 68,744 | 127,991 | (88,125) |
| Cash flows from operations | (13,879,417) | (22,005,766) | (21,140,373) |

Note 20: Financial instruments

a. Interest rate risk

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Other than cash at bank and borrowings associated with the finance facilities summarised below, none of the financial assets or liabilities on the statement of financial position are interest bearing.

Exposure to credit, interest rate and currency risks arises in the normal course of the consolidated entity's business. Derivative financial instruments are used to hedge exposure to fluctuations in interest rates.

The accompanying notes form part of these financial statements.

151

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

The entity adopts a policy of ensuring that 100% of its exposure to changes in interest rates on senior debt borrowings is on a fixed rate basis for the period up to June 2011 (except Tranche C June 2009). Interest rate swaps, denominated in Australian dollars, have been entered into to achieve this fixed rate exposure within the entity's policy (refer to table below).

The entity classifies interest rate swaps as cash flow hedges and states them at fair value. The fair value of swaps is recognised at \$6.3m (refer Notes 10 and 12) and consists of five sets of swaps on three tranches of debt (floating for fixed), with notional principals at 30 June 2006 as follows:

| | |
|--|--|
| Senior Debt Tranche C | \$109,020,000 (6.939% plus 1.65% margin, termination date 31 March 2009) |
| Senior Debt Tranche D | \$169,560,395 (7.022% plus 1.65% margin, termination date 31 March 2011) |
| Rolling Stock Debt Tranche E (Hedge 1) | \$36,499,449 (6.222% plus 1.65% margin, termination date 30 June 2011) |
| Rolling Stock Debt Tranche E (Hedge 2) | \$7,305,996 (6.160% plus 1.65% margin, termination date 30 June 2011) |
| Rolling Stock Debt Tranche E (Hedge 3) | \$5,279,444 (6.025% plus 1.65% margin, termination date 30 June 2011) |

Credit risk

The maximum exposure to credit risk, excluding the value of any collateral or other security, at balance date to recognised financial assets is the carrying amount of those assets, net of any provisions for doubtful debts, as disclosed in the statement of financial position and notes to the financial report.

The entity does not have any material credit risk exposure to any single debtor or group of debtors under financial instruments entered into by the entity.

b. Fair values

For all financial assets and liabilities, fair value approximates their carrying value. No financial assets and financial liabilities are readily traded on organised markets in a standardised form other than listed investments.

Forward exchange contracts are either marked to market using listed market prices or by discounting the contractual forward price and deducting the current spot rate. For interest rate swaps broker quotes are used. Those quotes are back tested using pricing models or discounted cash flow techniques.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate is a market related rate for a similar instrument at the balance sheet date. Where other pricing models are used, inputs are based on market related data at the balance sheet date.

The aggregate fair values and carrying amounts of financial assets and financial liabilities are disclosed in the balance sheet and in the notes to the financial statements.

c. Financing arrangements

Facilities for the Project have been contracted through Asia Pacific Transport Finance Pty Ltd (APTF). There is a loan agreement between Asia Pacific Transport Joint Venture (APT JV) and APTF whereby all loans from external parties are on-lent to APT JV on similar terms. The Project is funded by a combination of shareholder contributions (including loan notes), senior debt and mezzanine debt. Senior debt has three tranches for repayment on various terms and is secured by a charge over all the entity's assets under the Security Trust Deed. Interest rate swaps have been transacted by the

The accompanying notes form part of these financial statements.

152

APT JV Consortium Combined Financial Report

Table of Contents**Asia Pacific Transport Joint Venture Consortium Combined Financial Report**

Financial statements for the year ended 30 June 2007

financiers in order to manage interest rate exposures, as noted in 20(a) above. Senior debt has been hedged 100% (refer Note 16 Key principles of Phase 2 for comment on reduction from 100% post balance date) from April 2001 for a period of ten years (except tranche C; 8 years). Thereafter hedging will be on a rolling basis. The financing arrangements were amended on 14 March 2005 with a \$46.2 million facility provided by shareholders in the form of loan notes (Senior OpCo Series 1) Subsequent Events note.

| | Amount (\$ million) | Interest rate % | Profile |
|---------------------------------|------------------------|----------------------------------|---|
| Facilities arranged by APT JV: | | | |
| OpCo Notes (a) | 94.9 | 15.0% | Repayable based on financial performance as per Agreement |
| Senior OpCo Series 1 Notes (a) | 46.2 | 18.0% | Repayable based on financial performance as per Agreement |
| WCN Notes | 14.4 | 18.0% | Repayable based on financial performance as per Agreement |
| Corporation loan (subordinated) | 50.0 | 0 to 5% depends on profitability | Repayable based on financial performance with reference to benchmarks, as per Note 11(i) |
| Facilities arranged by APTF: | | | |
| Senior C Bullet | 109.0 | 8.589(b) | Interest only to March 2009, then bullet payment at March 2009. |
| Senior D Amortising | 185.3 | 8.672(b) | Originally interest only to March 2006, then amortised up to March 2016. Principal payments deferred from December 2006 to December 2008, inclusive. |
| Senior E Rolling stock | 54.9 | 7.830(b) | Originally interest only to March 2006, then amortised up to March 2016. Principal payments deferred from December 2006 to December 2008, inclusive. |
| Tier 1 mezzanine | 78.5 | 14.060(c) | Interest only to March 2012, then amortises up to March 2017, with \$52.1 million bullet payment. Interest capitalises if not paid. |
| Tier 2A mezzanine | 16.4 | 12.00 | Interest free to March 2006, then interest only up to March 2017, then amortises up to March 2024. Interest capitalises if not paid. Rate changes post March 2012 to BBR+ 6%. |
| Tier 2B mezzanine | 10.1 | 12.060 | Interest free to March 2006, then interest only up to March 2017, then amortises up to March 2024. Interest capitalises if not |

paid.

| | | | |
|-----------------|-----|-------|----------------------------|
| Working capital | 2.0 | 8.050 | Available up to March 2016 |
|-----------------|-----|-------|----------------------------|

For amounts drawn down/advanced as at 30 June 2006 and 30 June 2007, refer note 12.

- (a) OpCo notes are related party notes redeemable at the end of the Concession Period (see Note 17). Interest at a rate of 15% only accrues, and is only payable, if there is available cash (as defined in the Agreement) after servicing Senior OpCo notes. Senior OpCo Series 1 notes are interest bearing (18% coupon), also redeemable at the end of the Concession Period. Interest is payable quarterly. Senior OpCo Series 2 notes have the same terms as Senior OpCo Series 1 notes and are issued in lieu of interest on the latter in the event that available cash (as defined in the Agreement) is not sufficient to meet the quarterly interest

payments due.

- (b) Includes 1.65% swap margin as referred to in note 20(a).
- (c) Includes 5.5% margin as per Mezzanine Agreements. A 2% penalty rate also applies in Event of Default.

Covenants

Senior debt is subject to certain covenants. Compliance with certain covenants (including debt service coverage ratio, debt service reserve and capital expenditure reserve bank account minimum balances and hedging requirements) have been waived over the duration of the standstill period as described in Note 16.

The accompanying notes form part of these financial statements.

153

APT JV Consortium Combined Financial Report

Table of Contents

Asia Pacific Transport Joint Venture Consortium Combined Financial Report

Financial statements for the year ended 30 June 2007

Debt service coverage ratios required under the Mezzanine agreements have been in breach since January 2005, and 2% penalty interest on Tier 1 has been accrued since then. There is no other impact of the Mezzanine breaches on either of the Mezzanine debt tiers.

Note 21: Entity details

The registered office and principal place of business of the entity is:

1 Station Place, Hindmarsh, South Australia 5000

Note 22: Prior Year Changes in Accounting Policies

Fair value loans

In the 2006 financial year the entity adopted AASB 132 Financial Instruments: Presentation and Disclosure and AASB 139 Financial Instruments: Recognition and Measurement. This change in accounting policy has been adopted in accordance with the transition rules contained in AASB 1 which does not require the restatement of comparative information for financial instruments within the scope of AASB 132 and AASB 139.

Corporation Loan

In accordance with AASB 139, all loans at below-market rates are required to be measured at their fair value (i.e. the present value of future cash flows discounted at a market interest rate). Any difference between the fair value of the loan on initial recognition and the amount received should be accounted for according to its nature.

The entity has recorded its \$50m nominal (government) loan at its present value of \$973,049 discounted from 2054 at a rate of 8.6%, the weighted average cost of senior debt. The difference between the \$973,049 present value and the \$50m face value has been accounted for as a deferred government grant under AASB 120 Accounting for Government Grants and Disclosure of Government assistance (refer Notes 11 and 12).

OpCo Notes

The OpCo Notes were issued pursuant to the Equity Subscription Deed to equity holders of the consortium in May 2003, with further issuances in December 2003, April 2004, July 2004 and 2005. The notes have a stated interest rate of 15%, however interest only accrues, and is only payable, in the event of free cash (as defined in the Equity Subscription Deed). In accordance with AASB 132 and AASB 139, the OpCo Notes are a financial liability and interest must be charged to the income statement (at a rate of 15%). The Consortium has not generated free cash at any period through 30 June 2006.

Accordingly, as the OpCo Note interest is not payable by the entity, the offsetting entry for the interest charge is recognised as a contribution to equity. As a result of this change in accounting policy, the entity recorded a charge to Retained Earnings/Accumulated Deficit and increase in Other Contributed Equity of \$21.7m at 1 July 2005. For the year ended 30 June 2006, an interest charge of \$14.2m was recorded (as shown in Note 3) with a corresponding increase in Other Contributed Equity (refer Note 13).

The accompanying notes form part of these financial statements.

154

APT JV Consortium Combined Financial Report

Table of Contents**Note 23: Significant Accounting Policy Differences between AIFRS and U.S. GAAP**

In Australia, financial statements are required to be prepared in accordance with Australian Accounting Standards, adopted by the Australian Accounting Standards Board (AASB) (Australian GAAP) .

With effect for periods ending after 1 January 2005 International Financial Reporting Standards (IFRS) form the basis of Australian Accounting Standards (AASBs) adopted by the AASB and for the purpose of this report are called Australian equivalents to IFRS (AIFRS) to distinguish from previous Australian GAAP. During the transition to AIFRS, the consolidated entity elected not to restate the 2005 comparatives for AASB 139: *Financial instruments: Recognition and Measurement* and AASB 132: *Financial Instruments: Presentation*. This is explained in note 22. The financial statements of the Consortium for the years ended 30 June 2007, 2006, and 2005 comply with IFRSs and interpretations adopted by the International Accounting Standards Board.

AIFRS differs in certain material respects from US GAAP. A description of material differences between AIFRS and US GAAP applicable to the Consortium as of, and for the years ended 30 June 2007 and 2006 and 2005 is set out below:

(A) Debt Issuance Costs

Under AIFRS, debt issuance costs are included in the initial recognition of the debt liability, and are subsequently amortised to interest expense under the effective interest method. Under US GAAP, debt issuance costs are capitalized as a deferred cost, with subsequent amortization included in interest expense under the effective interest method. Accordingly, a difference between AIFRS and US GAAP arises in the balance sheet presentation. There is no income statement difference between AIFRS and US GAAP as interest expense amortization is determined in the same manner.

(B) Impairment of long-lived assets

Under AIFRS, the entity determines the recoverable amount of long-lived assets based upon the higher of its fair value less costs to sell and its value in use, the latter is generally determined on a discounted cash flow basis when assessing impairment. The discount rate is a pre-tax risk-adjusted market rate, which is applied both to assess recoverability and to calculate the amount of any impairment charge. Under US GAAP, long-lived assets are first tested for recoverability for impairment using undiscounted cash flows. Only if the long-lived asset's carrying amount exceeds the sum of undiscounted future cash flows is the asset considered impaired and written down to its fair value.

Accordingly, a difference between AIFRS and US GAAP may arise where the recoverability test under US GAAP does not result in an impairment although an impairment charge is recorded for AIFRS. The difference may result in lower impairment charges against income and higher asset carrying amounts for US GAAP; the difference in asset carrying amounts is subsequently reduced through higher depreciation charges against income.

Under AIFRS, impairment losses, except for goodwill, may be reversed in subsequent periods if the recoverable amount increases. Under US GAAP, impairment reversals are not allowed, as the impairment loss results in a new cost basis for the asset. Any credit to income resulting from reversal in impairment charges under AIFRS is derecognized under US GAAP. As stated in Note 3, the Consortium recognised an impairment charge in 2006. As a result of the US GAAP requirement for a recoverability test based on undiscounted cash flows, no US GAAP impairment charge would have been incurred in 2006.

The accompanying notes form part of these financial statements.

155

APT JV Consortium Combined Financial Report

Table of Contents***(C) Capitalized interest***

Under AIFRS, an entity may choose to capitalize or expense interest costs that are directly attributable to the acquisition, construction or production of a qualifying asset under AIFRS. Capitalization of interest costs (including the amortisation of discounts, premiums and issue costs on debt, if applicable) related to qualifying assets is required under US GAAP.

Where an entity chooses to capitalize interest costs under AIFRS, any interest earned on temporary investment of funds borrowed to finance the asset's construction is netted against interest cost in determining the capitalized interest. US GAAP generally does not allow interest income to be netted in determining the amount of interest cost to be capitalized.

The entity has elected to capitalize interest costs (including amortisation of debt issuance costs) incurred during the construction period and has netted interest income against interest expense in arriving at the capitalized value.

(D) Derivatives

The Consortium uses derivative financial instruments to hedge its exposure to movements in interest rates.

As explained above, the Consortium elected not to early adopt AASB 132 and AASB 139 for the 2005 comparative financial statements. Accordingly, in the 2005 comparative period, under previous Australian GAAP, derivatives outstanding at the balance sheet date were not recognised. Gains and losses on interest rate swaps were recognised as part of interest expense when settled (quarterly).

On 1 July 2005 the Consortium adopted AASB 139. This resulted in the consolidated entity recognising all derivative financial instruments as assets or liabilities at fair value. In addition, if the instrument is designated as a hedge of the variability in cash flows of a highly probable forecasted transaction, the effective part of any gain or loss on the derivative financial instrument is recognised directly in equity (hedge reserve) provided certain documentation and other criteria are met as required by the detailed AIFRS transition rules. Such rules required hedge documentation to be in place by 1 July 2005 for all previous hedge relationships and in place at inception of the hedge relationship for all subsequent hedges.

Under US GAAP all derivative financial instruments are recognised as assets or liabilities at fair value. The accounting for changes in the fair value of a derivative (that is gains and losses) depends on the intended use of the derivative and the resulting designation. The Consortium did not formally designate hedging relationships under US GAAP. Accordingly, in the 2005 comparative period, derivative financial instruments would have been measured at fair value under US GAAP with no derivatives qualifying for hedge accounting.

Certain instruments the Consortium designated as hedges under AIFRS would not have qualified for hedge accounting under US GAAP and, accordingly changes in fair value would have been recognised in the income statement rather than in equity (hedge reserve). The impact is to reduce net income. There is no impact on net equity.

(E) Start up costs

Under AIFRS the Consortium capitalizes as part of property, plant and equipment, costs associated with start-up activities relating to the Project which were incurred prior to commissioning date. These capitalized costs are depreciated in subsequent years. Under US GAAP, costs of start-up activities are expensed as incurred.

The accompanying notes form part of these financial statements.

156

APT JV Consortium Combined Financial Report

Table of Contents***(F) Income tax***

Under AIFRS the Consortium has not recognised deferred tax assets in relation to deductible temporary differences or potentially available income tax credits or capital loss carry forwards.

Under AIFRS deferred tax is calculated using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their respective tax basis. A deferred tax asset is recognized only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised.

Under U.S. GAAP, deferred tax assets and liabilities are recognised for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets are reduced by a valuation allowance if, in the opinion of management, it is more likely than not that some portion, or all of the deferred tax asset, will not be realised.

The Consortium has reported a cumulative net tax loss in recent years. Based on this significant negative evidence, under US GAAP the consolidated entity would recognise a full valuation allowance against its deferred tax assets. This will however have no impact on net deferred tax assets, income or net equity reported in the financial statements.

(H) Non-interest bearing loan

The AustralAsia Railway Corporation provided the Consortium with a Corporate loan (subordinated) of \$50 million in 2001 (refer note 22). Repayment of this loan is to occur at the end of the Concession period in 2054. Interest only accrues, and is only payable, if certain EBITDA targets are met. As described in Note 11, the likelihood of achieving these targets is remote, and therefore the loan is considered non-interest bearing.

As at 1 July 2005 the non-interest bearing loan from the AustralAsia Railway Corporation was recognised initially at fair value and subsequently stated at amortised cost with any difference between the amortised cost and repayment value being recognised in the income statement over the period of the borrowings on an effective interest rate basis.

Under US GAAP the entity recognises the financial liability at its original face value (\$50 million) and does not unwind the discount expense over the period of the borrowings.

(I) Recent Changes to US GAAP

In June 2006, FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48) was issued. FIN 48 states that the evaluation of a tax position in accordance with this Interpretation is a two-step process. The first step is recognition: The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. The Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for periods ending after December 15 2006. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption, with the cumulative effect adjustment reported as an adjustment to the opening balance of retained

The accompanying notes form part of these financial statements.

157

APT JV Consortium Combined Financial Report

Table of Contents

earnings. The adoption of FIN 48 has not resulted in any material impact on the Consortium as it relates to its financial position and results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. The statement applies whenever other statements require or permit assets or liabilities to be measured at fair value. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. 157-2 that provides for a one-year deferral for the implementation of SFAS 157 for non-financial assets and liabilities. SFAS 157 does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. Accordingly, the adoption of this Statement is not expected to have a material impact on the Consortium's financial position, results of operations and cash flows.

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 provides companies with an option to measure certain financial instruments and other items at fair value with changes in fair value reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. Most of the provisions of SFAS 159 apply only to entities that elect the fair value option. However, the amendment to FASB Statement No. 115,

Accounting for Certain Investments in Debt and Equity Securities , applies to all entities with available-for-sale and trading securities. Currently, the adoption of this Statement is not expected to have a material impact on the Consortium's financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations, (SFAS 141(R)), which replaces FASB Statement No. 141. SFAS 141(R), establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. This Statement also established disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008, early adoption is prohibited. Currently this statement is not expected to have a significant impact on the Consortium's financial position, results of operations and cash flows. A significant impact may however be realized on any future acquisitions by the Consortium. The amounts of such impact cannot be currently determined and will depend on the nature and terms of such future acquisitions, if any.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statement-amendments of ARB No. 51, (SFAS 160). SFAS 160 states that accounting and reporting for minority interests will be recharacterized as noncontrolling interests and classified as a component of equity. The Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective for fiscal years beginning after December 15, 2008, early adoption is prohibited. We are currently evaluating the impact the adoption of SFAS 160 will have on the Consortium's financial position, results of operations and cash flows.

The accompanying notes form part of these financial statements.

158

APT JV Consortium Combined Financial Report

Table of Contents

SIGNATURES

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

Dated: February 26, 2008

KBR, INC.

By: /s/ WILLIAM P. UTT
William P. Utt
President and Chief Executive Officer

Dated: February 26, 2008

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

| Signature | Title |
|---|--|
| /s/ WILLIAM P. UTT William P. Utt | President, Chief Executive Officer and Director (Principal Executive Officer) |
| /s/ CEDRIC W. BURGHER Cedric W. Burgher | Senior Vice President and Chief Financial Officer (Principal Financial Officer) |
| /s/ JOHN W. GANN, JR. John W. Gann, Jr. | Vice President and Chief Accounting Officer (Principal Accounting Officer) |
| /s/ W. FRANK BLOUNT W. Frank Blount. | Director |
| /s/ LOREN K. CARROLL Loren K. Carroll | Director |
| /s/ JEFFREY E. CURTISS Jeffrey E. Curtiss | Director |
| /s/ JOHN R. HUFF John R. Huff | Director |
| /s/ LESTER L. LYLES Lester L. Lyles | Director |

Lester L. Lyles

/s/ RICHARD J. SLATER

Director

Richard J. Slater

159

Table of Contents**EXHIBIT INDEX**

| Exhibit Number | Description |
|-------------------|--|
| 2.1 | Agreement relating to the sale and purchase of the entire issued share capital of Devonport Management Limited by and among KBR, Inc., Kellogg Brown & Root Holdings (U.K.) Limited, Balfour Beatty plc, The Weir Group plc, and Babcock International Group plc, dated May 10, 2007 (incorporated by reference to Exhibit 10.7 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-3492) |
| 3.1 | KBR Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 3.2 | Amended and Restated Bylaws of KBR, Inc. (incorporated by reference to Exhibit 3.1 to KBR's Form 10-Q for the period ended June 30, 2007; File No. 1-33146) |
| 4.1 | Form of specimen KBR common stock certificate (incorporated by reference to Exhibit 4.1 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.1 | Master Separation Agreement between Halliburton Company and KBR, Inc. dated as of November 20, 2006 (incorporated by reference to Exhibit 10.1 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.2 | Tax Sharing Agreement, dated as of January 1, 2006, by and between Halliburton Company, KBR Holdings, LLC and KBR, Inc., as amended effective February 26, 2007 (incorporated by reference to Exhibit 10.2 to KBR's Annual Report on Form 10-K for the year ended December 31, 2006; File No. 001-33146) |
| 10.3 | Amended and Restated Registration Rights Agreement, dated as of February 26, 2007, between Halliburton Company and KBR, Inc. (incorporated by reference to Exhibit 10.3 to KBR's Annual Report on Form 10-K for the year ended December 31, 2006; File No. 001-33146) |
| 10.4 | Transition Services Agreement dated as of November 20, 2006, by and between Halliburton Energy Services, Inc. and KBR, Inc. (KBR as service provider) (incorporated by reference to Exhibit 10.4 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.5 | Transition Services Agreement dated as of November 20, 2006, by and between Halliburton Energy Services, Inc. and KBR, Inc. (Halliburton as service provider) (incorporated by reference to Exhibit 10.5 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.6 | Employee Matters Agreement dated as of November 20, 2006, by and between Halliburton Company and KBR, Inc. (incorporated by reference to Exhibit 10.6 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.7 | Intellectual Property Matters Agreement dated as of November 20, 2006, by and between Halliburton Company and KBR, Inc. (incorporated by reference to Exhibit 10.7 to KBR's current report on Form 8-K dated November 20, 2006; File No. 001-33146) |
| 10.8 | |

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Five Year Revolving Credit Agreement, dated as of December 16, 2005, among KBR Holdings, LLC, a Delaware limited liability company, as Borrower, the Banks and the Issuing Banks party thereto, Citibank, N.A. (Citibank), as Paying Agent, and Citibank and HSBC Bank USA, National Association, as Co-Administrative Agents (Incorporated by reference to Exhibit 10.30 to Halliburton Company's Annual Report on Form 10-K for the year ended December 31, 2005; File No. 001-03492)

- 10.9 Amendment No. 1 to the Five Year Revolving Credit Agreement, dated as of April 13, 2006, among KBR Holdings, LLC, a Delaware limited liability company, as Borrower, the Banks and Institutional Banks parties to the Five Year Revolving Credit Agreement, and Citibank, N.A., as paying agent (incorporated by reference to Exhibit 10.9 to KBR's registration statement on Form S-1; Registration No. 333-133302)
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Table of Contents

| Exhibit Number | Description |
|-------------------|---|
| 10.10 | Amendment No. 2 to the Five Year Revolving Credit Agreement, dated as of October 31, 2006, among KBR Holdings, LLC, a Delaware limited liability company, as Borrower, the Banks and Institutional Banks parties to the Five Year Revolving Credit Agreement, and Citibank, N.A., as paying agent (incorporated by reference to Exhibit 10.24 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.11 | Amendment No. 3 to the Five Year Revolving Credit Agreement, dated as of January 11, 2008, among KBR Holdings, LLC, a Delaware limited liability company, as Borrower, the Banks and Institutional Banks parties to the Five Year Revolving Credit Agreement, and Citibank, N.A., as paying agent (incorporated by reference to Exhibit 10.1 to KBR's current report on Form 8-K dated January 17, 2008; File No. 1-33146) |
| 10.12+ | Employment Agreement, dated as of April 3, 2006, between William P. Utt and KBR Technical Services, Inc. (incorporated by reference to Exhibit 10.15 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.13+ | Employment Agreement, dated as of November 7, 2005, between Cedric W. Burgher and KBR Technical Services, Inc. (incorporated by reference to Exhibit 10.16 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.14+ | Employment Agreement, dated as of August 1, 2004, between Bruce A. Stanski and KBR Technical Services, Inc. (incorporated by reference to Exhibit 10.17 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.15 | Form of Indemnification Agreement between KBR, Inc. and its directors (incorporated by reference to Exhibit 10.18 to KBR's registration statement on Form S-1; Registration No. 333-133302) |
| 10.16+ | KBR, Inc. 2006 Stock and Incentive Plan (as amended June 27, 2007) (incorporated by reference to Exhibit 10.1 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146) |
| 10.17+ | KBR, Inc. Senior Executive Performance Pay Plan (incorporated by reference to Exhibit 10.21 to KBR's Form 10-K for the fiscal year ended December 31, 2006; File No. 1-33146) |
| 10.18+ | KBR, Inc. Management Performance Pay Plan (incorporated by reference to Exhibit 10.22 to KBR's Form 10-K for the fiscal year ended December 31, 2006; File No. 1-33146) |
| 10.19+ | KBR, Inc. Transitional Stock Adjustment Plan (incorporated by reference to Exhibit 10.23 to KBR's Form 10-K for the fiscal year ended December 31, 2006; File No. 1-33146) |
| 10.20+ | KBR Dresser Deferred Compensation Plan (incorporated by reference to Exhibit 4.5 to KBR's Registration Statement on Form S-8 filed on April 13, 2007) |
| 10.21+ | KBR Supplemental Executive Retirement Plan (incorporated by reference to Exhibit 10.3 to KBR's current report on Form 8-K dated April 9, 2007; File No. 1-33146). |

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- 10.22+ KBR Benefit Restoration Plan (incorporated by reference to Exhibit 10.4 to KBR's current report on Form 8-K dated April 9, 2007; File No. 1-33146).
 - 10.23+ KBR Elective Deferral Plan (incorporated by reference to Exhibit 10.5 to KBR's current report on Form 8-K dated April 9, 2007; File No. 1-33146).
 - 10.24+ Restricted Stock Unit Agreement pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.2 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146)
 - 10.25+ Stock Option Agreement pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.3 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146)
 - 10.26+ KBR Restricted Stock Agreement pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.4 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146)
 - 10.27+ KBR, Inc. Transitional Stock Adjustment Plan Stock Option Award (incorporated by reference to Exhibit 10.5 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146)
 - 10.28+ KBR, Inc. Transitional Stock Adjustment Plan Restricted Stock Award (incorporated by reference to Exhibit 10.6 to KBR's Form 10-Q for the quarter ended June 30, 2007; File No. 1-33146)
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Table of Contents

| Exhibit Number | Description |
|--|---|
| 10.29+ | Form of Restricted Stock Agreement between KBR, Inc. and William P. Utt pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.1 to KBR's Form 10-Q for the quarter ended September 30, 2007; File No. 1-33146) |
| 10.30+ | Form of KBR Performance Award Agreement pursuant to KBR, Inc. 2006 Stock and Incentive Plan (incorporated by reference to Exhibit 10.5 to KBR's Form 10-Q for the quarter ended September 30, 2007; File No. 1-33146) |
| 21.1 | List of subsidiaries |
| 23.1 | Consent of KPMG LLP - Houston, Texas |
| 23.2 | Consent of KPMG - Adelaide, South Australia |
| 31.1 | Certification by Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a). |
| 31.2 | Certification by Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a). |
| 32.1 | Certification Furnished Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification Furnished Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| + Management contracts or compensatory plans or arrangements | |