



Laser D Document Print Summary

Accounting:	Disabled
Date Printed:	04/08/98
Time Printed:	10:11 A.M.
Subject Name:	COMBUSTION ENGINEERING INC
Exchange:	N
Ticker Symbol:	CSP
Subject #:	C504000000
Document Type:	ARS
Document Date:	12/31/88
Amendment:	N/A
Document #:	00521069
Printed:	Document
Pages Printed:	51

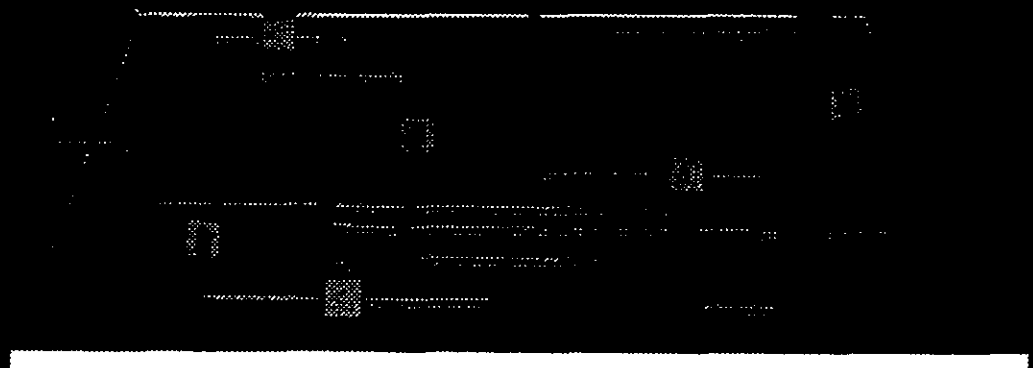
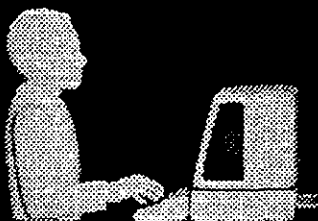
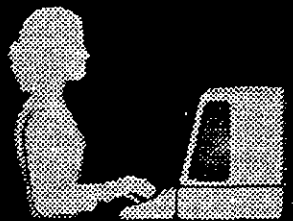
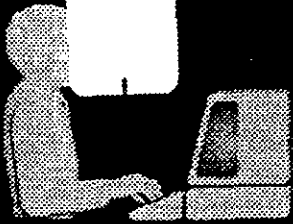
COMBUSTION ENGINEERING

Expert Solutions. Today.

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Combustion Engineering is a leading provider of engineered products, systems and services to the worldwide power, process and public sector markets.

The cover illustrates C-E's concept for helping clients link management and communications systems with automation products to create a framework for multiple levels of information exchange. Internally, C-E is following a similar approach. By merging information networks, management and control systems and engineering automation software, the Company is strengthening its traditional capabilities and creating new ones.

As a result, Combustion Engineering can create value for its clients that no other company can duplicate.

Financial Highlights

(Dollars in thousands, except per share amounts)	1988	1987	1986
Net sales	\$3,483,928	\$3,042,074	\$2,551,469
Income (loss) from continuing operations (2)	(\$ 245,173)	\$ 56,560	\$ 56,329
Per share (1)	(\$ 6.40)	\$ 1.54	\$ 1.69
Net income (loss) (2)	(\$ 245,173)	\$ 56,560	\$ 50,866
Per share (1)	(\$ 6.40)	\$ 1.54	\$ 1.53
Dividends declared	\$ 38,409	\$ 37,996	\$ 33,264
Per share	\$ 1.00	\$ 1.00	\$ 1.00
Backlog	\$3,704,502	\$3,620,517	\$2,766,512

(1) Based on an average number of common shares outstanding of approximately 38.3 million in 1988, 36.6 million in 1987 and 33.2 million in 1986.

(2) Includes third and fourth quarter 1988 pretax provisions of approximately \$272,800 for adjustments to contracts and restructuring (refer to Note 6 of Notes to Consolidated Financial Statements).

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To Our Shareholders



Charles E. Hugel,
Chairman and
Chief Executive
Officer

George S. Kimmel,
President and
Chief Operating
Officer

The past year has been one of marked contrasts. Much of the Company performed well. This good performance was overshadowed, however, by substantial losses on certain contracts, principally those involving new waste-to-energy and power plant technologies.

These losses are of such magnitude that their underlying causes should be clearly understood. By the mid-1980s, new electrical generating capacity in the United States was being added not by electric utilities using traditional coal-fired boilers, but by cogenerators, independent power producers and municipalities burning trash.

These new power generators required technologies to burn more difficult fuels and meet more stringent environmental requirements. In response to this changing market, we licensed and developed several new technologies. Among these were circulating fluid bed systems to burn low-grade fuels cleanly, and a process that converts municipal garbage to fuel for burning in our conventional industrial boilers. Most of the losses on these contracts represent costs associated with development, introduction and commercialization of such technologies, all of which have taken longer and been far more costly than originally anticipated.

We now have five of the fluid bed power plants in operation and performing well. On our first resource recovery plant, we have worked our way through initial operating problems and have processed and burned some 400,000 tons of trash. A second plant is expected to begin commercial operation later this year.

1988 Results

Primarily as a result of providing for losses on certain contracts and restructuring costs and the resulting absence of tax benefits, the Company had a net loss of \$245.2 million or \$6.40 per share, versus a profit of \$56.8 million or \$1.54 per share in 1987. Sales in 1988 were \$3.5 billion, compared with \$3.0 billion in 1987.

Both the Power Generation and Public Sector and Environmental segments operated at losses, largely due to the provisions for increased contract costs. Power Generation results were also reduced from 1987 by a significantly lower level of long-term contract closeouts.

The services business for existing fossil and industrial power plants continued to turn in a strong performance. In addition, sales of control and automation products to the power generation industry doubled.

Operating income in the Process Industries segment increased as a result of strong product positions, higher worldwide demand and improved operating efficiencies. Sales of the Taylor™ Mod 300 distributed control system, introduced in 1985, nearly doubled last year, while orders for AccuRay measurement and actuator systems increased by 34 percent over 1987. The control and automation products business reported an improvement in operating results of \$29 million.

Other Process Industry businesses also performed well. Process engineering bookings in 1988 were some 80 percent higher than in 1987, and the backlog in this business now stands at approximately \$570 million. Operating profits in our industrial mineral businesses increased by more than 30 percent.

Strategic Actions

C-E's operations compete in global business environments. In 1988, international sales were up by more than one-third and now account for 40 percent of the Company's total revenues. In the past twelve months, we have taken several steps that should further improve our ability to compete effectively in global markets.

In January of this year, C-E and Alstom S.A. of Paris announced a proposal to form a joint venture combining both companies' businesses supplying fossil boilers and related maintenance parts to electric utilities and industrial users worldwide. We expect the partners to own approximately equal shares in the new venture.

Alstom has been a licensee of C-E's steam generating technology for 40 years. By combining our respective strengths in technology, manufacturing and marketing, we will be able to better serve fossil boiler clients in the European Economic Community, North America and other important world markets.

We are making good progress on our initiatives within the Soviet Union. Our process control joint enterprise there is already providing systems and services for the modernization of refineries at Moscow and Omsk and for the Nijnekamsk ethylene facility. The feasibility study for the development of two petrochemical complexes in Western Siberia has been accepted by the Soviet Oil Ministry, and a western consortium led by C-E expects to begin initial work on the projects soon.

In the past three years, we've built a substantial business providing control and automation products to the power generation industry. This power automation business is performing well, has excellent long-term prospects, and we are continuing to expand our capability. In November 1988, C-E completed the acquisition of Systems Control Inc.'s Energy Systems Group, a leading worldwide supplier of systems that help electric power producers improve power generation efficiency and coordinate distribution. Power automation sales are expected to approach \$100 million in 1989.

We also have exited businesses that do not fit our strategy or serve our principal end-use markets. In the third quarter of 1988, we sold Jamesbury, a high-performance valve manufacturer, for \$136 million, realizing a pretax gain of \$36.8 million. We expect to complete soon the sale of our Tyler and Refractories industrial products businesses and our remaining oil and gas services operations for about \$125 million, which is approximately book value.

Outlook

We expect Combustion Engineering to return to profitability this year. Operating rates in the process industries are continuing at high levels. Power services and environmental markets remain strong, and the outlook for power systems is beginning to improve. We have excellent product positions in all of our major businesses. We have completed a realignment of our operations and are continuing to integrate C-E's product offerings and improve operating effectiveness.

The Process Industries segment should be the largest contributor to operating income this year. The Power Generation segment is expected to return to profitability — though not at the record levels of 1986 and 1987, since there will be significantly fewer closeouts of long-term contracts. The Public Sector and Environmental segment should improve as waste-to-energy losses are eliminated.

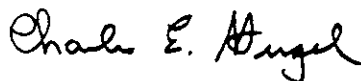
Financial Performance

Last year's financial performance was unsatisfactory, and we certainly share your disappointment in these results. We remain committed to providing returns on capital sufficient to properly reward your support of the Company and to permit reinvestment in the business.

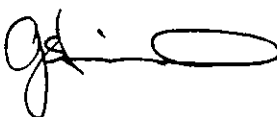
Despite our 1988 financial results, Combustion Engineering has entered 1989 with many strengths. The completion of the joint venture with Alsthom will add significantly to our established position as one of the leading suppliers of power boilers and related maintenance parts throughout the world — at a time when global demand for new equipment is expected to increase. In addition, Combustion Engineering will continue to build on its strong capabilities to improve the operating performance of its clients in the process and power industries.

Our commitment to our clients is to be the best value producer — offering products and services that optimize quality, cost and "functionality." We are achieving this in

three principal ways. First, we are acquiring, developing and retaining the very best people. Second, as our cover illustration suggests, we are making effective use of information technology to create advantages for C-E in the marketplace. Third, we are making sure that we understand our clients' changing requirements and are continuing to acquire and develop relevant technologies to meet those needs. We believe this operating approach will serve our shareholders, clients and employees well.



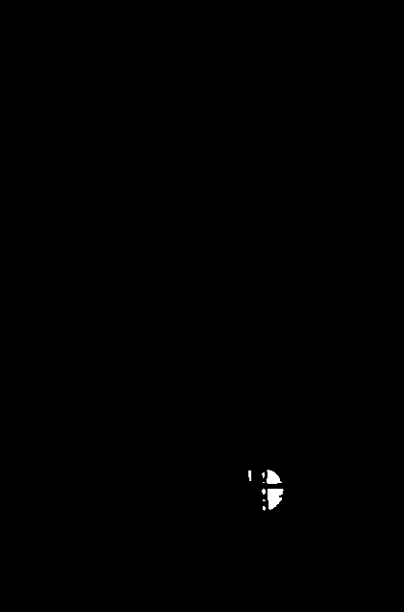
Charles E. Hugel
Chairman and Chief Executive Officer



George S. Kimmel
President and Chief Operating Officer

February 17, 1989

Business Segments



Power Generation

Dollars in Millions	1988	1987	1986
Net Sales	\$1,663.8	\$1,498.0	\$1,273.8
Operating Income (Loss)	(\$ 89.9)	\$ 179.3	\$ 149.9
Backlog	\$1,951.2	\$2,161.1	\$1,537.4

Principal Markets:

Electric utilities
Independent power projects
Process and other industries

Principal Services, Products and Equipment:

Engineering and management services
 Maintenance and spare parts
 Construction and project management
 Power plant control systems and operating software
 Fossil steam systems
 Nuclear steam systems, fuel and services
 Complete power generation plants
 Fluid bed combustors
 Power plant emission control equipment
 Heat recovery equipment and services
 Work and maintenance management software



Process Industries

Dollars in Millions	1988	1987	1986
Net Sales	\$1,546.5	\$1,283.2	\$1,079.9
Operating Income	\$ 55.1	\$ 48.1	\$ 8.8
Backlog	\$ 976.1	\$ 624.0	\$ 452.4

Principal Markets:

Pulp and paper
Refining, petrochemical, chemical and pharmaceutical
Food and beverage
Primary metals
Minerals and mining
Textiles

Principal Services, Products and Equipment:

Measurement and control systems and services
 Operating software and management services
 Instrumentation and valves
 Engineering, construction and project management services
 Petrochemical and refinery technology
 Pulping equipment
 Specialty minerals and refractories
 Screening, grinding and milling equipment
 Engineering design and information management software



Public Sector and Environmental

Dollars in Millions	1988	1987	1986
Net Sales	\$273.6	\$ 260.8	\$ 197.8
Operating Income (Loss)	(\$113.6)	(\$ 18.8)	\$ 4.1
Backlog	\$777.2	\$ 835.5	\$ 776.7

Principal Markets:

Municipalities
Government agencies
Process and power industries

Principal Services, Products and Equipment:

Municipal waste-to-energy systems
 Hazardous waste site cleanup
 Environmental consulting, assessment and monitoring
 Hazardous waste systems
 Operation, maintenance and training services
 Mass transit engineering and construction services

As utilities seek to increase plant efficiencies, control systems and performance software represent a growing opportunity. C-E's sales of these services doubled in 1988, and order rates continued to be strong.

The power generation market for C-E consists principally of two businesses: services to maintain or improve the performance or extend the life of existing plants and supply of new steam generator systems. Services to C-E's utility and industrial clients now include engineering, management and construction services, control systems and software, and maintenance parts. In recent years, the market for new boilers has broadened to include independent power generators as well as traditional domestic and international electric utilities.

Power Services

New products and services for utility and industrial plant modernization were important factors in our 1988 fossil services performance. For example, in an \$11 million contract, Gulf Power Company ordered C-E's new generation of pulverizers to replace those of a competitor at its Crist Electric Generating Plant in Florida. At a James River paper mill, C-E's new proprietary chromizing process was used in the redesign of a furnace bottom with enhanced corrosion resistance. After early completion of the initial contract, C-E was awarded an \$11 million contract to upgrade the entire boiler (see photo, page 8). In another major services award, from Electric Energy Inc., C-E is removing and upgrading the boiler insulation on five units in Illinois.

As utilities seek to increase plant efficiencies, control systems and performance software represent a growing opportunity (see photo, page 10). C-E's sales of these services doubled in 1988, and order rates continued to be strong. Shanghai United Electric, for example, ordered a \$7.5 million integrated control system for a power plant in the People's Republic of China. The system incorporates an OTIS™ (On-Line Thermal Information System) package and a C-E fuel supervisory safety system that provides automatic burner control. With the acquisition of Systems Control's Energy Systems Group in November 1988, C-E's offering for this market now includes energy management

systems that optimize electrical generation within a power plant to meet demand from the grid and supervisory control and data acquisition systems that balance electrical demand with power generation supply.

C-E also introduced an advanced control system (Nuplex 80+™) for nuclear power plants, and Impell provided engineering services for a plant computer replacement at a Philadelphia Electric unit. A 1987 contract exceeding \$200 million for two nuclear units in Korea is proceeding on schedule, and the Korean electric utility has made C-E's System 80™ technology the standard for future nuclear units. Other major nuclear awards in 1988 include a \$23 million contract extension from Baltimore Gas & Electric for reload fuel and two awards under a Department of Energy program to develop a gas-cooled nuclear reactor for electrical generation.

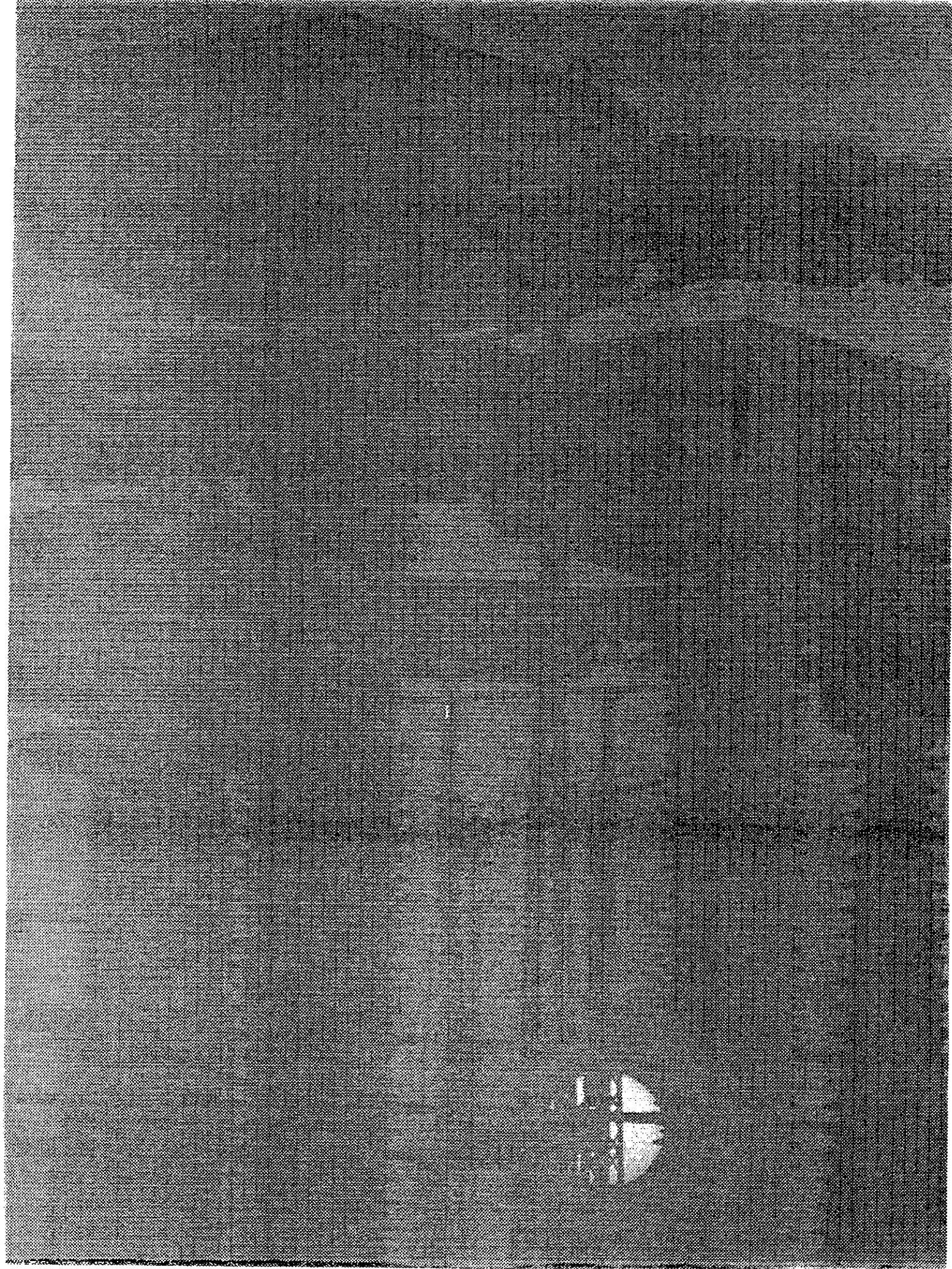
Fossil Systems

C-E is continuing to develop processes that reduce emissions from coal-fired power plants. These technologies include equipment that can be retrofitted to existing facilities, such as low nitrogen oxide burners and systems that inject sulfur dioxide-absorbing compounds into the boiler. They also include "repowering" technologies, such as waste heat recovery boilers that boost generating capacity.

Combustion Engineering is a leader in circulating fluid bed combustion (FBC) systems, another important clean coal technology. Texas-New Mexico Power Company, for example, contracted with C-E for its second 150 megawatt (MW) FBC unit (see photo, page 11).

Pulp and paper producers were also major clients as they expanded capacity and modernized their plants. C-E received two large orders for chemical recovery units and related equipment and services with a total value of \$64 million.

Outside the United States, a consortium of C-E Canada, Inc. and Marubeni Corporation of Japan received an \$82 million award to build two 300 MW lignite-fired steam generators for the Mae Moh Station in northeastern Thailand — the seventh and eighth units supplied by the consortium since 1980.





Paper production at James River Corp.'s Camas, Washington mill was threatened when a recovery boiler (originally supplied by a competitor) was shut down due to internal tube wall cracks. Using 3-D computer drafting, Hank Arenstam (right) and Len Bergeron evaluated structural options and created a solution based on relocating major components to speed rebuilding of the facility. C-E earned a performance bonus for completing the repairs ahead of schedule and has been awarded a second contract to redesign and upgrade the balance of the recovery unit.



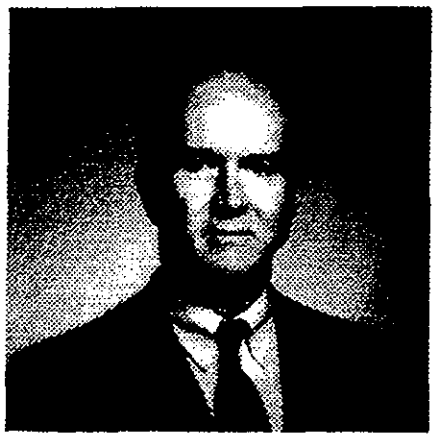
Ray A. Fortney
Power Services Businesses

Maintenance services, spare parts and a wide range of systems and services to improve power plant performance comprise C-E's largest business. Revenues in 1989 are expected to total nearly \$1 billion—double the amount of just five years ago. The quality and responsiveness of our services are also critical to our continued leadership in the market for new equipment.

The primary success factor in this business is maintaining a quality-driven, full-service point of view. Stay close to the client; anticipate his needs; provide total satisfaction. In keeping with this practice, more than half of our fossil services personnel are field technicians who work on-site daily with power plant operators. And, this year, our senior managers will spend at least one-third of their time directly meeting and working with clients.

New products and services also are helping to insure good performance. Future development priorities include emission control technologies and services to burn coal more cleanly, software to improve performance and extend plant life, materials control services for improved operation, and broader support for federal nuclear programs.

One further key to our continued success is the ability to package solutions to meet client needs. On a recent chemical recovery rebuild proposal, for example, we combined our environmental assessment skills, control systems, emissions technologies and in-house construction and maintenance parts services. We are increasingly able to combine such capabilities with teamwork and innovation to create value for our clients that no other company can duplicate.



Richard W. DeVane, Jr.
Fossil Systems

The fossil boiler business is now serving new customers with new technologies in a global marketplace with new competitors. Although demand for fossil systems remains low in North America, increasing electrical usage continues to lower reserve margins and to strain capacity in some regions. Internationally, major power equipment suppliers have begun forming new business relationships in anticipation of a unified European market.

The keys to our success in meeting these challenges are: improving our cost-effectiveness, maintaining our technology leadership and expanding our global access.

To control costs and provide a more focused strategy, we have simplified our organizational structure and consolidated our North American and international operations in a single, integrated business. We also are optimizing our product designs and continuing to increase our use of design and engineering automation.

The technology leadership that brought C-E to the forefront of this business will be maintained and expanded. To help electricity generators burn fossil fuels more cleanly, for example, we are developing technologies, such as fluid bed combustion, low nitrogen oxide burners, and systems that inject sulfur dioxide-absorbing compounds into the boiler.

In our global business development, we are teaming with others and developing strategic alliances to provide leading technologies on a cost-effective basis to the world market. In line with this, we recently announced plans to form a joint venture with Alsthom S.A., a leading European steam generator supplier.

At Mississippi Power & Light Company's Baxter-Wilson power plant, a 20-year-old control system was driving up maintenance costs and threatening plant efficiency. Scott Damesek (left) and Scott Andersen of C-E's Power Automation unit mapped the plant's complex network of sensors, actuators and cables and supervised the installation of a Taylor™ MOD 300 control system. In addition to monitoring real-time performance, C-E's OTIS™ package will achieve a quick payback through a significantly improved heat rate.





C-E's fluid bed combustion (FBC) technology will help Texas-New Mexico Power Company generate power from burning Texas lignite, a difficult

fuel with a combined ash and moisture content of more than 40 percent. Removal of sulfur dioxide is achieved by mixing limestone with fuel in the combustor, and low nitrogen oxide emissions are maintained due to

low combustion temperatures and the careful handling of combustion air. The plant is scheduled for commercial operation in mid-1990, with a second unit now in fabrication.

The Taylor™ MOD 300 distributed control system continued to gain broad client acceptance as an open architecture platform for process automation: The total number of systems sold nearly doubled in 1988, while installations tripled.

The process industries are major markets for C-E's process control and automation products, process technologies and engineering services, and industrial products. Sales have increased more than 40 percent over the past two years as a result of strong worldwide market demand, excellent product position and improved operational effectiveness.

Process Control

New orders for the Process Automation and Process Analytics businesses exceeded \$465 million, a 24 percent increase over 1987. The Taylor™ MOD 300 distributed control system continued to gain broad acceptance as an open architecture platform for process control and automation: The total number of systems sold nearly doubled in 1988, while installations tripled.

The performance of the Taylor MOD 300 platform resulted in three important system orders from Imperial Chemical Industries PLC for installations in Australia and the United Kingdom. To further improve control system cost-effectiveness for clients, C-E developed the Taylor Remote Input/Output (TRIO) subsystem with GE Fanuc Automation Corporation. This breakthrough product reduces control system installation costs by up to 30 percent, while improving overall system availability.

During the year, AccuRay measurement and actuator products were integrated with the Taylor MOD 300 control system to produce the new AccuRay 1180 MicroPlus™ System for paper and other web processing industries. This system provides true "single-window" insight into both product and process control factors. Strong customer acceptance of this product helped boost AccuRay measurement and actuator system (see photo, page 14) orders to over \$130 million, an increase of 34 percent over 1987. Further enhancements have been made to the 1180 MicroPlus System and introduced to the market in 1989.

Process Engineering

Lummus Crest's performance benefited from strong markets, its proprietary technologies, and its proven project engineering and management expertise.

New technologies developed by Lummus Crest, often in collaboration with clients, have been well received (see photo, page 18). For example, a new facility in Japan will use a process developed by Lummus Crest and Unocal Corporation for producing ethylbenzene. The new technology uses a mild chemical reaction that does not require corrosion-resistant steel vessels, resulting in significant capital savings.

On global projects, Lummus is able to combine technology transfer with cost-effective, on-schedule project execution. For example, the Company won a \$160 million order for two new petrochemical plants in the People's Republic of China.

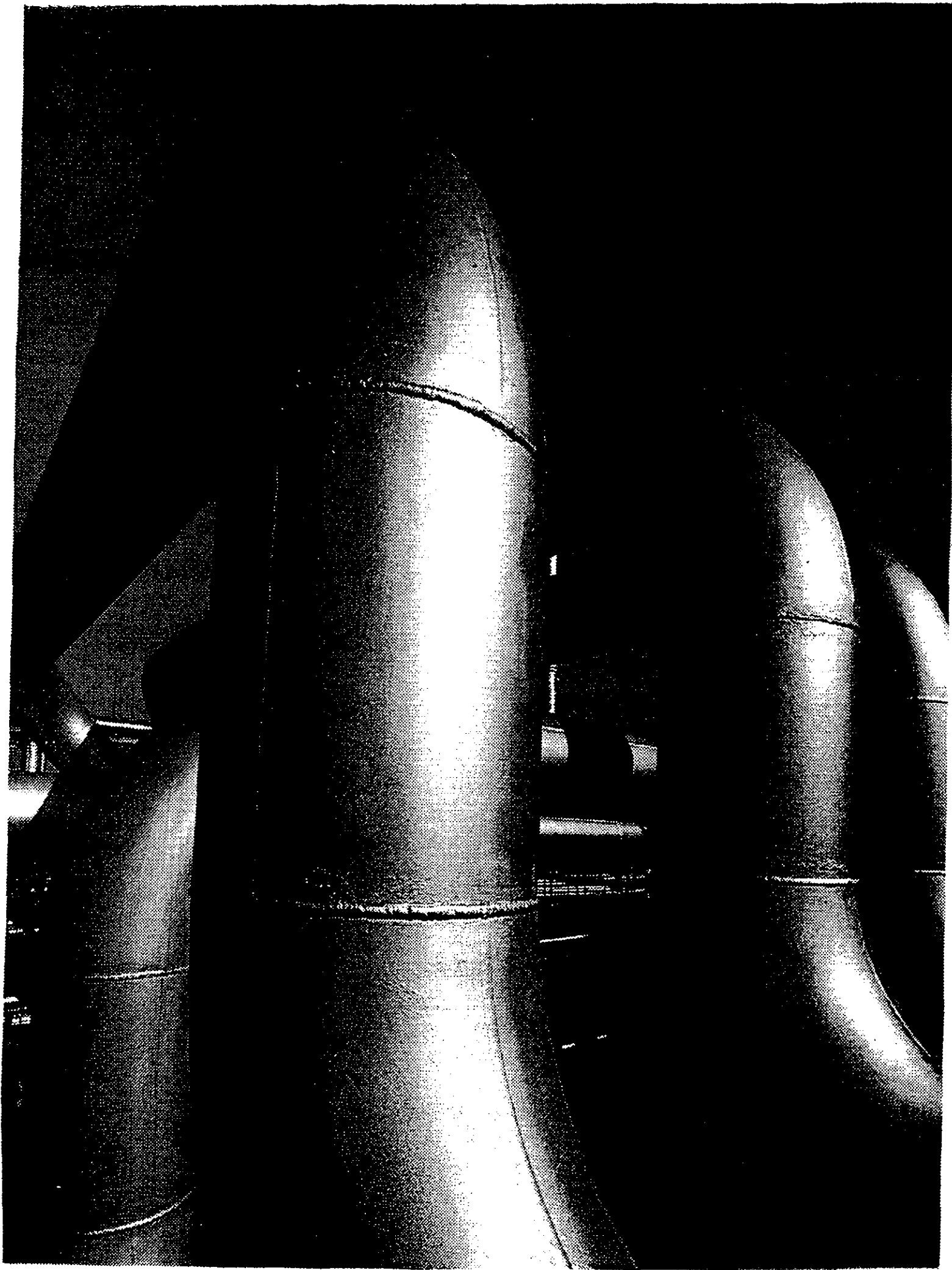
Lummus Crest also continued to enjoy success providing construction management to pulp and paper clients. In 1988 four major awards were won with a total value of more than \$130 million, including Lummus's first mill construction project in Europe.

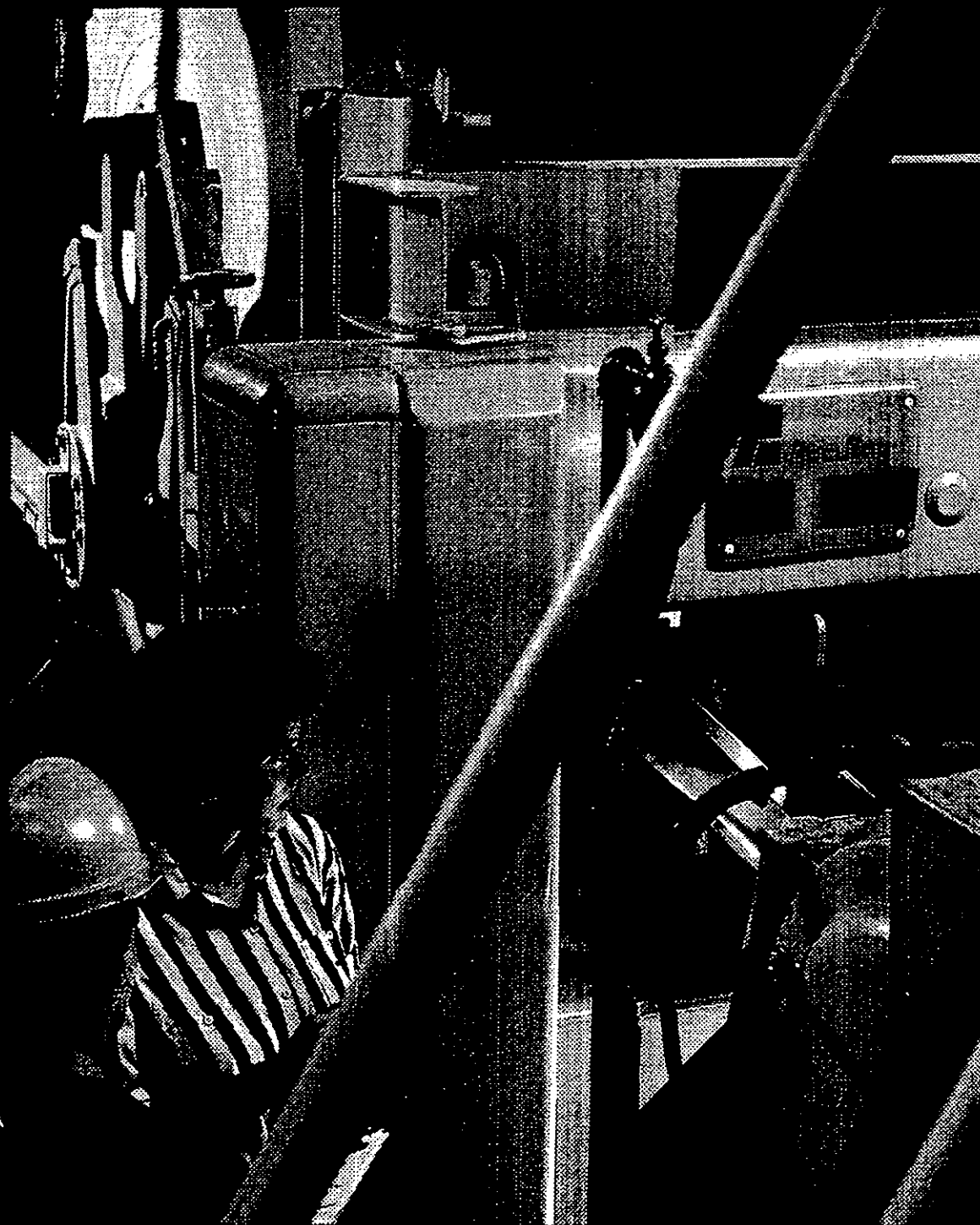
In addition, Lummus Crest continues to broaden its role as a supplier of turnkey engineering services on C-E projects, with a recent award for managing the installation of an automated process control system for a Norton Company coated abrasives facility.

C-E is also providing advanced automation systems to hydrocarbon process plants through its Simcon unit. Installation of a Simcon system for optimization of plant operations is under way at a world-scale styrene plant in Korea. Simcon is also leading the planning and implementation of computer integrated manufacturing (CIM) systems at several petrochemical complexes.

Industrial Products

The performance of C-E's industrial units was led by the mineral businesses — Georgia Kaolin and C-E Minerals — which had record sales. Georgia Kaolin (see photo, page 15) has enhanced its position as a leading low-cost producer of paper coating and filler clays through modernization programs that help achieve a maximum percentage of refined product from raw clays. C-E Minerals is a leading supplier of alumina- and silica-based minerals used in refractory, precision casting and semiconductor manufacturing.





To improve the overall quality of their fine printing grades, Simpson Paper Company is using an AccuRay MICROSCAN™ OptiPak sensor at their

Pasadena, Texas mill. The OptiPak sensor, mounted in a MICROSCAN Measurement Platform (pictured), provides on-line measurement of formation, opacity and brightness. These three important paper characteristics are measured by

simulating human "look-through" perception. The sensor takes 50,000 to 100,000 measurements each second during the production of papers such as the Simpson Sundance sheet used for this report's financial section.

Using an electron microscope at Georgia Kaolin's New Jersey laboratory, Dr. Jack L. Harrison helps design products and manufacturing techniques that give paper desirable qualities, such as opacity, gloss, printability and brightness. By studying the properties of kaolin clays under high magnification, Georgia Kaolin is developing new ways to meet client needs. More effective clay products for both paper and specialty applications are being developed by adjusting particle size, shape and distribution.



Jean-Paul Richard
Industrial Businesses

Our industrial businesses are well-established, with excellent market positions. They also are strong contributors to C-E's operating profitability.

The keys to success vary by business — though each unit will continue to take advantage of shared markets or complementary technologies. Georgia Kaolin will be bringing on new clay capacity in 1989, which should contribute to increased revenues in a continuing strong market. C-E Minerals will begin production of a higher value product for refractory applications and continue to develop alumina- and silica-based products for new uses.

The increasing demand for products to improve environmental quality is an important success factor in a number of our equipment businesses. In the absence of new clean air legislation in the United States, the major opportunities for our Environmental Systems unit's flue gas scrubbers and precipitators are international. Air Preheater is continuing to develop a recently introduced regenerative oxidizer to control gaseous emissions from printing, coating and painting operations. And, we expect growing demand in hazardous waste incineration, where C-E Raymond has an established position. At our largest process equipment business, Sprout-Bauer, improved manufacturing processes and project execution will enable us to take advantage of strong product demand, especially in the pulp and paper market.

Our mineral businesses have been particularly successful because they are low-cost producers of the highest quality products with excellent customer service. A major objective for the 1990s is to extend and strengthen this operating approach, particularly in the equipment businesses.



David L. Nelson
Process Control Business

We are now one of the leading suppliers of process control and automation products in the world, and the prospects for the business look very good. Our global clients must modernize to be competitive, and we are helping them achieve this goal with a significantly broadened product line. This offering includes Taylor instruments and distributed control systems, AccuRay measurement and actuator systems and Afora plantwide automation systems. Clients are taking advantage of all these capabilities using the Process Automation Business as a single source of supply.

By increasing the integration of our products, we are able to offer our clients the most cost-effective control and automation systems available. In flat sheet applications — for example, paper, plastics, and rubber — we are shifting some of the control functions from the AccuRay product line into the Taylor MOD 300 distributed control system. As a result, the recently introduced, more advanced AccuRay 1180 MicroPlus provides enhanced measurement and process control capabilities for these uses.

We are developing other products that make automation more cost-effective. Our Taylor TRIO remote input/output capability improves system performance while reducing installation costs. The new Taylor TurboNode, part of the MOD 300, incorporates the latest in microchip technology to achieve a fourfold improvement in processing speed.

We know that our continued success depends on providing total automation for clients, not just individual control solutions. We are now integrating our broad technical capabilities to develop true plantwide automation.



Sustained high quality is mandatory at Polaroid Corporation's Diversified Technical Coating Division in Waltham, Massachusetts. David Reitsma (standing), senior engineer

at Polaroid, uses the Taylor™ MOD 300 distributed control system to increase production efficiency, improve quality and study critical trends that develop during long production runs. Dan Nagle (seated), Combustion Engineering's account representative, has helped Polaroid install similar systems on eight coating lines.



安全第一 思想 要緊
初次檢驗的時候！

Two recently completed styrene plants in the People's Republic of China are demonstrating the cost-saving benefits of a new technology developed by C-E's Lummus Crest subsidiary. The proprietary heat exchanger design shown recovers low-level waste heat, reducing the heat input required by about 25 percent and giving clients a distinct operating cost advantage. In addition, the system is easier to operate, provides better reliability, and requires less maintenance than conventional technologies.



(From left) Stephen M. Solomon, Juan J. Carrere, Laurence M. Roth, and Eugene H. Martel
Process Engineering

Lummus Crest bookings for 1988 increased by 80 percent over 1987. Our current backlog represents projects in 30 countries, including twelve awards for ethylene plants, seven of which are for new facilities. Expansion also continued in the growing pulp and paper market, with awards totaling over \$132 million.

Our success will continue to depend on providing cost-effective, on-schedule project management services, the increasing use of engineering automation, and investment in high-value process technologies. We are bolstering our project execution capabilities by incorporating the latest advances in fast-track scheduling and by broadening our corps of highly skilled engineers. We also are continuing to invest in engineering automation to increase productivity, shorten response times and reduce costs.

Several recent ventures have expanded our inventory of high-value technologies. We completed an exclusive licensing agreement with Huntsman Chemical Corporation for its polystyrene process. In addition, Catalytic Distillation Technologies, our recently formed joint venture with a division of Polysar Basic Petrochemicals, has already been selected by six clients to improve production methods for chemicals such as MTBE, a gasoline octane booster.

Another key to long-term success lies in extending our management systems, engineering and project management capabilities into additional markets and technologies where C-E already has an established presence. We have successfully accomplished this in pulp and paper mills and are now extending our reach into other process markets.

During the year, C-E Environmental significantly expanded its scope of work and client base in the growing market for environmental services, with sales increasing by 51 percent over 1987.

 To help fulfill a national mandate for improved environmental quality and to serve a growing government market for technical expertise, C-E provides environmental engineering and hazardous waste cleanup services, waste-to-energy systems, and operations, maintenance and management services for government facilities.

Environmental Services

During the year, C-E Environmental significantly expanded its scope of work and client base in the growing market for environmental services, with sales increasing by 51 percent over 1987 (see top photo, page 23). The state of Florida, for example, awarded the Company a three-year, \$6 million contract to provide testing, monitoring and cleanup of leaking underground petroleum storage tanks. And the U.S. military awarded the Company multi-year contracts for remedial investigations and cleanups at sites throughout the United States.

One of the largest environmental markets, remedial construction, involves the application of on-site treatment technologies to reduce hazardous materials to acceptable levels. C-E successfully expanded into the remedial construction business, receiving a \$5 million contract to design, construct and start up a groundwater treatment plant at a site in Kansas City, Missouri. In addition, C-E Environmental, teaming with other C-E units, is offering investigation and assessment services for sites containing "mixed wastes," that is, industrial wastes with low-level radioactive content.

Resource Recovery Systems

In 1988, Combustion Engineering completed the first of three major waste-to-energy plants using C-E's prepared fuel method, in which municipal waste is pre-sorted and shredded to create a consistent fuel source and to allow recycling of certain materials.

The facility in Hartford is now in commercial operation and has met or exceeded some of the most stringent air compliance standards in the country (see bottom photo, page 23). A 4000 ton-per-day plant in Detroit is undergoing start-up and trial operation. After permitting delays, construction on a 2000 ton-per-day Honolulu plant has resumed and is scheduled for commercial operation in 1990.

Last year, Combustion Engineering was awarded a \$90 million contract by the Dakota County, Minnesota Board of Commissioners for a mass-burn waste-to-energy plant there. When permitting is completed, C-E will construct the 800 ton-per-day, 23 megawatt publicly owned facility and operate it under a 20-year contract. C-E is also nearing the final stages of permitting and financing for a mass-burn plant and materials recycling center for the Town of Huntington, New York.

Operations and Maintenance Services

C-E has extended its specialized technical services and broad experience with process technologies into the public sector market. In particular, the need to reduce costs and improve operating efficiencies at government installations has created a growing demand for management, operations and maintenance services.

In 1988, C-E's Operations & Maintenance Services unit was awarded contract extensions by the U.S. military totaling more than \$35 million for administration and engineering services, including work at the Electromagnetic Environmental Test Facility and the Instrumented Test Range at Fort Huachuca, Arizona (see photo, page 22). On both contracts C-E is using a new internally developed computerized program management system that can be integrated with the Government's vendor cost accounting, inventory control, procurement and other key reporting systems.

The Company also received contracts totaling \$95 million for the design, construction and operation of a chemical plant and added a new contract with the U.S. Army Intelligence and Security Board to develop, operate and maintain automated intelligence systems.



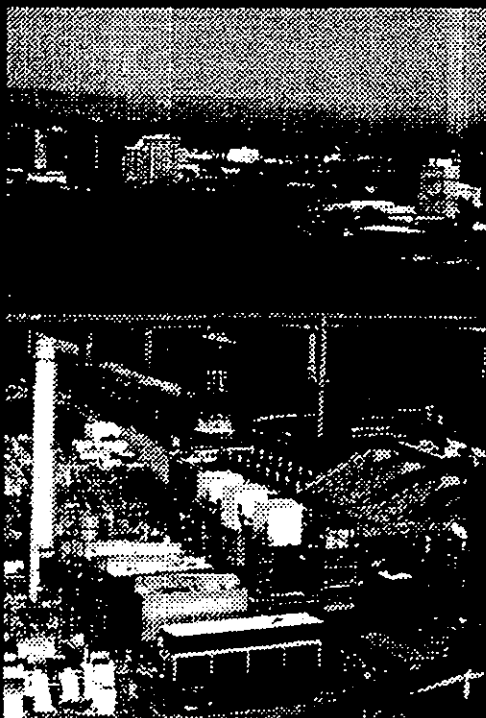


High performance aircraft, missiles and even the NASA space shuttles are tracked and evaluated by C-E's Operations and

Maintenance Services, Inc. under contract to the Department of Defense. Located at Fort Huachuca, Arizona, the Instrumented Test Range electronically checks out the surveillance, navigation and communications systems of aircraft and missiles

under simulated operating conditions. C-E personnel maintain radar, telemetry and photographic equipment at the main control room (shown) and remote systems located elsewhere on the range.

The Mid-Connecticut waste-to-energy plant built by Combustion Engineering in Hartford has processed over 400,000 tons of refuse and produced 360 million kilowatt hours of electricity since operating trials began in September 1987. The plant is proving to be one of the cleanest running such facilities in the country. In several categories, including acid gases, emissions from the plant are the lowest recorded for a waste-to-energy plant in Connecticut—where state air quality regulations are among the most stringent in the nation.



C-E Environmental, Inc. is helping both government and industry clean up hazardous waste sites as a part of the United States Environmental Protection Agency (EPA) Superfund program. At an abandoned dump site in New Jersey, C-E Environmental successfully removed about 1,500 cubic yards of soil contaminated with PCBs and other organic chemicals. Contaminated soil was removed to an average depth of eight feet and properly disposed of at an EPA-approved site.

Financial Section

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Management's Discussion and Analysis

(Dollars in thousands)

Results of Operations 1988 Compared to 1987

Power Generation

	1988	1987	Percentage Change
Net Sales	\$1,663,843	\$1,498,031	11.1%
Operating Income (Loss)	(\$ 89,946)	\$ 179,282	—
Backlog	\$1,951,177	\$2,161,050	(9.7%)

The Power Generation segment's major lines of business are: maintenance, engineering, management and material services and steam generator design, equipment and technology.

As a result of continued demand for smaller, non-utility power plants, the Company and its competitors have had to develop and rely on new, first-time technologies and continue to reassess their organizations in meeting present market demands.

Although sales were up for this segment in 1988, primarily as a result of increased activity on certain non-utility power contracts, a substantial operating loss was recognized. The recognition of an operating loss was caused by an increase in estimated costs to complete circulating fluid bed power plants involving new, first-time technologies, a reduction in steam supply systems contract close outs, cost overruns on other fossil fuel systems contracts administered in the United States and Canada and a provision for further restructuring of the Power Generation businesses.

The Company and Alstom S.A., headquartered in Paris, jointly announced in January 1989 that they intend to form a joint venture to combine their respective businesses supplying fossil-fueled steam supply systems and related maintenance parts to electric utilities and industrial users on a worldwide basis. The venture will combine each

partner's respective strengths in technology, manufacturing and marketing to supply steam systems to better serve customers in North America, the European Economic Community and other global markets. Upon approval by each company's board of directors and required government regulatory agencies, it is expected that the Company and Alstom would own equal shares in the new venture.

In addition, the Company looks toward the benefits of restructuring of this segment, maturing of newly developed technologies and a return to profitability with an organization that should be well-positioned to meet a strengthening aftermarket services and products market and continued demand for new boilers.

Backlog decreased in 1988 from the record level of 1987 as work progressed on the nuclear plants in Korea, circulating fluid bed plants in the United States and other fossil plants in the United States, Canada and the People's Republic of China. However, in 1988, Texas-New Mexico Power company contracted with the Company for its second 150 megawatt, circulating fluid bed unit and outside the United States, a consortium of C-E Canada, Inc. and Marubeni Corporation of Japan received an \$82,000 award to build two 300 megawatt, lignite-fired steam generators for the Mae Moh Station in northeastern Thailand.

Process Industries

	1988	1987	Percentage Change
Net Sales	\$1,546,455	\$1,283,218	20.5%
Operating Income	\$ 55,068	\$ 48,131	14.4%
Backlog	\$ 976,080	\$ 623,998	56.4%

Process Industries includes process controls and automation products, industrial minerals and equipment. This segment also includes the process engineering and construction business which primarily provides design, engineering and construction management services and process technology for chemical process plants, petroleum refineries, pulp and paper mills and other industrial facilities.

A strong market demand and product position and improved operational effectiveness for process controls, kaolin paper coating and filler clays and alumina- and silica-based minerals resulted in improved performance for this segment in 1988. The Company's process control business revenues were up 25% and its minerals businesses revenues were up 21% over 1987. Sales also increased

significantly for the process engineering and construction business in 1988 as this repositioned business continues to capitalize on providing advanced, proprietary, process technologies and continues to benefit from strong international markets.

Operating income was up in 1988 due to improved performance of the Process Automation Business unit which resulted from the combination of AccuRay® measurement and control systems and Taylor™ process control systems in 1987 and continued strong demand for the Company's minerals products. This was partially offset by costs associated with acquired contracts and implementation of new manufacturing technologies at Sprout-Bauer. Operating income of the process engineering and construction

business, exclusive of the recognition of a provision to close out an ethanol plant contract, was up significantly over 1987, reflecting the strengthening position of this business.

Backlog increased more than two-fold for the process engineering and construction business, reflecting a strong pulp and paper market, with four major awards won in 1988 with a total contract value of over \$130,000 and a strong international market exemplified by a \$160,000 order for two, new, petrochemical plants in the People's Republic of

China, also won in 1988.

The Company's industrial businesses are expected to perform well in 1989 as they continue to take advantage of strong pulp and paper markets and internal development programs. The performance of the process controls and process engineering and construction businesses should continue to improve as a result of continued strong markets, new product introductions and continued improvements in operational effectiveness.

Public Sector and Environmental

	1988	1987	Percentage Change
Net Sales	\$273,630	\$260,825	4.9%
Operating Loss	(\$113,634)	(\$ 18,786)	—
Backlog	\$777,245	\$835,469	(. 7.0%)

The Public Sector and Environmental segment includes resource recovery systems, environmental cleanup and consulting services and operations and maintenance services for governmental agencies and industrial facilities.

The operating results of this segment reflect charges recognized for the estimated cost to complete the waste-to-energy plants at Mid-Connecticut, Detroit and Honolulu, all of which involve new, first-time technologies. This cost included the cost to repair the boilers in the Mid-Connecticut plant which, on October 27, 1988, experienced tube failures due to corrosion and the cost of related modifications required on the two other plants under construction. The Mid-Connecticut plant is now in commercial operation and has processed over 400,000 tons of refuse. After permitting delays, construction has resumed on the

Honolulu plant which is scheduled for completion in 1990. The Detroit plant is undergoing acceptance testing in preparation for a mid-1989 commercial start-up.

The Company's Environmental and Operations & Maintenance Services units had significant increases in revenue in 1988 due to internal growth and the recognition of a full year of revenues from E.C. Jordan which was acquired in May 1987. This increase reflects the expanded scope of work and client base in the growing market for environmental services and the Company's growing business in providing management, operations and maintenance services.

Equity income (loss) improved in 1988 due to the absence of a \$32,000 pretax charge recorded in 1987 to reduce to estimated realizable value the carrying value of the Company's investment in and advances to an ethanol joint venture.

Interest expense, net of interest earned on securities, increased in 1988 due to higher borrowings primarily as a result of operating losses.

The effective income tax rate for continuing operations was 2.5% in 1988 and 43.7% in 1987. Income tax expense in 1988 primarily reflects the Company's inability to currently recognize tax benefits resulting from 1988 losses and a provision for the recapture of investment tax credits. The effective tax rate was lower than the statutory rate of 34% due to taxes on foreign operations, state income taxes and losses without income tax benefit.

The effective rate in 1988 was lower than in 1987 due primarily to losses without income tax benefit.

Results of Operations 1987 Compared to 1986

Power Generation

	1987	1986	Percentage Change
Net Sales	\$1,498,031	\$1,273,811	17.6%
Operating Income	\$ 179,282	\$ 149,857	19.6%
Backlog	\$2,161,050	\$1,537,415	40.6%

Net sales were at record levels in 1987. The growth in sales was a result of increased revenues from aftermarket products and services, non-utility power projects and close outs on certain long-term

contracts. These results reflected the benefit of the Company's repositioning to take advantage of customers' demand for products

and services for maintenance, renovation and facilities upgrade to improve plant performance.

Operating income was favorably affected by increased revenues, close outs on long-term contracts and strong performance in providing aftermarket services. A gain was also realized from the sale of the Company's investment in Northern Engineering Industries PLC offset by a charge for restructuring costs within this segment.

Record bookings were realized in this segment including contract awards for two 1,000 MW nuclear steam supply systems and associated technology for Korea Electric Power Company's plants at Yongkwang and two 600 MW coal-fired steam generators in Shanghai for the People's Republic of China.

Process Industries

	1987	1986	Percentage Change
Net Sales	\$1,283,218	\$1,079,858	18.8%
Operating Income	\$ 48,131	\$ 8,743	450.5%
Backlog	\$ 623,998	\$ 452,395	37.9%

The increase in net sales for 1987 was a result of the acquisition of AccuRay, Afora, the full year effect of the Sprout-Waldron acquisition in August 1986 and increased revenues from pulp and paper and instrumentation and controls products and services.

The process engineering and construction business returned to profitability despite lower sales due to the successful repositioning as a supplier of technology-based engineering services, significant reduction in costs of certain long-term contracts and the absence of a

provision for rework on an ethanol plant. Also, profitability due to strong performance from the industrial minerals lines was more than offset by recognition of costs associated with the introduction of new products and services.

Strengthening chemical, petrochemical, refining and pulp and paper markets resulted in the highest level of backlog for the process engineering and construction business since 1984.

Public Sector and Environmental

	1987	1986	Percentage Change
Net Sales	\$260,825	\$197,800	31.9%
Operating Income (Loss)	(\$ 18,786)	\$ 4,083	—
Backlog	\$835,469	\$776,702	7.6%

In expanding its environmental engineering, cleanup and consulting services business, the Company acquired Bell Technical Operations Corporation in April 1987, and E.C. Jordan in May 1987, which was the primary reason for increased sales in that period.

Recognition of additional costs on the Mid-Connecticut waste-to-energy project and delays on the Honolulu project resulted in the reported operating loss for this segment in 1987.

Equity income (loss) in 1987 included a \$32,000 pretax charge to reduce to estimated realizable value the carrying value of the Company's investment in and advances to an ethanol joint venture.

Interest expense, net of interest earned on securities, increased in 1987 due to higher borrowings primarily as a result of the funding of acquisitions.

The effective income tax rate for continuing operations was 43.7%

in 1987 and 42.8% in 1986. Income tax expense in 1987 was higher than the 40% statutory rate due principally to taxes on foreign operations and state income taxes, which were partially offset by depletion. The effective tax rate for 1987 was higher than in 1986 due primarily to higher goodwill amortization and taxes on foreign operations.

Liquidity and Working Capital

Pursuant to the Company's strategy to strengthen its position as a leading provider of engineered products, systems and services to the power, process and public sector markets, a number of acquisitions were made in the last several years and substantial investment has been made in product development and in restructuring the business. Over recent years, availability of advance and progress payments has lessened due to a decline in sales of products and services where such payments are common. Other sources of funds include sales of property, interest income, dividend income and, in 1988, the sale of Jamesbury Corp. In the first quarter of 1989, the Company is scheduled to consummate the sale of its Premier Refractories and Chemicals (formerly C-E Refractories), C-E Tyler, C-E Natco and Vetco Services businesses for proceeds of approximately \$125,000.

Long-term debt increased from December 31, 1987, as a result of the reclassification of an additional \$30,000 of short-term bank notes, bringing the total of such reclassification to approximately \$75,000. The refinancing of these short-term bank notes is expected for an uninterrupted period extending beyond one year through renewing, extending or replacing them with other short-term bank notes or by refinancing them through other long-term financing arrangements. At December 31, 1988, the Company had long-term debt of \$316,046 which was equal to 34% of long-term capitalization (deferred income taxes, long-term debt and shareholders' equity).

Short-term borrowings at December 31, 1988 of \$120,717, including the current portion of long-term debt, increased as a result of funding costs to complete certain contracts and restructuring programs. The Company has two revolving credit agreements for \$300,000 and \$200,000 established in 1987 and 1988, respectively, with a number of large, money-center banks. There were no borrowings under these two similar agreements.

On March 25, 1988, the Company entered into a five-year agreement whereby it can sell up to \$100,000 of undivided interests in a designated pool of accounts receivable, principally of the Power Generation and Process Industries segments. At December 31, 1988, approximately \$100,000 of receivables were sold for cash under this agreement. The undivided interest in the designated pool of receivables was sold with limited recourse. On December 31, 1987, the Company sold net receivables amounting to approximately \$100,000.

In April 1987, the Company completed the public offering of 4,600,000 shares of its common stock for net proceeds of \$150,972 and filed a \$225,000 debt shelf registration. In May 1987, the Company issued 9.70% Subordinated Notes due in 1997 for \$150,000. The net proceeds of these offerings were applied to refinance bank debt incurred to finance the acquisition and associated costs of AccuRay, as well as to repay certain indebtedness of AccuRay and to refinance existing short-term debt.

The Company's net working capital balance declined in 1988 due to the adverse effect of a provision for adjustment to contracts, an increase in accounts payable and short-term borrowings. This resulted in a negative net working capital balance which is principally due to substantial liabilities related to contract accruals and advance payments. Historically, these obligations have not required immediate payment. Working capital levels have also varied because of acquisitions, dispositions and discontinued operations.

Internal cash flow, proceeds of non-strategic asset sales and available credit facilities are expected to be sufficient to meet the liquidity and working capital needs of the Company. From time to time, the Company has and may continue to access capital markets to meet its longer-term needs and to refinance short-term borrowings.

Acquisitions, Dispositions and Discontinued Operations

The Company has been repositioning with selected divestments and strategic acquisitions to focus on engineering services and products based on advanced technologies that meet customer needs for increased efficiency and performance.

To further improve its offerings to the market for control, monitoring and optimization of power production and distribution, the Company, acquired, in November 1988, the operations of Systems Control Inc.'s Energy Systems Group (ESG), a leading supplier of energy management systems (EMS), supervisory control and data acquisition systems (SCADA) and advanced application software to the electric power industry for approximately \$15,235. The operating results of this operation have been consolidated with those of the Company since the date of acquisition. Had this acquisition been consummated at the beginning of 1988, the pro forma effect on the results of operations would not have been material.

During September 1988, the Company completed the sale of its investment in Jamesbury Corp., a manufacturer and supplier of high-performance valves, including Hammel Dahl Inc., a manufacturer of control valves. During June 1988, the Company had purchased the remaining 70% of Hammel Dahl, Inc. The Company realized net proceeds on this sale of approximately \$136,000.

AccuRay Corporation was acquired in January 1987 for a purchase price of approximately \$206,000 plus associated costs. The Process Automation Business unit was created to combine AccuRay® measurement and control systems and Taylor™ process control systems. Also within this unit is Afora Ltd. which was acquired in August 1987. Afora Ltd. develops and markets process software.

In April 1987, the Bell Technical Operations Corporation of Textron was acquired. This expanded the Company's Operations & Maintenance Services business to include technical services for government clients.

In May 1987, the Company acquired E.C. Jordan which was added to the newly created business, C-E Environmental, Inc. E.C. Jordan's engineering and scientific skills have been merged with existing laboratory analysis and remedial service capabilities to offer full-scope environmental services to our clients.

In September 1987, the Company completed the acquisition of certain assets and business operations from the Lurgi Corporation of River Edge, NJ, giving the Company the ability to further develop Lurgi's circulating fluid bed (CFB) combustion process combined with internal experience in coal burning steam generator technology and equipment.

The operating results of Bell Technical Operations Corporation, E.C. Jordan, Afora Ltd. and the assets and business operations acquired from Lurgi Corporation have been consolidated with those of the Company since their respective dates of acquisition.

In June 1988, Baker Hughes sold 70.1% of the VG Common Shares to Vetco Gray Inc. to Bain Venture Capital. The Company has maintained its investment position in Vetco Gray Inc. As a result of restructuring programs, cost savings and an improving market, 1988 operating results of Vetco Gray Inc. have improved significantly over the prior year.

Reference should be made to Note 14 and Note 17 of the Notes to Consolidated Financial Statements on pages 42 and 44.

Accounting for Income Taxes

In December 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 96 "Accounting for Income Taxes" (SFAS 96). In December 1988, the Board amended SFAS 96 (through SFAS 100) by delaying its effective date for financial statements issued for fiscal years beginning on or after January 1, 1990. Adoption of the new standard will result in a cumulative

adjustment that will be reported in the year the standard is implemented. This adjustment is not expected to be significant.

At December 31, 1988, the Company has approximately \$196,000 and \$47,000 of domestic and foreign net operating loss carryforwards for financial reporting purposes, which expire in 2003 and beginning in 1992, respectively and approximately \$13,000 of foreign tax credit carryforwards which expire in 1990.

At December 31, 1988, the Company has approximately \$27,000 and \$12,000 of foreign and investment tax credit carryforwards, respectively, for income tax reporting purposes which expire beginning in 1991 and beginning in 2001, respectively. Domestic and foreign net operating loss carryforwards of approximately \$50,000 and \$52,000 expire in 2003 and beginning in 1990, respectively. The future utilization of these carryforwards will reduce both the cash cost of income taxes as well as the related book

Capital Resources

Expenditures for property, plant and equipment aggregated \$257,215 during the years 1986 through 1988. Capital expenditures during 1988 emphasized improved production efficiency, maintenance of operating facilities and the pursuit of market opportunities for new and existing products and services. Provisions for depreciation and amortization of facilities during the years 1986 through 1988 aggregated \$216,142.

Investment in property, plant and equipment, excluding acquisitions

and capitalized software, during 1988 totaled \$88,728. This compares to additions of \$83,599 in 1987.

The unexpended balance of authorized capital projects aggregated \$49,848, \$52,427 and \$40,976 at December 31, 1988, 1987 and 1986, respectively. The general purpose of these projects is summarized below:

December 31,	Percentage to Total		
	1988	1987	1986
New Products and Services/Additions to Existing Capacity	44%	47%	48%
Replacement and Improvement of Existing Facilities	54	49	47
Other	2	4	5
	100%	100%	100%

Impact of Inflation and Changing Prices

Since the rate of inflation subsided, its immediate impact has not been as severe as that experienced in past history. However, generally

competitive market conditions made it difficult to increase selling prices as an offset to inflation.

Business Segment Information

December 31, (Dollars in thousands)		1988	1987	1986
Net Sales (1) —	Power Generation	\$1,663,843	\$1,498,031	\$1,273,811
	Process Industries (2)	1,546,455	1,283,218	1,079,858
	Public Sector and Environmental	273,630	260,825	197,800
		\$3,483,928	\$3,042,074	\$2,551,469
Operating Income (Loss) (3) —	Power Generation	(\$ 89,946)	\$ 179,282	\$ 149,857
	Process Industries (2)	55,068	48,131	8,743
	Public Sector and Environmental	(113,634)	(18,786)	4,083
		(148,512)	208,627	162,683
	Corporate expenses — unallocated	(73,923)	(60,397)	(52,801)
	Gain on dispositions	22,829	8,664	—
	Equity income (loss) (4)	4,558	(24,824)	3,934
		(\$ 195,048)	\$ 132,070	\$ 113,816
Backlog (Unaudited) —	Power Generation	\$1,951,177	\$2,161,050	\$1,537,415
	Process Industries (2)	976,080	623,998	452,395
	Public Sector and Environmental (5)	777,245	835,469	776,702
		\$3,704,502	\$3,620,517	\$2,766,512
Identifiable Assets —	Power Generation	\$ 679,817	\$ 682,820	\$ 670,022
	Process Industries (2)	1,321,651	1,303,279	890,552
	Public Sector and Environmental	102,752	98,127	38,149
		2,104,220	2,084,226	1,598,723
	Equity investments	48,450	46,465	37,700
	Investment in Vetco Gray Inc.	164,099	163,099	163,099
	Corporate and unallocated assets (6)	123,069	295,274	353,084
	Net assets of discontinued operations	105,997	114,666	115,421
		\$2,545,835	\$2,703,730	\$2,268,027
Additions to Capital Assets —	Power Generation	\$ 18,021	\$ 21,387	\$ 27,941
	Process Industries (2)	73,969	63,244	50,800
	Public Sector and Environmental	1,912	3,629	11,434
		93,902	88,260	90,175
	Corporate	4,549	5,509	6,594
		\$ 98,451	\$ 93,769	\$ 96,769
Depreciation and Amortization (7) —	Power Generation	\$ 40,523	\$ 27,102	\$ 27,552
	Process Industries (2)	59,368	53,924	39,923
	Public Sector and Environmental	3,350	1,753	416
		103,241	82,779	67,891
	Corporate	6,823	5,873	3,233
		\$ 110,064	\$ 88,652	\$ 71,124

(1) Includes only sales to unaffiliated customers (intersegment sales are not significant) and no single customer accounts for 10% or more of the consolidated sales.

(2) Process Industries business segment information has been restated to include the Engineering and Construction operations.

(3) Includes third and fourth quarter 1988 pretax provisions totaling approximately \$272,800 for adjustments to contracts and restructuring (refer to Note 6 of Notes to Consolidated Financial Statements).

(4) Includes a pretax charge of \$32,000 in 1987 to reduce to estimated realizable value the carrying value of the Company's investment in and advances to an ethanol joint venture.

(5) Includes contract backlog relating to government contract services totaling approximately \$178,000 and \$158,000 in 1988 and 1987, respectively, which extend over periods approximating five years, many of which are subject to annual government funding authorization.

(6) Includes primarily cash, short-term and cost basis investments and corporate facilities.

(7) Includes amortization of capitalized software of \$21,930, \$7,926 and \$6,356 in 1988, 1987 and 1986, respectively (refer to Note 4 of Notes to Consolidated Financial Statements for change in estimated useful life for capitalized software).

Consolidated Balance Sheet

December 31,	1988	1987
Assets		
	(Dollars in thousands)	
Current assets:		
Cash and short-term investments	\$ 157,852	\$ 151,240
Accounts receivable, net	658,342	629,775
Inventories	490,173	488,136
Prepaid expenses	25,067	23,889
Deferred income taxes	—	103,397
Total current assets	1,331,434	1,396,437
Investments in associated and other companies:		
Investment in Vetco Gray Inc.	164,099	163,099
Net assets of discontinued operations	105,997	114,666
Other investments	74,549	75,650
	344,645	353,415
Capital assets, net	571,369	630,064
Goodwill	221,751	251,654
Other assets	76,636	72,160
	\$2,545,835	\$2,703,730
Liabilities and Shareholders' Equity		
Current liabilities:		
Short-term borrowings	\$ 120,717	\$ 77,848
Accounts payable	267,328	188,787
Accrued liabilities	753,370	653,375
Income taxes	65,461	43,334
Advance payments	395,244	390,878
Total current liabilities	1,602,120	1,354,222
Deferred income taxes	20,779	175,322
Long-term debt	316,046	293,957
Other liabilities	13,702	17,768
Commitments and contingent liabilities (Note 12)		
Shareholders' equity:		
Preferred stock, no par value —		
Authorized and unissued — 5,000,000 shares		
Common stock (Note 10), \$1 par value —		
Authorized — 100,000,000 shares		
Issued — 38,753,596 shares in 1988 and 38,078,983 shares in 1987	268,737	254,437
Retained earnings	335,991	619,573
Cumulative translation adjustment	(10,844)	(10,887)
	593,884	863,123
Treasury stock, at cost	696	662
	593,188	862,461
	\$2,545,835	\$2,703,730

Reference is made to the accompanying notes to consolidated financial statements.

Consolidated Statement of Income

Years ended December 31,	1988	1987	1986
	(Dollars in thousands, except per share amounts)		
Net Sales	\$3,483,928	\$3,042,074	\$2,551,469
Costs and Expenses:			
Cost of sales (Note 6)	3,338,140	2,585,820	2,163,448
Selling, general and administrative expenses	379,300	322,633	281,976
	3,717,440	2,908,453	2,445,424
	(233,512)	133,621	106,045
Equity income (loss)	4,558	(24,824)	3,934
Dividend income	4,274	2,728	3,131
Other income, net	1,440	158	706
Gain on dispositions	28,192	20,387	—
Operating income (loss)	(195,048)	132,070	113,816
Interest expense	(61,352)	(44,632)	(23,132)
Interest earned on securities	17,174	13,024	7,714
Income (loss) from continuing operations before income taxes	(239,226)	100,462	98,398
Provision for income taxes	5,947	43,902	42,069
Income (loss) from continuing operations	(245,173)	56,560	56,329
Net loss from discontinued operations	—	—	(5,463)
Net income (loss)	(\$ 245,173)	\$ 56,560	\$ 50,866
Earnings (Loss) Per Share of Common Stock:			
Continuing operations	(\$ 6.40)	\$ 1.54	\$ 1.69
Discontinued operations	—	—	(.16)
Net income (loss)	(\$ 6.40)	\$ 1.54	\$ 1.53
Average Number of Common Shares (in thousands)	38,309	36,645	33,241

Reference is made to the accompanying notes to consolidated financial statements

Consolidated Statement of Changes in Shareholders' Equity

(Dollars in thousands)	Common Stock		Retained Earnings	Cumulative Translation Adjustment	Treasury Stock	
	Shares Issued	Amount			Shares	Amount
January 1, 1986	33,257,878	\$ 97,802	\$583,407	(\$16,064)	46,705	\$1,041
Net income			50,866			
Dividends declared			(33,264)			
Exercise of stock options	53,139	1,176			4,065	133
Translation adjustments				4,130		
December 31, 1986	33,311,017	98,978	601,009	(11,934)	50,770	1,174
Net income			56,560			
Dividends declared			(37,996)			
Issuance of common stock	4,600,000	150,972				
Exercise of stock options	167,966	4,487			8,765	340
Issuance of contingent performance rights awards					(26,308)	(852)
Translation adjustments				1,047		
December 31, 1987	38,078,983	254,437	619,573	(10,887)	33,227	662
Net loss			(245,173)			
Dividends declared			(38,409)			
Restricted stock issued	265,340	7,137			33,500	—
Unamortized deferred compensation – restricted stock	—	(5,014)				
Exercise of stock options	52,097	1,108			1,280	34
Issuance of common stock – thrift plan	306,171	9,519				
Dividend reinvestment	51,005	1,550				
Translation adjustments				43		
December 31, 1988	38,753,596	\$268,737	\$335,991	(\$10,844)	68,007	\$ 696

Reference is made to the accompanying notes to consolidated financial statements

Consolidated Statement of Cash Flows

Years ended December 31,	1988	1987	1986
	(Dollars in thousands)		
Cash Flows from Operating Activities:			
Income (loss) from continuing operations	(\$245,173)	\$ 56,560	\$ 56,329
Adjustments to Reconcile Income (Loss) from Continuing Operations to Net Cash:			
Provision for adjustments to contracts and restructuring	272,800	—	—
Depreciation and amortization	110,064	88,652	71,124
Gain on sale of investments	(28,192)	(20,387)	—
Deferred income taxes	(28,375)	54,761	115,273
Change in assets and liabilities net of effects from business acquisitions and divestments:			
Decrease (increase) in accounts receivable	(34,272)	16,308	(214,261)
(Increase) in inventory	(51,594)	(8,346)	(-11,876)
(Increase) in other current assets	(2,840)	(3,234)	(3,511)
(Decrease) in accounts payable and accrued liabilities	(105,457)	(144,453)	(16,306)
Increase (decrease) in advance payments	4,039	(23,489)	(85,102)
Other, net	6,196	18,113	(13,264)
Net cash provided (used) by operating activities	(102,804)	34,485	(101,594)
Cash Flows from Investing Activities:			
Proceeds from sales of property, plant and equipment	22,182	29,484	27,693
Additions to property, plant and equipment	(88,728)	(83,599)	(84,888)
Additions to capitalized software	(9,723)	(10,170)	(11,881)
Business divestment	135,750	—	—
Payment for the acquisition of certain businesses, net of cash acquired (Note 17)	(11,212)	(245,989)	(34,463)
Proceeds from sales of investments	13,933	36,507	1,043
Purchases of investments	(18,102)	(6,586)	(13,593)
Other	9,353	(2,802)	23,380
Net cash provided (used) in investing activities	53,453	(283,155)	(92,709)
Cash Flows from Financing Activities:			
Dividends paid	(36,711)	(36,796)	(33,255)
Exercise of stock options	1,074	4,999	1,043
Issuance of common stock	—	150,972	—
Issuance of restricted common stock	2,123	—	—
Principal payments under capital lease obligations	(2,862)	(2,670)	(1,388)
Issuance of Subordinated Notes	—	150,000	—
Proceeds of long-term debt	23,540	4,274	4,342
Proceeds (repayment) of short-term debt	63,402	(17,931)	31,277
Net cash provided by financing activities	50,566	252,848	2,019
Discontinued Operations:			
Cash provided	8,669	755	41,013
Disposition of assets	—	—	110,000
	8,669	755	151,013
Effect of Exchange Rate Changes on Cash	(3,272)	2,194	(264)
Net Increase (Decrease) in Cash and Short-term Investments	6,612	7,127	(41,535)
Balance at Beginning of Year	151,240	144,113	185,648
Balance at End of Year	\$157,852	\$151,240	\$144,113

Reference is made to the accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(Dollars in thousands, except per share amounts)

1. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Combustion Engineering, Inc. and its subsidiaries (the Company).

Investments in unconsolidated subsidiaries, in which the Company has a 20% to 50% interest, are accounted for on the equity basis and are included in Other Investments. Retained earnings at December 31, 1988, included \$7,102 with respect to the undistributed earnings of unconsolidated subsidiaries. Dividends recorded from such subsidiaries aggregated \$4,821, \$5,004 and \$5,536 in 1988, 1987 and 1986, respectively.

Investments in companies which are less than 20% owned are carried at the lower of aggregate cost or net realizable value and are included in Other Investments.

All significant intercompany transactions and balances have been eliminated.

In 1988, the Company adopted Statement of Financial Accounting Standards No. 95 "Statement of Cash Flows", which requires a statement of cash flows, classified by cash receipts and disbursements according to whether the cash flows stem from operating, investing or financing activities. Prior years have been restated.

Certain reclassifications have been made to prior year financial statements to conform with current year presentation.

Long-term Contracts

Profits on long-term contracts are recognized on the percentage-of-completion method. Percentage-of-completion is measured principally by the percentage of costs incurred and accrued to date versus the estimated total costs for each contract. Profits on short-term contracts are not recorded for equipment manufactured in the Company's plants prior to billing the customer and prior to shipment of the equipment. Contracts typically extend over a period of several months to three or more years.

Provisions for estimated losses, if any, on uncompleted contracts are made in the period in which such losses are determined. Changes in contract performance and estimated profitability, including those arising from contract penalty provisions and final contract settlements, may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Profit incentives are included in income when their realization is reasonably assured.

In accordance with industry practice, inventories, receivables and advance payments include amounts relating to contracts and programs having production cycles longer than one year and therefore, a portion will not be realized within one year.

Inventories

Inventories, other than inventoried costs relating to long-term contracts, are stated at the lower of cost (principally first-in, first-out) or market.

Inventoried costs relating to long-term contracts are valued at the lower of cost (average or actual) or market. Such inventories include, among other things, material costs, direct labor and indirect costs (primarily manufacturing overhead). General and administrative costs are charged to expense when incurred.

Capital Assets

Land, buildings, machinery and equipment and capitalized software are stated at cost. Buildings and machinery and equipment are generally depreciated on a straight-line basis over their estimated useful lives. Annual rates for major items range from 2% to 4% for buildings and from 5% to 20% for machinery and equipment. Capitalized software is being amortized over periods ranging from five to seven years.

Goodwill

Substantially all the goodwill is being amortized on a straight-line basis primarily over a forty-year period. At December 31, 1988 and 1987, accumulated amortization was \$13,961 and \$9,510, respectively.

Income Taxes

The provision (benefit) for deferred income taxes represents the tax effect of differences in the timing of income and expense recognition for tax purposes and financial reporting purposes. Deferred income taxes are provided for those earnings of consolidated foreign subsidiaries that are expected to be remitted.

Earnings Per Share

Earnings per share of common stock is computed based on the weighted-average number of common shares outstanding during each year.

Translation of Foreign Currencies

Assets and liabilities of operations outside the United States are translated at the current rates of exchange at the balance sheet dates. Results of operations are translated using the weighted-average exchange rates prevailing throughout the period. The gains or losses which result from this translation process are included in the caption, Cumulative Translation Adjustment, while gains and losses resulting from currency transactions are included in net income (loss).

Warranty Expense

The Company provides for estimated future warranty costs for contractual requirements which it may be required to satisfy. Such costs are expensed relative to revenue recognition on the respective contracts. In addition, specific provisions are made where the costs of warranty are expected to significantly exceed such accruals.

Cash and Short-term Investments

For purposes of reporting cash flows, cash and short-term investments include cash-on-hand and liquid investments.

2. Accounts Receivable

December 31,	1988	1987
Billed		
Work in progress or completed	\$569,187	\$506,569
Retainage	50,222	32,801
Unbilled receivables	217,480	215,548
Other	5,161	20,685
	842,050	775,603
Unearned billings	(158,275)	(123,113)
Allowance for doubtful accounts	(25,433)	(22,715)
	\$658,342	\$629,775

At December 31, 1988, unbilled receivables included approximately \$169,000 which has been recognized as sales in current and prior periods under the percentage-of-completion method. With respect to amounts earned, the Company anticipates that approximately \$23,000 will be collected after 1989. Other receivables represent income tax refunds.

On March 25, 1988, the Company entered into a five-year agreement whereby it can sell up to \$100,000 of undivided interests in a

designated pool of accounts receivable, principally of the Power Generation and Process Industries segments. At December 31, 1988, approximately \$100,000 of receivables were sold for cash under this agreement. The undivided interest in the designated pool of receivables was sold with limited recourse.

On December 31, 1987, the Company sold net receivables amounting to approximately \$100,000.

3. Inventories

December 31,	1988	1987
Long-term contracts, less amounts attributed to earned billings	\$134,252	\$125,241
Raw materials and supplies	42,301	42,846
Work in process	282,793	281,830
Finished goods	30,827	38,219
	\$490,173	\$488,136

The last-in, first-out (LIFO) method is used for approximately 16% and 19% of inventories at December 31, 1988 and 1987, respectively. The excess of current cost over the LIFO basis of such inventories was \$22,832 and \$19,698 at December 31, 1988 and 1987, respectively.

Reductions in the levels of LIFO valued inventories (LIFO liquidation) decreased cost of sales by approximately \$583, \$2,202 and \$5,451 in 1988, 1987 and 1986, respectively.

4. Capital Assets

December 31,	1988	1987
Land and land improvements	\$ 58,196	\$ 61,530
Clay and other mineral deposits	25,383	24,213
Buildings and facilities	246,709	257,264
Machinery and equipment	742,596	765,760
Construction in progress	41,955	36,039
	1,114,839	1,144,806
Less — Accumulated depreciation and amortization	580,373	565,460
	534,466	579,346
Capitalized software, net of accumulated amortization of \$43,086 in 1988 and \$25,151 in 1987	36,903	50,718
	\$ 571,369	\$ 630,064

Expenditures for maintenance, repairs, renewals and betterments which do not materially prolong the useful life of the asset, or are of a minor nature, are generally charged to costs and expenses. Such amounts aggregated \$56,932, \$47,738 and \$42,442 in 1988, 1987 and 1986, respectively. In 1988, the Company changed the useful life of

capitalized software from periods greater than seven years to periods ranging from five to seven years. The effect of this change was to increase 1988 Cost of Sales by approximately \$11,000. Amounts amortized for capitalized software amounted to \$21,930, \$7,926 and \$6,356 in 1988, 1987 and 1986, respectively.

Costs incurred in connection with research and development work are expensed as incurred. Company-sponsored research and development expense relating to the development of new products or services or the improvement of existing products or services aggregated

\$55,943, \$50,493 and \$48,025 in 1988, 1987 and 1986, respectively. Customer-sponsored research and development arrangements are accounted for as contracts to perform research and development services with no obligation for repayment.

5. Accrued Liabilities

December 31,	1988	1987
Wages, salaries and benefits	\$192,601	\$182,422
Warranty costs	51,500	52,116
Accrued costs in connection with adjustments to facilities and operations	26,503	18,668
Additional costs on open contracts	215,688	142,432
Taxes, insurance and interest	68,611	47,266
Other	198,467	210,471
	\$753,370	\$653,376

6. Provision for Adjustment to Contracts and Restructuring

During the third quarter of 1988, the Company began experiencing completion difficulties on certain long-term contracts. As a result, the Company commenced a reestimation of costs on all long-term contracts. The contract review and reestimation process was not completed for all contracts until the fourth quarter of 1988. As a result, for the third and fourth quarters the Company recorded pretax provisions totaling approximately \$272,800 for additional contract costs and restructuring.

These charges were made primarily to recognize: (a) increases in estimated costs to complete waste-to-energy plants and fluid bed

power plants, both involving new, first-time technologies; (b) cost overruns on other fossil fuel systems contracts administered in the United States and Canada and (c) the estimated costs to repair the boilers in the Hartford, Connecticut waste-to-energy plant which experienced tube failures due to corrosion and the cost of related modifications required on two other plants under construction. In addition, the Company decided to further restructure its Power Generation segment principally for staff reductions and reorganizations.

7. Short-term Borrowings

Short-term borrowings and current maturities are as follows:

December 31,	1988	1987
Notes payable to:		
Banks	\$ 73,220	\$27,012
Other	39,135	39,426
Current portion of long-term debt and capital lease obligations	8,362	11,410
	\$120,717	\$77,848

Other notes payable included \$38,964 and \$31,809 in 1988 and 1987, respectively, in connection with a joint venture to construct and operate a resource recovery facility for the City of Honolulu, whereby the Company obtained the right to utilize cash advanced to the joint venture.

The bank notes are supported by revolving credit agreements totaling \$500,000; \$300,000 was established in 1987 and \$200,000 was established in 1988. There were no borrowings outstanding under these agreements during 1988 and 1987. These credit agreements are available to the Company until December 16, 1992 and February 24,

1993, respectively. The Company pays commitment fees averaging .08 of 1% per annum on the unused portions of the \$300,000 commitments. Under the \$200,000 agreement, the Company pays a fee of .125 of 1% per annum for the total facility and .03125 of 1% on the unused portion of the commitments. At December 31, 1988 and 1987, \$75,000 and \$45,000, respectively, of bank notes were classified long-term based on the Company's ability and intent to refinance such obligations on a long-term basis. In addition, the Company defeased in December 1988, \$18,000 of short-term debt due January 1989 through the placement of funds in an irrevocable trust.

8. Long-term Debt

Long-term debt payable after one year and final maturity dates are:

December 31,	1988	1987
7.45% Sinking Fund Debentures due 1996	\$ 21,267	\$ 21,418
9.70% Subordinated Notes due 1997	150,000	150,000
12.43% Non-recourse note due 2002	25,000	25,000
Bank notes (Note 7)	75,000	45,000
Industrial Revenue Bonds at interest rates ranging from 4.275% to 9.75%	5,482	9,704
Notes and other term payables	39,297	42,835
	\$316,046	\$293,957

The Sinking Fund Debentures and Subordinated Notes are direct, unsecured obligations of the Company and are redeemable at the option of the Company, as a whole or in part, at times prior to their respective maturity dates at redemption prices as set forth in the respective Indentures plus accrued interest to the redemption date. The Sinking Fund Debentures can be currently redeemed for amounts approximating par value.

Certain of the Indentures under which the long-term debt was issued provide, among other things, for restrictions on the payment of cash dividends and the incurrence of funded debt. At December 31, 1988, consolidated retained earnings were not restricted as to the payment of cash dividends. Under the most restrictive condition, neither the Company nor any restricted subsidiary, as defined by the agreement, may become liable for any senior funded debt, with certain

exceptions, unless immediately thereafter consolidated net tangible assets aggregate at least 200% of consolidated senior funded debt. Restrictions on the payment of dividends by consolidated subsidiaries, either by reason of loan agreements or otherwise, are not significant.

Notes and other term payables consist of loans and mortgages payable by the Company. Certain fixed assets were pledged to secure \$21,205 of these payables at December 31, 1988. The 12.43% Non-recourse note relates to a cogeneration facility which the Company owns and is leasing to an equity investee. This note is secured by the facility.

Annual maturities of total long-term debt approximate \$5,456, \$12,453, \$10,467, \$8,971 and \$7,489 for the years 1989 through 1993, respectively.

The Company has made interest payments for long- and short-term debt totaling \$56,868, \$34,562 and \$19,834 for 1988, 1987 and 1986, respectively.

9. Income Taxes

Income (loss) from continuing operations before income taxes consists of:

	1988	1987	1986
Domestic	(\$262,640)	\$ 69,829	\$107,801
Foreign	23,414	30,633	(9,403)
	(\$239,226)	\$100,462	\$ 98,398

The provision (benefit) for income taxes consists of:

Current			
Federal	\$ 9,222	(\$ 28,754)	(\$ 82,348)
Foreign	22,568	12,651	2,072
State	2,532	5,244	7,072
Deferred	(28,375)	54,761	115,273
	\$ 5,947	\$ 43,902	\$ 42,069

Deferred income taxes (benefits) have been provided for as follows:

	1988	1987	1986
Long-term contracts	\$ —	\$12,223	\$ 3,640
Adjustments to facilities and operations	—	25,093	79,438
Depreciation	—	11,249	1,483
Undistributed earnings	—	—	12,756
Investment in Vetco Gray Inc.	—	—	19,384
Other	—	6,196	(1,428)
Reduction of deferred tax requirements from utilization of net operating loss carryforwards			
State	(5,687)	—	—
Federal	(22,688)	—	—
	(\$28,375)	\$54,761	\$115,273

The Company's effective income tax rate differed from the Federal statutory rate as follows:

Federal statutory rate	(34.0%)	40.0%	46.0%
Depletion	(2.2)	(6.6)	(6.6)
Goodwill amortization	1.1	2.5	0.4
Foreign operations	6.0	6.7	(3.2)
Foreign losses without income tax benefit	3.2	—	—
Investment tax credit	1.2	(2.5)	(0.9)
Minimum tax	—	—	5.1
State income taxes	(1.3)	3.1	3.9
Losses without income tax benefit	27.8	—	—
Other	0.7	0.5	(1.9)
	2.5%	43.7%	42.8%

At December 31, 1988, the Company has approximately \$196,000 and \$47,000 of domestic and foreign net operating loss carryforwards for financial reporting purposes, which expire in 2003 and beginning in 1992, respectively and approximately \$13,000 of foreign tax credit carryforwards which expire in 1990.

At December 31, 1988, the Company has approximately \$27,000 and \$12,000 of foreign and investment tax credit carryforwards, respectively, for income tax reporting purposes which expire beginning in 1991 and beginning in 2001, respectively. Domestic and foreign net

operating loss carryforwards of approximately \$50,000 and \$52,000 expire in 2003 and beginning in 1990, respectively.

In December 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 96 "Accounting for Income Taxes" (SFAS 96). In December 1988, the Board amended SFAS 96 (through SFAS 100) by delaying its effective date for financial statements issued for fiscal years beginning on or after January 1, 1990. Adoption of the new standard will result in a cumulative adjustment that will be reported in the year the standard is implemented. This adjustment is not expected to be significant.

10. Common Shareholders' Equity

Shareholder Rights Plan

On December 19, 1988, the Board of Directors of the Company declared a dividend distribution of one Preferred Stock Purchase Right (the Right(s)) on each outstanding share of the Company's common stock. The Rights were granted to shareholders of record on December 30, 1988 and are not taxable to shareholders. One Right will also be issued with each additional share of the Company's common stock which becomes outstanding prior to the earliest of the time the Rights become exercisable, expire or are redeemed.

In general, each Right entitles the holder to purchase a fractional share of a new series of preferred stock of the Company at a specified exercise price. The Rights will only become exercisable ten days after a person or group: (a) acquires shares of the Company's stock having 20% or more of the general voting power; (b) commences a tender offer that would result in such person or group owning shares having ownership of 20% or more of the voting power or (c) has become the

beneficial owner of a substantial amount of common stock and the independent directors determine such ownership adverse to the best interests of the Company and its shareholders. If any person becomes the beneficial owner of 20% or more of the Common Stock, other than pursuant to an offer which is fair to and in the best interest of the Company and its shareholders, or if the Board declares a person's substantial ownership of shares to be adverse, each Right not owned by such person will entitle the holder to purchase, for the exercise price, a number of shares of Common Stock having a market value of twice the exercise price. In addition, if the Company is involved in a merger or other business combination in which its shares are changed or converted, each Right will entitle its holder to purchase, for the exercise price, a number of shares of the acquiring or surviving company's common stock having a market value of twice the exercise price.

Thrift and Dividend Reinvestment Plan

During 1988, the Company revised its thrift plan to allow the Company to issue common stock to this plan in lieu of cash contributions. In addition, on July 8, 1988, the Company filed a registration statement, with respect to 200,000 shares of its Common Stock, to be used in

connection with the Company's Dividend Reinvestment Plan. During 1988, the Company issued 306,171 and 51,005 shares of common stock to the thrift and dividend reinvestment plans, respectively.

11. Stock Incentives

The "1982 Stock Option Plan", which was approved by the Shareholders on April 27, 1982, provides for the granting to officers and other salaried employees of the Company options to purchase 1,821,396 shares of its Common Stock and related Stock Appreciation Rights (SARs). The payment may be in shares, cash, or a combination of both,

at the discretion of the Compensation Committee of the Board of Directors. Options are granted at no less than fair market value at the time of grant for a period not in excess of ten years.

Combined information with respect to stock options is as follows:

	Shares
Options outstanding, January 1, 1988	1,780,209
Granted	1,750
Cancelled	(221,681)
Exercised (\$17.00 to \$33.25 per share)	
Shares	(52,097)
SARs	(40,000)
Options outstanding, December 31, 1988 (\$25.25 to \$40.375 per share)	1,468,181
Currently exercisable, December 31, 1988	1,128,081

At December 31, 1988, 458,614 SARs are outstanding, of which 451,114 are exercisable. Under the plan, either the option or the related SARs may be exercised. In addition, there are 402,700 stand-alone SARs outstanding exercisable only for cash, of which 172,500 are currently exercisable. At December 31, 1988 and 1987, there were 290,971 and 71,040 common shares, respectively, available for grant.

During 1988, the Company established a restricted stock plan for senior executives, limited to 500,000 shares and non-employee direc-

tors, limited to approximately 100,000 shares. During 1988, the Company granted, under both plans, 265,340 shares at no cost. The deferred compensation expense represents the market value of the Company's Common Stock at the date of grant and is recognized ratably over the vesting period, which cannot exceed five years. The restricted shares are considered issued and outstanding.

12. Commitments and Contingent Liabilities**Contingent Liabilities**

It is customary in the Company's industries to issue financial guarantees and guarantees of Company performance on major projects. Provisions are made in the financial statements at the time it becomes likely that the Company will become liable under such guarantees.

Pending Litigation

On June 26, 1987, the participants in the Arizona Nuclear Power Project filed a complaint against the Company relating to a 1973 contract under which the Company supplied three nuclear steam supply systems to the participants for the project. The complaint alleges breach of contract and breach of warranty with respect to the reactor coolant systems and the low pressure safety injection system pumps and certain other items of equipment and service, which breaches are alleged to have caused millions of dollars of project delay expenses and unreimbursed costs. The Company believes that it has meritorious defenses and that the resolution of plaintiffs' claims is not

likely to have a material adverse effect upon the Company's financial condition.

The Company was included in approximately 12,300, 16,300 and 10,850 personal injury claims asserted nationwide in asbestos-related litigation in 1988, 1987 and 1986, respectively. As of December 31, 1988, 15,691 claims were pending. It can be expected that a substantial number of additional asbestos-related claims will continue to be asserted against the Company.

Although the amount of liability, if any, at December 31, 1988, with respect to the actions then pending to which the Company is party cannot be ascertained, in the opinion of the Company, any resulting liability will not materially affect the Company's consolidated financial position.

Long-term Leases

Total rent, other than on capital leases, charged to expense was \$53,311, \$48,553 and \$43,382 in 1988, 1987 and 1986, respectively.

At December 31, 1988, the approximate minimum future payments under capital leases and noncancelable operating leases are:

	Capital Leases	Noncancelable Operating Leases
1989	\$ 3,668	\$ 43,086
1990	3,748	37,543
1991	4,737	30,884
1992	1,007	22,750
1993	698	13,471
After 1993	872	40,253
Total minimum lease payments	14,730	<u>\$187,987</u>
Less — Amount representing interest	2,370	
Present value of net minimum lease payments	<u>\$12,360</u>	

The present value of net minimum lease payments, less the current portion of \$2,906, is classified in Other Liabilities.

Noncancelable operating leases consist predominantly of office

space leases at numerous locations, mainly within the United States and Canada.

13. Post Employment Benefits

The Company has retirement plans or makes contributions to multi-employer union pension plans which cover substantially all employees. The plans are defined benefit plans, certain of which are entirely non-contributory and others which permit employee contributions toward the cost of current service benefits. Under the terms of the plans, retirement benefit calculations take into consideration, among other things, years of credited service and compensation levels. Plans covering salaried employees were amended in late 1988 to provide for individual accounts which offer lump sum or annuity payment options, with benefits based on accumulated compensation and interest credits made monthly throughout the career of each participant, with an initial opening credit based on the value of retirement benefits accrued prior to the date of such amendment.

The Company's funding policy is to make an annual contribution equal to or exceeding the minimum required by the Employee Retirement Income Security Act of 1974 (ERISA) as amended.

In 1986, the Company adopted Statement of Financial Accounting Standards No. 87 "Employers' Accounting for Pensions" (SFAS 87) for its United States pension plans. The effect of this change was to decrease pension expense by \$15,677 in 1986.

Effective January 1, 1988, the Company has adopted SFAS 87 for all hourly and salaried pension plans in Canada. Adoption for foreign pension plans is not required until 1989 with early adoption allowed on a country-by-country basis. The effect of this adoption was not material to the Company's financial condition and results of operations.

The actuarial present value of the benefit obligation and the funded status of the Company's various United States and Canadian pension plans at December 31 was:

	1988			1987
	Total Plans	Canadian Plans	U.S. Plans	Total U.S. Plans
Estimated amount of assets required to provide funds for future payment of:				
Projected benefits based on employment service to date and present pay levels				
Vested	\$509,104	\$15,198	\$493,906	\$491,203
Non-vested	8,923	322	8,601	11,233
Accumulated benefit obligation	518,027	15,520	502,507	502,436
Additional amounts related to assumed pay increases	59,306	1,025	58,281	29,863
Projected benefit obligation	577,333	16,545	560,788	532,299
Funded assets at fair value	603,523	26,690	576,833	563,321
Assets in excess of projected benefit obligation	26,190	10,145	16,045	31,022
Unamortized net transition asset	(52,261)	(8,759)	(43,502)	(54,683)
Unrecognized net gain	(15,571)	(32)	(15,539)	(8,000)
Unrecognized prior service cost	13,355	—	13,355	563
Prepaid (accrued) pension cost	(\$ 28,287)	\$ 1,354	(\$ 29,641)	(\$ 31,098)

Generally, pension funds are invested in various fixed income and equity securities, and held in trust by a major money center bank. The 1988 and 1987 actuarial computations, which used the "projected unit credit" method, assumed a discount rate on benefit obligations of 9.5%, expected long-term rates of return on plan assets of 9.5% and annual compensation increases of 6% over the average remaining

service lives of employees under the plans. Variances between actual experience and assumptions are amortized over the remaining service lives of the employees in the plans in accordance with the provisions of SFAS 87.

The components of net periodic pension cost for United States and Canadian plans were:

	1988			1987
	Total Plans	Canadian Plans	U.S. Plans	Total U.S. Plans
Service cost — benefits earned during the year	\$10,181	\$ 518	\$ 9,663	\$11,376
Interest cost on projected benefit obligations	51,100	1,505	49,595	47,674
Actual return on plan assets	(69,848)	(2,565)	(67,283)	(2,407)
Net amortization, estimated gains and other deferred items	17,666	191	17,475	(52,564)
Amortization of net transition asset	(3,929)	(959)	(2,970)	(3,778)
Net periodic pension cost (income) for the year	\$ 5,170	(\$1,310)	\$ 6,480	\$ 301

Total pension costs for all plans aggregated \$19,535, \$15,002 and \$10,458 in 1988, 1987 and 1986, respectively. Included in 1988, 1987 and 1986, respectively, are amounts for multi-employer union pension plans which approximated \$8,256, \$7,475 and \$6,900 and amounts for foreign pension plans which continue to be accounted for under prior guidelines.

The Company provides certain health care and life insurance benefits for domestic retired employees. These costs which approximated \$16,654, \$14,946 and \$13,251 in 1988, 1987 and 1986, respectively, are charged to operations as incurred.

14. Investment in Vetco Gray Inc.

In November 1986, Hughes Tool Company (Hughes) acquired the Company's Vetco/Gray operations. These operations became part of a subsidiary (Vetco Gray Inc.) of which Hughes owned 80.1% of the common stock (VG Common Shares) and to which Hughes contributed its Hughes offshore operations. In exchange for the Vetco/Gray operations, the Company received 19.9% of the VG Common Shares, 2,955,878 shares of preferred stock (VG Preferred Shares) with an initial liquidation value of \$50 per share (an aggregate of approximately \$148,000) and \$110,000 from bank borrowings made by Vetco Gray Inc. The investment in VG Preferred Shares and VG Common Shares is carried in the consolidated balance sheet at cost.

In April 1987, Baker International Corporation and Hughes consummated a merger of the two companies into Baker Hughes Incorporated (Baker Hughes). In June 1988, Baker Hughes sold 70.1% of the VG Common Shares to Bain Venture Capital (Bain).

The VG Preferred Share dividends for each year are to be approximately 50% of Vetco Gray Inc.'s net income (subject to certain adjustments) for the year. Vetco Gray Inc. is obligated to redeem 295,588 VG Preferred Shares on December 31 of each year, commencing December 31, 1992. The redemption price per share for that redemption date is \$51.40 and increases by \$1.25 for each subsequent redemption date, plus, in each case, any accumulated unpaid dividends. In addition, VG Preferred Shares under certain circumstances are subject to earlier redemption at the option of the holder or may be redeemed or purchased by Vetco Gray Inc. or Bain. The VG Common Shares held by the Company are exchangeable, pursuant to warrants of Baker

Hughes, for shares of Baker Hughes Common Stock after the later of October 1, 1991, or the date on which at least one VG Preferred Share has been redeemed. Baker Hughes has options to purchase the shares of its common stock issued pursuant to the warrants and the VG Common Shares held by the Company. Bain also has an option to purchase the VG Common Shares upon redemption or purchase of all of the VG Preferred Shares.

In 1988, Vetco Gray Inc. issued 20,000 additional VG Preferred Shares to the Company, valued at \$1,000, as a settlement for various trade payables owed to the Company. The liquidation value of these shares is \$50 per share redeemable on December 31, 2001.

During 1987, Vetco Gray Inc. began a significant restructuring of its worldwide operations. Additionally, the worldwide oil and gas markets continued to be depressed. As a result of these factors, Vetco Gray Inc. reported a significant loss for the year 1987, including charges relating to the restructuring program. As a result of the above restructuring, cost savings and an improving market, 1988 operating results have improved significantly over the same period last year.

As of December 31, 1988 and 1987, the Company had guaranteed \$60,000 and \$78,000, respectively, of Vetco Gray Inc. debt of which \$52,000 is outstanding at December 31, 1988. The Company's rights to receive payments and exercise certain rights in respect to VG Preferred Shares are subordinate to the rights of the lenders under certain circumstances.

15. Discontinued Operations

In 1985, the Company announced that it would sell major portions of its oil and gas equipment and services operations and provided a pre-tax provision of \$120,812 (\$79,599 after-tax or \$2.39 per share). In 1986, the Company provided an additional \$5,463 for losses net of a tax benefit of \$2,140 as a result of continued weakness in the markets

served by these operations.

Revenues and income (losses) from these operations were \$291,065 and \$147 in 1988, \$258,940 and \$178 in 1987 and \$501,603 and (\$5,463) in 1986.

Net assets of discontinued operations include:

December 31,	1988	1987
Current assets	\$ 79,591	\$105,128
Current liabilities	44,765	68,684
Working capital	34,826	36,444
Capital assets	47,375	64,571
Other, net	23,796	13,651
	<u>\$105,997</u>	<u>\$114,666</u>

16. Business Segments

Information with respect to the revenues, operating income (loss), identifiable assets, depreciation and amortization and additions to capital assets of the Company's principal business segments is con-

tained on page 30. Significant financial data by geographic area follows (1):

December 31,	1988	1987	1986
Net sales (2) —			
United States			
Domestic sales	\$2,106,269	\$2,034,798	\$1,784,412
Export sales (4)	560,020	383,663	357,416
	<u>2,666,289</u>	<u>2,418,461</u>	<u>2,141,828</u>
Canada	334,398	255,439	217,966
Europe	365,953	293,344	155,582
Other foreign	117,288	74,830	36,083
	<u>\$3,483,928</u>	<u>\$3,042,074</u>	<u>\$2,551,469</u>
Net income (loss) —			
United States	(\$ 265,642)	\$ 40,727	\$ 74,634
Canada	(26,426)	979	(6,594)
Europe	29,443	6,664	(13,438)
Other foreign	17,452	8,190	1,727
	<u>(\$ 245,173)</u>	<u>\$ 56,560</u>	<u>\$ 56,329</u>
Identifiable assets (3) —			
United States	\$1,903,401	\$2,045,843	\$1,785,752
Canada	111,540	128,995	96,830
Europe	317,693	279,623	161,539
Other foreign	107,204	134,603	108,485
	<u>\$2,439,838</u>	<u>\$2,589,064</u>	<u>\$2,152,606</u>

(1) Data presented for geographic areas outside of the United States includes operations of foreign subsidiaries and operations of domestic subsidiaries located in foreign areas.

(2) Includes only sales to unaffiliated customers (intergeographic sales are not significant).

(3) Excludes the net assets of discontinued operations.

(4) Includes United States export sales by geographic area as follows:

Europe, Middle East and Africa	\$ 221,881	\$ 172,847	\$ 178,805
Canada, Central and South America	99,065	57,143	56,102
Far East	239,074	153,673	122,509
	<u>\$ 560,020</u>	<u>\$ 383,663</u>	<u>\$ 357,416</u>

17. Business Acquisitions and Dispositions

1988

In September, the Company completed the sale of its investment in Jamesbury Corp., a manufacturer and supplier of high-performance valves including Hammel Dahl, Inc., a manufacturer of control valves, realizing net proceeds of approximately \$136,000 resulting in a pretax gain of approximately \$36,800. In June, the Company had purchased the remaining 70% of Hammel Dahl, Inc. which was previously accounted for as an equity investee.

In November, the Company acquired the assets of Energy Systems Group (ESG) from Systems Control Inc., using the purchase method of accounting, for approximately \$15,235. ESG specializes in energy management and supervisory control systems which are used for data acquisition, analysis and control in optimizing electrical power grids, including distribution and transmission networks. The operating results of ESG have been consolidated with those of the Company since its date of acquisition. Had ESG been acquired at the beginning of 1987, the pro forma effect on results of operations (including financing costs) would not have been material.

In December, the Company signed an agreement for the disposition of its C-E Natco, C-E Invalco, Premier Refractories and Chemicals (formerly C-E Refractories) and C-E Tyler businesses for estimated proceeds of \$90,000 which approximates net book value. The transaction is scheduled to be completed during the first quarter of 1989.

In February 1989, the Company signed an agreement for the sale of its Vetco Services oil and gas operations for an amount in excess of its net book value.

1987

In January, the Company acquired AccuRay Corporation (AccuRay), a leading supplier of control technology primarily to the pulp and paper industry, using the purchase method of accounting, for approximately \$206,000 plus associated costs. The Company's acquisition of AccuRay resulted in approximately \$170,000 of goodwill.

On a pro forma basis, assuming that the Company had acquired AccuRay as of January 1, 1986, the Company's 1986 sales would have increased from \$2,551,469 to \$2,701,900 and income from continuing operations would have decreased from \$56,329 to \$41,800 (equivalent to \$1.69 and \$1.26 per share, respectively). The operating results of AccuRay have been consolidated with those of the Company since January 1987.

During 1987, the Company made the following additional acquisitions, using the purchase method of accounting:

In April, the Company acquired Bell Technical Operations Corporation, expanding the Company's operations and maintenance services business to include technical services for governmental clients.

In May, the Company acquired the E.C. Jordan operations adding consulting, engineering and design services to the Company's remedial services and waste treatment systems and analysis business.

In August, the Company expanded its process automation business through the acquisition of the operations of Afora Ltd., a company based in Finland. Afora Ltd.'s operations include advanced, on-line, sensing devices and pulpmill optimization software.

In September, the Company acquired certain assets and business operations from Lurgi Corporation of River Edge, New Jersey (Lurgi CFB).

The operating results of Bell Technical Operations Corporation, E.C. Jordan, Afora Ltd. and Lurgi CFB have been consolidated with those of the Company since their respective dates of acquisition. Had these acquisitions been consummated at the beginning of 1987 and 1986, the pro forma effect on results of operations (including financing costs) would not have been material. Aggregate costs of these acquisitions were approximately \$60,000.

1986

In August, the Company acquired the Sprout-Waldron division of Koppers Company, Inc. for approximately \$37,000.

Report of Independent Public Accountants

To the Board of Directors and Shareholders of Combustion Engineering, Inc.:

We have audited the accompanying consolidated balance sheet of Combustion Engineering, Inc. (a Delaware corporation) and subsidiary companies as of December 31, 1988 and 1987, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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 financial statements referred to above present fairly, in all material respects, the financial position of Combustion Engineering, Inc. and subsidiary companies as of December 31, 1988 and 1987, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1988, in conformity with generally accepted accounting principles.

As explained in Note 13 to the financial statements, effective January 1, 1986, the Company changed its method of accounting for pension costs.

Stamford, Connecticut
February 17, 1989

Arthur Andersen & Co.

18. Quarterly Financial Data (Unaudited)

Summarized quarterly financial data is as follows:

1988	First	Second	Third(1)	Fourth(2)	Total
Net sales	\$756,133	\$907,739	\$897,149	\$922,907	\$3,483,928
Operating income (loss)	\$ 30,549	\$ 36,652	(\$ 114,165)	(\$ 148,084)	(\$ 195,048)
Net income (loss)	\$ 13,638	\$ 15,205	(\$ 91,747)	(\$ 182,269)	(\$ 245,173)
Earnings (loss) per share of common stock	\$.36	\$.40	(\$ 2.39)	(\$ 4.72)	(\$ 6.40)
Dividends declared	\$.25	\$.25	\$.25	\$.25	\$ 1.00
Common stock price					
High	\$37½	\$36	\$36	\$32	
Low	28⅞	29⅞	30¾	25¾	
1987	First(3)	Second(4)	Third(5)	Fourth	Total
Net sales	\$638,901	\$716,822	\$791,224	\$895,127	\$3,042,074
Operating income	\$ 25,457	\$ 29,267	\$ 35,636	\$ 41,710	\$ 132,070
Net income	\$ 11,012	\$ 12,688	\$ 15,322	\$ 17,538	\$ 56,560
Earnings per share of common stock	\$.33	\$.34	\$.40	\$.46	\$ 1.54
Dividends declared	\$.25	\$.25	\$.25	\$.25	\$ 1.00
Common stock price					
High	\$40¾	\$38¼	\$45¾	\$45¾	
Low	31¼	32¾	36¾	22¾	

Due to changes in the number of shares outstanding, quarterly earnings per share of common stock do not add to the total for the year.

- (1) Includes a \$147,500 provision primarily for: (a) the recognition of increases in estimated costs to complete waste-to-energy plants and fluid bed power plants both involving new, first-time technologies; (b) cost overruns on other fossil fuel systems contracts administered in the United States and in Canada and (c) the estimated costs to repair the boilers in the Hartford, Connecticut waste-to-energy plant which experienced tube failures due to corrosion, and the cost of related modifications required on two other plants under construction. In the third quarter of 1988, the Company completed its previously announced sale of Jamesbury Corp., realizing net proceeds of approximately \$136,000 resulting in a pretax gain of approximately \$36,800. In addition, the Company recorded a pretax provision of \$14,000 in connection with the anticipated losses on the potential sale of other businesses and a \$5,400 pretax gain from the sale of a foreign equity basis investment.
- (2) Includes a \$125,300 provision for recognition of increases, resulting from the reestimation process for costs, to complete waste-to-energy plants and fluid bed power plants and restructuring charges for the Power Generation segment. In addition, the Company recorded a charge of \$11,000 to reflect the change in useful lives of capitalized software.
- (3) Includes a \$7,700 provision for restructuring the Power Generation segment, offset by a gain from the sale of the Company's investment in Northern Engineering Industries PLC.
- (4) Includes a \$20,000 charge to reduce to estimated realizable value the carrying value of the Company's investment in and advances to an ethanol joint venture, partially offset by gains from the sales of a foreign investment held at cost and a portion of the Company's investment in Westwood Energy Properties Limited Partnership.
- (5) Includes a \$12,000 charge to reduce to estimated realizable value the carrying value of the Company's investment in and advances to an ethanol joint venture.

Summary of Operations

(Dollars in thousands, except per share amounts)	1988(1)	1987	1986	1985(2)	1984	1983(2)
Net sales	\$3,483,928	\$3,042,074	\$2,551,469	\$2,407,658	\$2,331,734	\$2,272,598
Operating income (loss)	(195,048)	132,070	113,816	(22,922)	98,355	20,062
Interest, net	(44,178)	(31,608)	(15,418)	2,521	20,465	41,086
Income (loss) from continuing operations before income taxes	(239,226)	100,462	98,398	(20,401)	118,820	61,148
Income taxes (3)	5,947	43,902	42,069	(19,037)	10,575	10,799
Income (loss) from continuing operations	(245,173)	56,560	56,329	(1,364)	108,245	50,349
Loss from discontinued operations (4)	—	—	(5,463)	(94,049)	(8,675)	(70,724)
Net income (loss)	(\$ 245,173)	\$ 56,560	\$ 50,866	(\$ 95,413)	\$ 99,570	(\$ 20,375)
Earnings (loss) per share of common stock						
Continuing operations	(\$ 6.40)	\$ 1.54	\$ 1.69	(\$.04)	\$ 3.26	\$ 1.51
Discontinued operations (4)	—	—	(.16)	(2.83)	(.26)	(2.12)
Net income (loss)	(\$ 6.40)	\$ 1.54	\$ 1.53	(\$ 2.87)	\$ 3.00	(\$.61)
Average number of common shares (In thousands)	38,309	36,645	33,241	33,193	33,152	33,110
Dividends declared						
Total	\$ 38,409	\$ 37,996	\$ 33,264	\$ 47,164	\$ 61,033	\$ 60,991
Per share	1.00	1.00	1.00	1.42	1.84	1.84

(1) A provision of \$272,800 was included in operating loss in 1988 for the recognition of: (a) increases in estimated costs to complete waste-to-energy plants and fluid bed power plants both involving new, first-time technologies; (b) cost overruns on other fossil fuel systems contracts administered in the United States and in Canada; (c) the estimated costs to repair the boilers in the Hartford, Connecticut waste-to-energy plant which experienced tube failures due to corrosion, and (d) the cost of related modifications required on two other plants under construction, and (d) restructuring charges for the Power Generation segment.

(2) Provisions of \$92,070 and \$109,100 were included in operating income (loss) in 1985 and 1983, respectively, for the following purposes: (a) adjustments to facilities to improve overall cost effectiveness and to reduce the Company's productive capacity in several business segments; (b) to reduce to estimated realizable value the carrying value of certain operations in distressed markets and (c) in 1985, to record the costs of an early retirement program.

(3) Includes in 1984, \$32,200 (\$.97 per share) from the waiver of DISC deferred taxes provided in prior years.

(4) In September 1985, the Company announced plans to sell major portions of its oil and gas equipment and services operations. Accordingly, the results of those operations and the estimated loss on disposition have been classified as discontinued operations for all periods presented (see Note 15 of the Notes to Consolidated Financial Statements).

Financial Position and Other Data

(Dollars in thousands, except per share amounts)	1988	1987	1986	1985	1984	1983
Financial Position						
Working capital	(\$ 270,686)	\$ 42,215	(\$ 44,230)	(\$ 338,430)	(\$ 127,286)	(\$ 36,120)
Capital assets	571,369	630,064	559,609	528,373	516,876	463,599
Investments	344,645	353,415	358,124	523,498	577,242	612,654
Total assets	2,545,835	2,703,730	2,268,027	2,161,118	2,306,654	2,366,453
Deferred income taxes	20,779	175,322	156,779	20,368	166,079	204,044
Long-term debt	316,046	293,957	86,362	78,110	55,743	54,726
Long-term lease obligations	9,454	13,590	9,570	10,672	11,936	11,412
Common shareholders' equity						
Amount	593,188	862,461	686,879	664,104	795,787	769,195
Per share (1)	15.33	22.67	20.65	20.00	24.00	23.21
Other Data						
Return on equity	(33.7%)	7.3%	7.5%	(13.1%)	12.7%	(2.5%)
Return on sales	(7.0%)	1.9%	2.2%	(0.1%)	4.6%	2.2%
Current ratio	.8	1.0	1.0	.8	.9	1.0
Long-term debt to capital	34.6%	22.9%	10.2%	11.5%	6.6%	6.4%
Capital expenditures	\$ 98,451	\$ 93,769	\$ 96,769	\$ 91,647	\$ 60,888	\$ 51,897
Depreciation and amortization	110,064	88,652	71,124	69,009	63,665	60,967
Bookings	3,641,663	3,865,162	3,042,360	2,095,564	2,319,002	1,900,913
Backlog	3,704,502	3,620,517	2,766,512	2,175,405	2,430,466	2,199,370
Employees	28,832	27,581	24,149	24,761	27,642	26,212
Shareholders of record	25,369	25,854	28,014	30,646	32,361	32,955

(1) Based on net assets and common shares outstanding at year end.

Board of Directors

Lucy Wilson Benson (1987)^{††}

President
Benson & Associates

Walter H. Helmerich, III (1981)^{††}

Chairman and Chief Executive Officer
Helmerich & Payne, Inc.

Charles E. Hugel (1982)*

Chairman and Chief Executive Officer
Combustion Engineering, Inc.

Robert M. Jenney (1963)^{††}

Trustee, Jenney Oil Trust

George S. Kimmel (1981)

President and Chief Operating Officer
Combustion Engineering, Inc.

Paul W. MacAvoy (1980)^{††}

Dean, William E. Simon Graduate School
of Business Administration
University of Rochester

Scott L. Probasco, Jr. (1960)

Chairman of the Board
American National Bank and Trust Company

Arthur J. Santry, Jr. (1957)*^{††}

Retired Chairman of the Board
Combustion Engineering, Inc.

Robert C. Seamans, Jr. (1977)*

Senior Lecturer, Department of Aeronautics
and Astronautics
Massachusetts Institute of Technology

Robert G. Stone, Jr. (1963)*

Chairman of the Board
Kirby Exploration Company, Inc.

Kenneth J. Whalen (1984)*

Retired Executive Vice President
American Telephone & Telegraph Company

David R. Whitwam (1987)

Chairman and Chief Executive Officer
Whirlpool Corporation

Director Emeritus

James F. Thomson

*Member of the Executive Committee
Robert G. Stone, Jr., Chairman

^{††}Member of the Audit Committee
Walter H. Helmerich, III, Chairman

Date following name indicates the year first elected Director

Officers

Charles E. Hugel

Chairman and Chief Executive Officer

George S. Kimmel

President and Chief Operating Officer

Charles E. Barnett

Vice President and General Counsel

William J. Connolly

Vice President – Corporate
and Investor Relations

Robert E. Kistner

Vice President – Information Systems and Services

Robert H. Masson

Vice President – Venture Finance
and International

Jeffrey S. Rubin

Vice President – Finance

Jack T. Sanderson

Vice President – Corporate Technology

Dale E. Smith

Vice President – Human Resources and Operations Support

Bernard J. Garry

Secretary

Preston E. Insley

Controller

Fred R. Jones

Treasurer

Shareholder Information

Combustion Engineering provides engineered products, systems and services to the worldwide power, process and public sector markets.

World Headquarters

Combustion Engineering, Inc.

900 Long Ridge Road

Post Office Box 9308

Stamford, Conn. 06904

Telephone: (203) 329-8771

Telex: 965950 (COMBENG STD)

Fax: (203) 328-2263

Form 10-K

The Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission may be obtained after March 31, 1989, by writing to the Office of the Secretary at the above address.

Transfer Agents and Registrars

The Chase Manhattan Bank, N.A.

One New York Plaza, New York, N.Y. 10081

The Connecticut Bank and Trust Company

One Constitution Plaza, Hartford, Conn. 06115

Shareholder Inquiries

Shareholder inquiries concerning name or address changes, stock transfers, dividend mailings or consolidation of accounts should be directed to The Chase Manhattan Bank at the above address.

Questions on other matters related to your holdings should be directed to the Corporate Secretary at the Company headquarters address at the head of this column.

Annual Meeting

Shareholders are cordially invited to attend the Company's Annual Meeting, which will be held Thursday, April 27, 1989, at 10:30 a.m., in the Baroque Room of The Plaza, Fifth Avenue at 59th Street, New York, N.Y.

Securities Listing

The Common Stock and 7.45% Sinking Fund Debentures due 1996 are listed on the New York Stock Exchange.

Ticker Symbol for Common Stock: CSP

The Company's daily trading activity and common stock price may be found in the financial section of most major U.S. newspapers under: CmbEn.

Dividend Reinvestment Plan

Combustion Engineering's Dividend Reinvestment Plan enables shareholders to use dividend payments to buy shares of common stock without incurring bank service charges or brokerage commissions. Authorization forms for participation are available from:

The Chase Manhattan Bank, N.A.

Dividend Reinvestment Service

Post Office Box 283

Bowling Green Station

New York, N.Y. 10274

The high gloss paper used in this Annual Report is coated with Georgia Kaolin™ clay. The uncoated sheets contain Georgia Kaolin filler clay. Both are specialty mineral products supplied by Combustion Engineering.

The names Combustion Engineering, C-E, or the Company, as used in this publication, refer to Combustion Engineering, Inc., or its subsidiaries.

Public Broadcasting Television Series

CONSERVING AMERICA
Combustion Engineering is continuing its sponsorship of the public television series *Conserving America*. Two new programs, produced in conjunction with the National Wildlife Federation, the Richard King Mellon Foundation and public broadcast station WQED/Pittsburgh, will be presented. *Champions of Wildlife* is scheduled for broadcast in most areas March 22 on the Public Broadcasting System. It features people dedicated to saving endangered species. Later in the year, *Conserving America* will examine efforts underway to protect the nation's coastlines from the pressures of urban growth.