

HALLWOOD GROUP INC

Form 10-K/A

November 06, 2007

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

Form 10-K/A

MARK ONE

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM _____ TO _____

For the Year Ended December 31, 2006

Commission File Number: 1-8303

The Hallwood Group Incorporated
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

51-0261339
(I.R.S. Employer
Identification Number)

3710 Rawlins, Suite 1500, Dallas, Texas
(Address of principal executive offices)

75219
(Zip Code)

Registrant's telephone number, including area code: (214) 528-5588

Securities Registered Pursuant to Section 12(b) of the Act:

| Title of Class | Name of Each Exchange On Which Registered |
|---------------------------------|--|
| Common Stock (\$0.10 par value) | American Stock Exchange |

Securities Registered Pursuant to Section 12(g) of the Act:

Title of Class
Series B Redeemable Preferred Stock

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

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The aggregate market value of the Common Stock, \$0.10 par value per share, held by non-affiliates of the registrant as of June 30, 2006, based on the closing price of \$112.53 per share on the American Stock Exchange, was \$55,075,000.

1,516,711 shares of Common Stock, \$0.10 par value per share, were outstanding at March 23, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

The information called for by Part III is incorporated by reference to the definitive Proxy Statement for the Annual Meeting of Stockholders of the Company filed with the Securities and Exchange Commission on May 14, 2007.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
EXPLANATORY NOTE**

This Amendment No. 1 (the Amendment) amends The Hallwood Group Incorporated's (the Company) Annual Report on Form 10-K for the year ended December 31, 2006 filed on May 14, 2007 (the Original Filing) to address comments received from the Staff of the Securities and Exchange Commission (SEC Comments). This Amendment amends the report of Deloitte & Touche LLP (Deloitte), the Company's independent registered public accounting firm, with respect to Hallwood Energy, L.P., which report inadvertently omitted the city and state in which the report was issued. This Amendment also amends the consent of Deloitte filed as Exhibit 23.1 to the Original Filing, which inadvertently did not refer to Deloitte's report with respect to the consolidated financial statements of Hallwood Energy, L.P. included in the Original Filing. The remainder of the Original Filing, excluding Item 15, is unchanged and is not reproduced in this Amendment No. 1. This Amendment No. 1 speaks as of the filing date of the Original Filing and reflects only the provision of the updated certifications of the Company's officers and the amended report and consent of Deloitte as noted above. No other information included in the Original Filing, including the Company's financial statements and the footnotes thereto, has been modified or updated in any way to reflect any events that occurred subsequent to May 14, 2007.

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**PART IV
PART IV**

Item 15. *Financial Statements, Financial Statement Schedules and Exhibits*

Reference is made to the Index to Financial Statements and Schedules appearing after the signature page hereof.

1. Financial Statements.

Included in Part II, Item 8 of this report are the following

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets, December 31, 2006 and 2005
Consolidated Statements of Operations, Years ended December 31, 2006, 2005 and 2004
Consolidated Statements of Comprehensive Income, Years ended December 31, 2006, 2005 and 2004
Consolidated Statements of Changes in Stockholders' Equity, Years ended December 31, 2004, 2005 and 2006
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2. Financial Statement Schedules.

- I. Condensed Financial Information of Registrant
- II. Valuation and Qualifying Accounts and Reserves

All other schedules are omitted since the required information is not applicable or is included in the consolidated financial statements or related notes.

Financial Statements of Hallwood Energy, L.P. and Subsidiaries

Consolidated Financial Statements for the Years Ended December 31, 2006, 2005 and 2004 (unaudited) and Report of Independent Registered Public Accounting Firm

3. Exhibits.

(a) *Exhibits.*

- 3.1 Second Restated Certificate of Incorporation of The Hallwood Group Incorporated, is incorporated herein by reference to Exhibit 4.2 to the Company's Form S-8 Registration Statement, filed on October 26, 1995 File No. 33-63709.
- 3.2 Amendment to Second Restated Certificate of Incorporation of The Hallwood Group Incorporated, is incorporated herein by reference to Exhibit 2.2 to the Company's Form 8-K filed on May 14, 2004, File No. 1-8303.
- 3.3 Restated Bylaws of the Company is incorporated herein by reference to Exhibit 3.2 to the Company's Form 10-K for the year ended December 31, 1997, File No. 1-8303.
- *10.1 Employment Agreement, dated January 1, 1994, between the Company and Melvin John Melle, as incorporated by reference to Exhibit 10.9 to the Company's Form 10-K for the fiscal year ended July 31, 1994, File No. 1-8303.
- 10.2 Tax Sharing Agreement, dated as of March 15, 1989, between the Company and Brookwood Companies Incorporated is incorporated herein by reference to Exhibit 10.25 to the Company's Form 10-K for the fiscal year ended July 31, 1989, File No. 1-8303.
- *10.3 Amended Tax-Favored Savings Plan Agreement of the Company, effective as of February 1, 1992, is incorporated herein by reference to Exhibit 10.33 to the Company's Form 10-K for the fiscal year ended July 31, 1992, File No. 1-8303.

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- *10.4 Hallwood Special Bonus Agreement, dated as of August 1, 1993, between the Company and all members of its control group that now, or hereafter, participate in the Hallwood Tax Favored Savings Plan and its related trust, and those employees who, during the plan year of reference are highly-compensated employees of the Company, is incorporated herein by reference to Exhibit 10.34 to the Company's Form 10-K for the fiscal year ended July 31, 1994, File No. 1-8303.
- *10.5 Financial Consulting Agreement, dated as of December 31, 1996, between the Company and Hallwood Investments Limited, formerly HSC Financial Corporation, is incorporated herein by reference to Exhibit 10.22 to the Company's Form 10-K for the year ended December 31, 1996, File No. 1-8303.
- *10.6 Amendment to Financial Consulting Agreement, dated as of May 16, 2001, between the Company and Hallwood Investments Limited is incorporated herein by reference to Exhibit 10.9 to the Company's Form 10-K for the year ended December 31, 2001, File No. 1-8303.
- *10.7 Amendment to Financial Consulting Agreement, dated as of January 1, 2000, between the Company and Hallwood Investments Limited, is incorporated herein by reference to Exhibit 10.15 to the Company's Form 10-Q for the quarter ended March 31, 2000, File No. 1-8303.
- 10.8 Promissory Note and Security Agreement regarding equipment term loan in the amount of \$541,976.24, dated as of February 25, 2002, between Brookwood Companies Incorporated, Kenyon Industries, Inc., Brookwood Laminating, Inc., Ashford Bromely, Inc., Xtramile, Inc., and Land Ocean III, Inc. and Key Leasing, a division of Key Corporate Capital, Inc., Libor plus 325 basis points-floating, due February 25, 2007, is incorporated herein by reference to exhibit 10.20 to the Company's Form 10-Q for the quarter ended March 31, 2002, File No. 1-8303.
- 10.9 Promissory Note and Security Agreement regarding equipment term loan in the amount of \$298,018, dated as of December 20, 2002, between Brookwood Companies Incorporated, Kenyon Industries, Inc., Brookwood Laminating, Inc., Ashford Bromely, Inc., Xtramile, Inc., Land Ocean III, Inc. and Strategic Technical Alliance LLC and Key Leasing, a division of Key Corporate Capital, Inc., fixed interest 4.67%, due December 20, 2007, is incorporated herein by reference to Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 2002, File No. 1-8303.
- 10.10 Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of January 30, 2004, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries, is incorporated by reference to Exhibit 10.21 to the Company's Form 10-K for the year ended December 31, 2003, File No. 1-8303.
- *10.11 Amendment to Financial Consulting Agreement, dated March 10, 2004, by and between the Company and Hallwood Investments Limited, is incorporated by reference to Exhibit 10.22 to the Company's Form 10-K for the year ended December 31, 2003, File No. 1-8303.
- *10.12 Compensation Letter, dated May 11, 1998, between Brookwood Companies Incorporated and Amber M. Brookman is incorporated by reference to Exhibit 10.24 to the Company's Form 10-Q for the quarter ended March 31, 2004, File No. 1-8303.
- *10.13 Amended 1995 Stock Option Plan for The Hallwood Group Incorporated is incorporated by reference to Annex B of the Company's Proxy Statement, as filed on April 18, 2001, File No. 1-8303.

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- *10.14 Form of Stock Option Agreement to 1995 Stock Option Plan for The Hallwood Group Incorporated, is incorporated herein by reference to Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 2004, File No. 1-8303.
- *10.15 Amendment to Financial Consulting Agreement, dated March 9, 2005, by and between the Company and Hallwood Investments Limited, is incorporated herein by reference to Exhibit 10.16 to the Company's Form 10-K for the year ended December 31, 2004, File No. 1-8303.
- 10.16 First Amendment to Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of March 25, 2005, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries, is incorporated by reference to Exhibit 10.20 to the Company's Form 10-Q for the quarter ended March 31, 2005, File No. 1-8303.
- *10.17 The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated and Unit Agreement under the Plan between Amber M. Brookman and the Company, is incorporated herein by reference to Exhibits 99.1 and 99.2 to the Company's Form 8-K dated January 17, 2006, File No. 1-8303.
- 10.18 Limited Partnership Agreement of Hallwood Energy 4, L.P., a Delaware Limited Partnership, dated as of August 23, 2005; Memorandum of Amendment Changing the Name of Hallwood Energy 4, L.P. to Hallwood Energy, L.P., effective immediately before midnight on December 31, 2005; and Amendment to Limited Partnership Agreement of Hallwood Energy, L.P. dated as of December 31, 2005, is incorporated by reference to Exhibit 10.21 to the Company's Form 10-K for the year ended December 31, 2005, File No. 1-8303.

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- 10.19 Second Amendment to Second Amended and Restated Revolving Credit Loan and Security Agreement, dated as of March 25, 2006, by and among Key Bank National Association, Brookwood Companies Incorporated and certain subsidiaries, is incorporated by reference to Exhibit 10.22 to the Company's Form 10-K for the year ended December 31, 2005, File No. 1-8303.
- *10.20 Change in compensation payable to Amber Brookman is incorporated herein by reference to Item 5.02 to the Company's Form 8-K dated March 15, 2007, File No. 1-8303.
- 20 Information contained in the definitive Proxy Statement for the Annual Meeting of Stockholders of the Company, is incorporated herein by reference to Form DEF 14A filed on May 14, 2007, File No. 1-8303.
- 21 Active subsidiaries of the Registrant as of February 28, 2007, is incorporated by reference to Exhibit 21 to the Company's Form 10-K for the year ended December 31, 2006, File No. 1-8303.
- 23.1 Independent Registered Public Accounting Firm's Consent, dated May 11, 2007, *filed herewith*.
- 31.1 Certification of the Chief Executive Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002, *filed herewith*.
- 31.2 Certification of the Chief Financial Officer, pursuant to Section 302 of Sarbanes-Oxley Act of 2002, *filed herewith*.
- 32.1 Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, *filed herewith*.
- * Constitutes a compensation plan or agreement for executive officers.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**THE HALLWOOD GROUP
INCORPORATED**

Dated: November 6, 2007

By: /s/ Melvin J. Melle
Melvin J. Melle, Vice President
(Duly Authorized Officer and Principal
Financial and Accounting Officer)

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Directors of
The Hallwood Group Incorporated

We have audited the accompanying consolidated balance sheets of The Hallwood Group Incorporated and subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, comprehensive income (loss), changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedules listed in the Index at Item 15. These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of The Hallwood Group Incorporated and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share-Based Payment*.

Deloitte & Touche LLP

Dallas, Texas
May 11, 2007

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(Dollars in thousands, except per share amounts)

| | December 31, | |
|--|---------------------|-------------------|
| | 2006 | 2005 |
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 10,054 | \$ 16,648 |
| Accounts receivable, net | | |
| Trade and other | 19,623 | 18,987 |
| Related parties | 161 | 616 |
| Inventories, net | 17,293 | 16,879 |
| Prepaid federal income taxes | 3,861 | 1,322 |
| Prepays, deposits and other assets | 916 | 831 |
| Deferred income tax, net | 904 | 1,029 |
| | 52,812 | 56,312 |
| Noncurrent Assets | | |
| Investments in Hallwood Energy, L.P. | 39,864 | 40,854 |
| Property, plant and equipment, net | 13,853 | 11,358 |
| Deferred income tax, net | 751 | |
| Other assets | 317 | 277 |
| | 54,785 | 52,489 |
| Total Assets | \$ 107,597 | \$ 108,801 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities | | |
| Accounts payable | \$ 10,491 | \$ 7,274 |
| Accrued expenses and other current liabilities | 3,217 | 4,848 |
| Current portion of loans payable | 275 | 352 |
| Income taxes payable | 31 | 9 |
| | 14,014 | 12,483 |
| Noncurrent Liabilities | | |
| Long term portion of loans payable | 10,617 | 6,460 |
| Redeemable preferred stock | 1,000 | 1,000 |
| Deferred income tax | | 415 |
| | 11,617 | 7,875 |
| Total Liabilities | 25,631 | 20,358 |

Contingencies and Commitments

Stockholders Equity

| | | |
|---|-------------------|-------------------|
| Common stock, \$0.10 par value; authorized 10,000,000 shares; issued 2,396,105 and 2,396,103 shares, respectively; outstanding 1,515,438 and 1,511,218 shares, respectively | 240 | 240 |
| Additional paid-in capital | 56,451 | 56,258 |
| Accumulated other comprehensive income | 55 | |
| Retained earnings | 38,401 | 45,126 |
| Treasury stock, 880,667 and 884,885 shares, respectively; at cost | (13,181) | (13,181) |
| Total Stockholders Equity | 81,966 | 88,443 |
| Total Liabilities and Stockholders Equity | \$ 107,597 | \$ 108,801 |

See accompanying notes to consolidated financial statements.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

(Amounts in thousands, except per share amounts)

| | Years Ended December 31, | | |
|--|---------------------------------|------------------|------------------|
| | 2006 | 2005 | 2004 |
| Revenues | | | |
| Textile products sales | \$ 112,154 | \$ 133,108 | \$ 136,276 |
| Administrative fees from energy affiliates | | 1,499 | 1,004 |
| | 112,154 | 134,607 | 137,280 |
| Expenses | | | |
| Textile products cost of sales | 93,134 | 105,299 | 102,772 |
| Administrative and selling expenses | 18,248 | 29,255 | 22,837 |
| | 111,382 | 134,554 | 125,609 |
| Operating income | 772 | 53 | 11,671 |
| Other Income (Loss) | | | |
| Equity income (loss) from investments in energy affiliates | (10,418) | (8,500) | (9,901) |
| Interest expense | (616) | (545) | (1,197) |
| Interest and other income | 566 | 1,532 | 1,536 |
| Gain (loss) from disposition of investments in energy affiliates | | | |
| HE III | (17) | 52,425 | |
| HEC | | (113) | 62,288 |
| Amortization of deferred revenue noncompetition agreement | | | 1,007 |
| Separation Agreement income | | | 375 |
| | (10,485) | 44,799 | 54,108 |
| Income (loss) from continuing operations before income taxes | (9,713) | 44,852 | 65,779 |
| Income tax expense (benefit) | (2,988) | 18,510 | 11,079 |
| Income (loss) from continuing operations | (6,725) | 26,342 | 54,700 |
| Income from discontinued operations, net of tax | | | |
| Real estate | | | 39,002 |
| Hotels | | | 783 |
| | | | 39,785 |
| Net Income (Loss) | \$ (6,725) | \$ 26,342 | \$ 94,485 |

Income (Loss) Per Common Share

Basic

| | | | |
|--|-----------|----------|----------|
| Income (loss) from continuing operations | \$ (4.44) | \$ 18.22 | \$ 41.24 |
| Income from discontinued operations | | | 30.00 |

| | | | |
|-------------------|-----------|----------|----------|
| Net income (loss) | \$ (4.44) | \$ 18.22 | \$ 71.24 |
|-------------------|-----------|----------|----------|

Assuming Dilution

| | | | |
|--|-----------|----------|----------|
| Income (loss) from continuing operations | \$ (4.44) | \$ 17.47 | \$ 36.79 |
| Income from discontinued operations | | | 26.76 |

| | | | |
|-------------------|-----------|----------|----------|
| Net income (loss) | \$ (4.44) | \$ 17.47 | \$ 63.55 |
|-------------------|-----------|----------|----------|

Weighted Average Shares Outstanding

| | | | |
|-------|-------|-------|-------|
| Basic | 1,514 | 1,446 | 1,326 |
|-------|-------|-------|-------|

| | | | |
|-------------------|-------|-------|-------|
| Assuming Dilution | 1,514 | 1,508 | 1,487 |
|-------------------|-------|-------|-------|

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands)

| | Years Ended December 31, | | |
|---|---------------------------------|------------------|------------------|
| | 2006 | 2005 | 2004 |
| Net Income (Loss) | \$ (6,725) | \$ 26,342 | \$ 94,485 |
| Other Comprehensive Income (Loss) | | | |
| Unrealized increase in fair value of marketable securities | 55 | | |
| Pro rata share of other comprehensive income from equity investments: | | | |
| Sale of real estate investments | | | (105) |
| Amortization of interest rate swap | | | (30) |
| | | | (135) |
| Comprehensive Income (Loss) | \$ (6,670) | \$ 26,342 | \$ 94,350 |

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

Years Ended December 31, 2004, 2005 and 2006

(Amounts in thousands)

| | Common Stock Shares | Stock Par Value | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock Shares | Treasury Stock Cost | Total Stockholders Equity |
|--|------------------------|-----------------------|----------------------------------|----------------------|---|--------------------------|------------------------|---------------------------------|
| Balance, January 1, 2004 | 2,396 | \$ 240 | \$ 54,430 | \$ (9,042) | \$ 135 | 1,070 | \$ (15,934) | \$ 29,829 |
| Net income | | | | 94,485 | | | | 94,485 |
| Pro rata share of partners capital transactions from equity investments: Sale of real estate investments | | | 362 | | (105) | | | 257 |
| Amortization of interest rate swap | | | | | (30) | | | (30) |
| Balance, December 31, 2004 | 2,396 | 240 | 54,792 | 85,443 | | 1,070 | (15,934) | 124,541 |
| Net income | | | | 26,342 | | | | 26,342 |
| Cash dividends on common stock | | | | (66,113) | | | | (66,113) |
| Reissuance of treasury shares from exercise of stock options and related income tax effect | | | 1,466 | (546) | | (185) | 2,753 | 3,673 |
| Balance, December 31, 2005 | 2,396 | 240 | 56,258 | 45,126 | | 885 | (13,181) | 88,443 |
| Net loss | | | | (6,725) | | | | (6,725) |
| Reissuance of treasury shares from exercise of stock options and related income tax | | | 193 | | | (5) | 73 | 266 |

| | | | | | | | | | |
|--|-------|--------|-----------|-----------|-------|-----|-------------|----|--------|
| effect | | | | | | | | | |
| Purchase of common stock for treasury | | | | | | 1 | (73) | | (73) |
| Unrealized increase in fair value of marketable securities | | | | | 55 | | | | 55 |
| Balance, December 31, 2006 | 2,396 | \$ 240 | \$ 56,451 | \$ 38,401 | \$ 55 | 881 | \$ (13,181) | \$ | 81,966 |

See accompanying notes to consolidated financial statements.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**
(In thousands)

| | Years Ended December 31, | | |
|--|---------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net income (loss) | \$ (6,725) | \$ 26,342 | \$ 94,485 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Equity loss from investments in energy affiliates | 10,418 | 8,500 | 9,901 |
| Depreciation and amortization | 1,864 | 1,850 | 1,870 |
| Deferred tax expense (benefit) | (1,041) | 4,043 | (1,094) |
| Excess tax benefits from share-based payment arrangements | (187) | | |
| Gain from sale of investment in HE III | 17 | (52,425) | |
| Proceeds from sale of (investments in) marketable securities | | 6,051 | (5,000) |
| Gain from sale of investment in HEC | | 113 | (62,288) |
| (Income) loss from investments in marketable securities | | 49 | (944) |
| Payment to exercise option of Separation Agreement | | | (3,000) |
| Amortization of deferred revenue noncompetition agreement | | | (1,007) |
| Gain from extinguishment of Separation Agreement | | | (375) |
| Amortization of deferred gain from debenture exchange | | | (101) |
| Changes in assets and liabilities: | | | |
| Increase (decrease) in accounts payable | 3,055 | (7,237) | 4,903 |
| (Increase) decrease in inventories | (414) | 6,702 | (2,359) |
| (Increase) decrease in accounts receivable | (651) | 6,372 | (6,899) |
| Increase (decrease) in income taxes payable/prepaid | (2,560) | (1,014) | |
| Increase (decrease) in accrued expenses and other current liabilities | (1,631) | (874) | 3,460 |
| Increase (decrease) in other assets and liabilities | 160 | (118) | (1,039) |
| Discontinued operations: | | | |
| Net change in other assets and liabilities | | 163 | 190 |
| Gain from sale of investments in HRP, net | | | (46,074) |
| Deferred tax expense (benefit) | | | 5,143 |
| Equity loss from investments in HRP | | | 2,769 |
| Payment of litigation judgment to HRP | | | (1,877) |
| Gain from extinguishment of hotel debt | | | (1,598) |
| Increase in accrued litigation expense to HRP | | | 50 |
| Net cash provided by (used in) operating activities | 2,305 | (1,483) | (10,884) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Investment in energy affiliates | (8,975) | (40,556) | (11,032) |
| Investments in property, plant and equipment, net | (4,197) | (2,726) | (3,361) |
| Proceeds from sale of investment in HE III | | 55,648 | |
| Proceeds from sale of investment in HEC | | 387 | 55,788 |

| | | | |
|--|------------------|------------------|------------------|
| Discontinued operations: | | | |
| Proceeds from sale of investments in HRP, net of transaction costs | | 59 | 59,488 |
| Investments in hotel | | | (65) |
| Net cash provided by (used in) investing activities | (13,172) | 12,812 | 100,818 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Proceeds from (repayment of) revolving credit facilities, net | 4,432 | (1,977) | (7,023) |
| Repayment of other bank borrowings and loans payable | (352) | (347) | (14,742) |
| Excess tax benefits from share-based payment arrangements | 187 | | |
| Proceeds from exercise of stock options | 79 | 2,207 | |
| Purchase of common stock for treasury | (73) | | |
| Cash dividends on common stock | | (66,113) | |
| Proceeds from loans | | | 6,963 |
| Redemption of 10% Debentures | | | (6,468) |
| Net cash provided by (used in) financing activities | 4,273 | (66,230) | (21,270) |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (6,594) | (54,901) | 68,664 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 16,648 | 71,549 | 2,885 |
| CASH AND CASH EQUIVALENTS, END OF YEAR | \$ 10,054 | \$ 16,648 | \$ 71,549 |

See accompanying notes to consolidated financial statements.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Organization and Significant Accounting Policies

Continuing Operations. The Hallwood Group Incorporated (Hallwood or the Company) (AMEX:HWG), a Delaware corporation, is a holding company that currently operates in the textile products and energy business segments. The Company's former real estate and hotel business segments have been reported as discontinued operations.

Textile Products. Textile products operations are conducted through the Company's wholly owned Brookwood Companies Incorporated (Brookwood) subsidiary. Brookwood is an integrated textile firm that develops and produces innovative fabrics and related products through specialized finishing, treating and coating processes. Brookwood's subsidiary, Strategic Technical Alliance, LLC (STA) markets advanced breathable, waterproof laminate and other fabrics primarily for military applications. Continued development of these fabrics for military, industrial and consumer applications is a key element of Brookwood's business plan.

Textile products accounts for substantially all of the Company's operating revenues.

Energy. Prior to December 31, 2005, the Company had investments in Hallwood Energy Corporation (HEC), which was sold in December 2004 and Hallwood Energy III, L.P. (HE III), which was sold in July 2005, Hallwood Energy II, L.P. (HE II), Hallwood Energy 4, L.P. (HE 4) and Hallwood Exploration L.P. (Hallwood Exploration). The Company owned between 20% and 28% of the entities (between 16% and 22% on a fully diluted basis) and accounted for the investments using the equity method of accounting, recording its pro rata share of net income (loss), stockholders' equity/partners' capital transactions and comprehensive income (loss).

Effective December 31, 2005, HE II and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy, L.P. (Hallwood Energy). At the consolidation date, Hallwood Energy was principally involved in acquiring oil and gas leases and drilling, gathering and sale of natural gas in the Barnett Shale formation located in Parker, Hood and Tarrant Counties in North Texas and the Barnett Shale and Woodford Shale formations in Reeves and Culberson Counties in West Texas and in the Fayetteville Shale formation of Central Eastern Arkansas and conducting 3-D seismic surveys over optioned land covering a Salt Dome in South Louisiana in order to determine how best to proceed with exploratory activity. The Company's investment in Hallwood Energy at December 31, 2005 was comprised of its capital contributions to each of the former private energy affiliates.

Following the completion of the energy consolidation on December 31, 2005, all energy activities are conducted by Hallwood Energy. Following the July 2006 sale of its properties in North Texas (discussed below), Hallwood Energy's management has classified its energy investments into three identifiable areas: Central Eastern Arkansas, South Louisiana and West Texas.

In July 2006, Hallwood Energy completed the sale of a 60% undivided working interest in its oil and gas properties in Reeves and Culberson Counties in West Texas and all of its interest in the properties in Parker, Hood and Tarrant Counties in North Texas to Chesapeake Energy Corporation (Chesapeake). Chesapeake assumed operation of these properties. See Note 6.

At December 31, 2006, the Company owned approximately 25% (20% after consideration of profit interests) of Hallwood Energy.

Discontinued Operations. The Company's real estate operations were conducted primarily through the Company's wholly owned subsidiaries. Hallwood Realty, LLC (Hallwood Realty) served as the general partner of Hallwood Realty Partners, L.P. (HRP), a former publicly-traded master limited partnership. Hallwood Commercial Real Estate, LLC (HCRE) served as property manager. Revenues were generated from the receipt of management fees, leasing commissions and other fees from HRP and third parties and the Company's 22% pro rata share of earnings of HRP using the equity method of accounting.

In July 2004, HRP was merged with a subsidiary of HRPT Properties Trust (HRPT). As a result, HRP became a wholly-owned subsidiary of HRPT and was no longer publicly traded. The general partner interest in HRP was also sold to a HRPT subsidiary in a separate transaction and the management agreements for the properties

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

under management were terminated. The Company no longer holds any interest in HRP. The Company received approximately \$66,119,000 for its investments in HRP and related assets.

In December 2000, the Company decided to dispose of its hotel segment, which at that time consisted of five hotel properties. Accordingly, the Company's hotel operations were reclassified as a discontinued operation. Two hotels were disposed of in 2001 and two hotels were disposed of in 2002. The Company continued to operate a leasehold interest in one hotel until December 2004, when the hotel subsidiary entered into a Lease Termination and Mutual Release Agreement with the landlord. In connection with the lease termination, the remaining assets of the subsidiary were transferred to the landlord, and the Company obtained a release from any further obligations.

Significant accounting policies, which are in accordance with accounting principles generally accepted in the United States of America, are as follows:

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its continuing and discontinued subsidiaries:

Continuing subsidiaries:

Brookwood Companies Incorporated and subsidiaries
Hallwood-Integra Holding Company Incorporated and subsidiaries (inactive)

Discontinued subsidiaries:

Brock Suite Greenville, Inc. (until October 2004)
Brock Suite Huntsville, Inc. (until December 2005)
Brock Suite Tulsa, Inc. (until October 2004)
HCRE California, Inc. (until October 2005)
HWG, LLC (until December 2005)
HWG 95 Advisors, Inc. (until September 2004)
HWG 98 Advisors, Inc. (until September 2004)
HWG Holding One, Inc. (until December 2005)
HWG Holding Two, Inc. (until December 2005)
HWG Realty Investors, LLC (until October 2004)
Hallwood Commercial Real Estate, LLC (until October 2005)
Hallwood Investment Company (until December 2005)
Hallwood Petroleum, LLC (from October 2004 to May 2005)
Hallwood Realty, LLC (until October 2005)
HSC Securities Corporation (until November 2006)

The Company fully consolidates all of the above subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Recognition of Income

Textile products sales are recognized upon shipment or release of product, when title passes to the customer. Brookwood provides allowances for expected cash discounts, returns, claims and doubtful accounts based upon historical bad debt and claims experience and periodic evaluation of the aging of accounts receivable. If the financial condition of Brookwood's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

On occasion, Brookwood receives instructions from some of its customers to finish fabric, invoice the full amount and hold the finished inventory until the customer sends shipping instructions. In those cases, Brookwood records the sale and sends the customer an invoice containing normal and usual payment terms and segregates the inventory from Brookwood's inventory.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Carrying Value of Investments

Investments are recorded at fair value determined as of the date acquired. Thereafter, for less than 50% owned investments, equity accounting is utilized where the Company exercises significant influence over the investee's operating and financial policies.

Impairment

Management reviews its investments for impairment losses when events and circumstances indicate that the carrying amount of an asset may not be recoverable. In the event such indicators exist for assets held for use, and if undiscounted cash flows before interest charges are less than carrying value, the asset is written down to estimated fair value. Assets held for sale are carried at the lower of cost or estimated sales price less costs of sale.

Investments that are accounted for under the equity method of accounting are reviewed for impairment when the fair value of the investment is believed to have fallen below the Company's carrying value. When such a decline is deemed other than temporary, an impairment charge is recorded to the statement of operations for the difference between the investment's carrying value and its estimated fair value at the time. In making the determination as to whether a decline is other than temporary, the Company considers such factors as the duration and extent of the decline, the investee's financial performance, and the Company's ability and intention to retain its investment for a period that will be sufficient to allow for any anticipated recovery in the investment's market value. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors to be evaluated. Differing assumptions could affect whether an investment is impaired. From time to time, the Company reviews and determines if a writedown is required.

Depreciation and Amortization

Depreciation of textile products buildings, equipment and improvements is computed on the straight-line method. Buildings and improvements are depreciated over a period of 15 to 20 years. Equipment is depreciated over a period of 3 to 10 years.

Income Taxes

The Company files a consolidated federal income tax return. Deferred tax assets and liabilities are recorded based on the difference between the tax basis of assets and liabilities and their carrying amounts for financial reporting purposes, referred to as temporary differences and the amount of net operating loss carryforwards and tax credits reduced by a valuation allowance as considered appropriate. Provision is made for deferred taxes relating to temporary differences in the recognition of income and expense for financial reporting.

Inventories

Inventories are valued at the lower of cost (first-in, first-out or specific identification method) or market. The valuation of inventory requires the use of estimates regarding the amount of inventory and the prices at which it will be sold. The valuation includes an obsolescence reserve for excess and slow moving inventory that considers a variety

of factors, such as the Company's historical loss experience, changes in products, changes in customer demand and general economic conditions.

Cash and Cash Equivalents

The Company considers highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents.

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Marketable Securities

Marketable securities classified as trading are carried at fair value on the balance sheet. Unrealized gains and losses are included in operations. Marketable securities classified as available for sale are carried at fair value on the balance sheet. Unrealized gains and losses are included in a separate component of stockholders equity entitled Accumulated Other Comprehensive Income . Unrealized losses are included in operations if the decline in value is determined to be other than temporary .

Environmental Remediation Costs

The Company accrues for losses associated with environmental remediation obligations when such losses are probable and can be reasonably estimated. Accruals for estimated losses from environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study. Such accruals are adjusted as further information develops or circumstances change. Recoveries of environmental remediation costs from other parties are recorded as assets when their receipt is deemed probable. Company management is not aware of any environmental remediation obligations which would significantly affect the operations, financial position or cash flow of the Company.

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment* , which revised SFAS No. 123 Accounting for Stock-Based Compensation , using a modified method of prospective application. Under SFAS No. 123(R), all forms of share-based payments to employees, including employee stock options, are treated the same as other forms of compensation by recognizing the related cost in the statement of operations. The expense of the award would generally be measured at fair value at the grant date. SFAS 123(R) eliminates the ability to account for share-based compensation transactions using Accounting Principles Board (APB) Opinion No. 25. All options were fully vested as of December 31, 2005. Because all of the Company s stock options are fully vested, there was no impact on income before taxes or net income from adopting SFAS No. 123(R).

Prior to January 1, 2006, the Company had elected, as provided by SFAS No. 123, not to recognize employee stock-based compensation expense as calculated under SFAS No. 123, but had recognized such expense in accordance with the provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* . As all of the Company s options were fully vested prior to December 21, 2003, there was no difference between the historical operations and pro forma operations for each of the two years ended December 31, 2005 had the expense provisions of SFAS No. 123 been adopted.

Research and Development Costs

Expenditures relating to the development of new products and processes, including significant improvements to existing products, are expensed as incurred. Research and development expenses were approximately \$594,000 in 2006, \$335,000 in 2005 and were not significant in 2004.

Other Comprehensive Income

Other comprehensive income items are revenues, expenses, gains and losses that under accounting principles generally accepted in the United States of America are excluded from current period net income and reflected as a component of stockholders' equity. The Company records a pro rata share of comprehensive income items reported by its investments accounted for using the equity method of accounting.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

certain assets, liabilities, revenues and expenses as of and for the reporting periods. Actual results may differ from such estimates.

Concentration of Credit Risk

The financial instruments of its wholly owned subsidiaries, which potentially subject the Company to concentration of credit risk, consist principally of accounts receivable. The Company grants credit to customers based on an evaluation of the customer's financial condition. Exposure to losses on receivables is principally dependent on each customer's financial condition. The Company controls its exposure to credit risks through credit approvals, credit limits and monitoring procedures and the use of factors.

Derivatives

The Company accounts for derivative instruments in accordance with Statement of Financial Accounting Standards No. 133 *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133). The Company does not directly have any derivative instruments, however, Hallwood Energy has and HRP did have such instruments. Accordingly, the Company recorded its proportional share of any impact of these instruments in accordance with the equity method of accounting.

Hallwood Energy has a make-whole provision contained within its former and current loan facilities. The make-whole fee is recorded at its estimated fair value on Hallwood Energy's balance sheet and changes in its fair value are recorded in interest expense in Hallwood Energy's statement of operations.

HRP had one derivative, an interest rate cap. Since this derivative was designated as a cash flow hedge, changes in the fair value of the derivative were recognized in other comprehensive income until the hedged item was recognized in earnings. Hedge effectiveness was measured based on the relative changes in the fair value between the derivative contract and the hedged item over time. Any changes in fair value resulting from ineffectiveness, as defined by SFAS No. 133, were recognized immediately in current earnings.

Per Common Share Calculations

Basic income (loss) per common share was computed by dividing net income (loss) by the weighted average shares outstanding. Income (loss) per common share assuming dilution was computed by dividing net income (loss) by the weighted average of shares and diluted potential shares outstanding. Stock options are considered to be potential common shares. The number of potential common shares from assumed exercise of options is computed using the treasury stock method.

New Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 and 140. SFAS No. 155 addresses accounting for beneficial interests in securitized financial instruments. The guidance allows fair value remeasurement for any hybrid financial instrument containing an embedded derivative that would otherwise require bifurcation and it clarifies which interest-only and principal-only strips are not subject to SFAS No. 133. SFAS No. 155 also established a requirement to evaluate

interests in securitized financial assets to identify any interests that either are freestanding derivatives or contain an embedded derivative requiring bifurcation. The statement is effective for all financial instruments issued or acquired after the beginning of the first fiscal year that begins after September 15, 2006. The Company is currently evaluating the impact of this statement.

On May 18, 2006, the State of Texas passed a bill to replace the current franchise tax with a new margin tax to be effective January 1, 2008. The Company estimates the new margin tax will not have a significant impact on tax expense or deferred tax assets and liabilities.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting and reporting for

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48 and does not believe FIN 48 will have a material impact on its financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosure related to the use of fair value measures in financial statements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the timing of adoption and the impact that adoption might have on its financial position or results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108. Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and it did not have a material impact on the Company's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Post Retirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. SFAS No. 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its balance sheet. The funded status is defined as the difference between the fair value of plan assets and the projected benefit obligation (for pension plans) or the accumulated postretirement benefit obligation (for other postretirement benefit plans). SFAS No. 158 also requires that actuarial gains and losses and changes in prior service costs not included in net periodic pension costs be included, net of tax, as a component of other comprehensive income. The statement does not affect the determination of net periodic benefit costs included in the income statement. SFAS No. 158 also requires that an employer measure defined benefit plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position. The requirement to recognize the funded status of defined benefit plans and to provide required disclosures is effective as of the end of fiscal years ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end is effective for fiscal years ending after December 15, 2008. The adoption of the recognition and disclosure provisions of SFAS No. 158 did not have any impact on the Company's financial statements.

On February 15, 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The FASB believes the statement will improve financial reporting by providing companies the opportunity to mitigate volatility in reported earnings by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Use of the statement will expand the use of fair value measurements for accounting for financial instruments. The Company does not believe SFAS No. 159 will have a material impact on its financial position, results of operations or cash flows.

Note 2 Cash and Cash Equivalents

Cash and cash equivalents as of the balance sheet dates were as follows (in thousands):

| | December 31, | |
|------------------|---------------------|-------------|
| | 2006 | 2005 |
| Cash | \$ 770 | \$ 395 |
| Cash equivalents | 9,284 | 16,253 |
| Total | \$ 10,054 | \$ 16,648 |

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Cash equivalents consisted of secured bank repurchase agreements, money market funds (consisting of AAA rated institutional commercial paper), and interest-bearing demand deposits.

Note 3 Inventories

Inventories as of the balance sheet dates were as follows (in thousands):

| | December 31, | |
|----------------------------|---------------------|-------------|
| | 2006 | 2005 |
| Raw materials | \$ 5,590 | \$ 6,257 |
| Work in progress | 4,300 | 5,103 |
| Finished goods | 8,260 | 6,093 |
| | 18,150 | 17,453 |
| Less: Obsolescence reserve | (857) | (574) |
| Total | \$ 17,293 | \$ 16,879 |

Note 4 Property, Plant and Equipment

Property, plant and equipment consists of the following (in thousands):

| | December 31, | |
|--------------------------------|---------------------|-------------|
| | 2006 | 2005 |
| Machinery and equipment | \$ 19,342 | \$ 17,061 |
| Buildings and improvements | 5,267 | 5,082 |
| Office furniture and equipment | 4,012 | 3,337 |
| Construction in progress | 2,737 | 2,155 |
| Leasehold improvements | 1,033 | 401 |
| Land | 594 | 594 |
| | 32,985 | 28,630 |
| Less: Accumulated depreciation | (19,132) | (17,272) |
| Total | \$ 13,853 | \$ 11,358 |

Note 5 Operations of Brookwood Companies Incorporated

Receivables. Brookwood maintains factoring agreements which provide that receivables resulting from credit sales to customers, excluding the U.S. Government, may be sold to the factor, subject to a commission of 0.6% - 0.7% and the factor's prior approval. Commissions paid to factors were approximately \$478,000, \$670,000 and \$615,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Factored receivables were \$14,412,000 and \$14,503,000 at December 31, 2006 and 2005, which were net of an allowance for doubtful accounts of \$62,000 and \$102,000, respectively.

Trade receivables were \$4,987,000 and \$4,204,000 at December 31, 2006 and 2005, which were net of an allowance for doubtful accounts of \$72,000 and \$64,000, respectively.

Sales Concentration. Sales to one Brookwood customer, Tennier Industries, Inc. (*Tennier*), accounted for more than 10% of Brookwood's sales in each of the three years ended December 31, 2006. Its relationship with Tennier is ongoing. Sales to Tennier, which are included in military sales, were \$31,300,000, \$56,883,000 and \$53,149,000 in 2006, 2005 and 2004, respectively, which represented 27.9%, 42.7% and 39.0% of Brookwood's sales. Sales to another customer, ORC Industries, Inc. (*ORC*), have increased in 2006 and accounted for more than 10% of Brookwood's 2006 sales. Its relationship with ORC is ongoing. Sales to ORC, which are also included

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

in military sales, were \$12,609,000, \$10,099,000 and \$13,229,000 in 2006, 2005 and 2004, respectively, which represented 11.2%, 7.6% and 9.7% of Brookwood's sales.

Through 2005, military sales, including the sales to Tennier and ORC, generally comprised an increased portion of Brookwood's total sales and a greater share of gross profit. However, Brookwood has experienced reduced military sales in 2006. Military sales accounted for \$53,885,000, \$72,456,000 and \$75,899,000 in 2006, 2005 and 2004, respectively, which represented 48.0%, 54.4% and 55.7% of Brookwood's sales.

Stockholders' Equity. The Company is the holder of all of Brookwood's outstanding \$13,500,000 Series A, \$13.50 annual dividend per share, redeemable preferred stock and all of its 10,000,000 outstanding shares of common stock. The preferred stock has a liquidation preference of \$13,500,000 plus accrued but unpaid dividends. At December 31, 2006, cumulative dividends in arrears on the preferred stock amounted to approximately \$10,230,000.

The Brookwood stock option plan was cancelled with the approval of the Company's shareholders at the May 2006 Annual Meeting concurrent with the approval of the 2005 Long-Term Incentive Plan for Brookwood discussed below.

2005 Long-Term Incentive Plan for Brookwood. In December 2005, the outside directors of the board of directors of the Company approved The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (the 2005 Long-Term Incentive Plan for Brookwood) to attract, retain and motivate key personnel of Brookwood. The incentive plan was approved by the holders of a majority of shares of the Company's common stock at the annual shareholders' meeting held on May 10, 2006. Pursuant to the incentive plan, the directors of Brookwood and key long-term employees, including officers of Brookwood and its subsidiaries, are eligible to receive awards of units that may result in the payment of cash to the participant upon the occurrence of certain events, including a merger, sale of substantially all of the assets to other than management or a change of control of Brookwood. The Brookwood stock option plan was terminated concurrently with the adoption of the incentive plan and any options held pursuant to the Brookwood stock option plan were cancelled concurrently with shareholder approval of the 2005 Long-Term Incentive Plan for Brookwood.

The terms of the incentive plan provide for individual awards to eligible participants. In the event of a change of control transaction, as defined, a total award amount would be payable to the participants equal to 15% of the amount by which the net fair market value of all consideration received by the Company as a result of the change of control transaction exceeds the sum of the liquidation preference plus accrued but unpaid dividends on the Brookwood preferred stock (approximately \$23,730,000 at December 31, 2006). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently \$1,823,000, and decreases by the amount of the actual dividends paid by Brookwood to the Company. Provided certain circumstances are met, the minimum total award amount shall be \$2,000,000. The incentive plan also provides that, if certain members of senior management do not have, prior to a change of control transaction, in the aggregate an equity or debt interest of at least two percent in the entity with whom the change of control transaction is completed (exclusive of any such interest any such individual receives with respect to his or her employment following the change of control transaction), then the Company will be obligated to pay an additional \$2,600,000.

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Investments in Hallwood Energy, L.P. as of the balance sheet dates were as follows (in thousands):

| Description of Investment | Cost as of | Amount at Which | | Equity Income (Loss) for the | | |
|------------------------------|----------------------|----------------------|----------------------|--|----------|----|
| | December 31, 2006 | December 31, 2006 | December 31, 2005 | Years Ended December 31, 2006 2005 2004 | | |
| Hallwood Energy, L.P. | | | | | | |
| Limited partner interest | \$ 50,381 | \$ 39,859 | \$ 40,848 | \$ (10,417) | \$ (106) | \$ |
| General partner interest | 6 | 5 | 6 | (1) | | |
| | \$ 50,387 | \$ 39,864 | \$ 40,854 | \$ (10,418) | \$ (106) | \$ |

At December 31, 2006, the Company owned approximately 25% (20% after consideration of profit interests) of Hallwood Energy. The Company accounts for this investment using the equity method of accounting and records its pro rata share of Hallwood Energy's net income (loss) and partner capital transactions.

Effective December 31, 2005, HE II and Hallwood Exploration were consolidated into HE 4, which was renamed Hallwood Energy, L.P. (Hallwood Energy). The equity loss for the year ended December 31, 2005 was an aggregate of the income previously reported by HE II, HE 4 and Hallwood Exploration.

The partners' capital interests in Hallwood Energy were proportionate to the capital invested in each entity at December 31, 2005. The Company's initial investment in Hallwood Energy at December 31, 2005 was comprised of its capital contributions to each of the former private energy affiliates, as follows (in thousands):

| Entity | Amount |
|-------------------------|-----------|
| HE 4 | \$ 22,325 |
| HE II | 14,011 |
| Hallwood Exploration | 4,624 |
| Accumulated equity loss | (106) |
| Total | \$ 40,854 |

Following the completion of the energy consolidation on December 31, 2005, all energy activities are conducted by Hallwood Energy. After completion of the July 2006 sale of its properties in North Texas (discussed below), Hallwood Energy's management has classified its energy investments into three identifiable areas: Central Eastern

Arkansas, South Louisiana and West Texas.

Certain of the Company's officers and directors are investors in Hallwood Energy. In addition, as members of management of Hallwood Energy, one director and officer and one officer of the Company hold a profit interest in Hallwood Energy.

During 2006, the Company invested an additional \$9,427,000 in Hallwood Energy, of which \$2,721,000 was invested in January 2006, \$6,281,000 in November 2006 (including the contribution of a \$452,000 receivable) and \$425,000 in December 2006.

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The following table sets forth summarized financial data of Hallwood Energy as of and for the three years ended December 31, 2006 (in thousands):

| | 2006 | 2005 | 2004 |
|--|-------------|-------------|-------------|
| Balance Sheet Data | | | |
| Cash and cash equivalents | \$ 25,978 | \$ 91,235 | |
| Oil and gas properties, net | 179,986 | 61,657 | |
| Total assets | 214,362 | 164,340 | |
| Loans Payable | 39,019 | | |
| Total liabilities | 54,209 | 7,858 | |
| Partners capital | 160,153 | 156,482 | |
| Statement of Operations Data | | | |
| Revenues | | | |
| Natural gas sales | \$ 774 | \$ | \$ |
| Expenses | | | |
| Impairment of oil and gas properties | 28,408 | | |
| General and administrative expenses | 5,587 | 2,062 | 205 |
| Operating expenses | 2,076 | | |
| Depreciation and depletion | 555 | 211 | |
| | 36,626 | 2,273 | 205 |
| Operating Loss | (35,852) | (2,273) | (205) |
| Other Income and Expense | | | |
| Interest expense | (7,204) | | |
| Interest income | 1,658 | 357 | 106 |
| Other income (expense) | 7 | (209) | |
| Gain from sale of oil and gas properties | | 2,751 | |
| | (5,539) | 2,899 | 106 |
| Net Income (Loss) | \$ (41,391) | \$ 626 | \$ (99) |

A description of Hallwood Energy's activities is provided below:

Operations. In January 2006, Hallwood Energy entered into a participation agreement (the Participation Agreement) with Activa Resources, Ltd. Under the Participation Agreement, upon Activa's payment of approximately \$4,960,000 to Hallwood Energy in April 2006, Hallwood Energy transferred to Activa an undivided 25% interest in oil and gas leases with respect to 44,219 net acres that Hallwood Energy currently holds in Central Eastern Arkansas. During the

term of the Participation Agreement, Hallwood Energy is designated as operator of the leases. As operator, Hallwood Energy was required to commence actual drilling operations before June 2006 for the first of two initial wells. Hallwood Energy commenced drilling before that date. Activa agreed to participate to the extent of its participation interest in the two initial wells, and paid 50% of the first \$750,000 incurred for costs associated with the drilling, completion and equipping operations in connection with each of the initial wells. The Participation Agreement also establishes an area of mutual interest (the AMI) potentially covering an area of approximately 184,000 gross acres, which area includes the 44,219 acres. Pursuant to the AMI, Hallwood Energy will have the right to an undivided 75% participation interest, and Activa will have the right to an undivided 25% participation interest, in any additional leases acquired by either of the parties within the AMI. If either party acquires any additional leases covering lands within the AMI, it must offer the other party the right to acquire its participation interest in the leases acquired. The agreement related to the acquisition of additional leases expires in December 2007.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In April 2006, Hallwood Energy sold a 5% limited partner interest to an affiliate of its lender.

In July 2006, Hallwood Energy completed the sale of a 60% undivided working interest in its oil and gas properties in Reeves and Culberson Counties in West Texas and all of its interest in the properties in Parker, Hood and Tarrant Counties in North Texas to Chesapeake Energy Corporation (Chesapeake). Chesapeake assumed operation of these properties. The sales price of \$39,400,000, including reimbursement of certain development and drilling costs and subject to any post closing adjustments, exceeded the book value of the assets sold by \$10,600,000. The excess amount was credited to the full cost pool.

Loan Financing. In February 2006, Hallwood Energy entered into a \$65,000,000 loan facility, and had drawn \$40,000,000 as of December 31, 2006. During 2006, the loan facility was amended twice. First, it was amended to allow for the sale of undeveloped leaseholds to Chesapeake in July 2006 (discussed above). Secondly, it was amended in December 2006 to cure several technical loan defaults because of, among other things, Hallwood Energy's general and administrative expenses exceeded the maximum amount permitted under the loan facility and to extend the test dates for proved collateral coverage ratios and the make whole payment period. In connection with an additional \$25,000,000 capital contribution made by its investors in the 2006 fourth quarter, the lender agreed to waive the defaults, and a waiver and loan amendment were completed.

Subsequent to December 31, 2006, Hallwood Energy was not in compliance with the proved collateral coverage ratio.

In March and April 2007, the Company advanced a total of \$9,000,000 to Hallwood Energy, of which \$7,000,000 was in the form of demand notes bearing interest at 6% above prime rate, and \$2,000,000 was an advance that was repaid four days later with interest. In April 2007, Hallwood Energy made a request for additional capital contributions in the amount of \$25,000,000. The Company and Hallwood Energy have agreed that the \$7,000,000 amount previously advanced will be applied as the Company's portion of this capital call. On May 10, 2007, Hallwood Energy repaid \$257,000 to the Company, which represented the excess of amounts advanced over the Company's share of the capital contribution and related oversubscription.

In April 2007, Hallwood Energy entered into a \$100,000,000 senior secured credit facility (the Credit Facility) with an affiliate of one of the investors and drew \$65,000,000 from the Credit Facility. The proceeds were used to repay \$40,000,000 in an existing note payable, pay approximately \$10,300,000 for a make-whole fee and incremental interest to the original lender related to the \$40,000,000 note payable, and transaction fees of approximately \$200,000. Borrowings under the Credit Facility are secured by Hallwood Energy's oil and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum. An additional 2% of interest is added upon continuance of any defaulting event. The new lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event. In conjunction with executing the Credit Facility, the new lender resigned its position on the board of directors and assigned its general partner interest to the remaining members.

Provided that Hallwood Energy raises \$25,000,000 through an equity call or through debt subordinate to the Credit Facility (discussed below), the new lender will match subsequent amounts raised on a dollar for dollar basis up to the remaining \$35,000,000 under the Credit Facility through the availability termination date of July 31, 2008.

The Credit Facility contains various financial covenants, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The initial proved collateral coverage ratio test is performed June 30, 2008, and each quarter thereafter. Non-financial covenants restrict the ability of Hallwood Energy to dispose of assets, incur additional indebtedness, prepay other indebtedness or amend certain debt instruments, pay dividends, create liens on assets, enter into sale and leaseback transactions, make investments, loans or advances, make acquisitions, engage in mergers or consolidations or engage in certain transactions with affiliates, and otherwise restrict certain activities by Hallwood Energy.

The Credit Facility contains a make-whole provision whereby Hallwood Energy is required to pay the lender the amount by which the present value of interest and principal from the date of prepayment through January 31, 2009, exceeds the principal amount on the prepayment date. The lender received warrants exercisable for 2.5% of

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the partnership interests at an exercise price of 2.5% of 125% of the amount of the total capital contributed to Hallwood Energy at December 31, 2006.

Equity Investment. In November 2006, Hallwood Energy requested an additional capital contribution in the amount of \$25,000,000 from its partners. The Company invested an additional \$6,281,000 to maintain its proportionate interest in Hallwood Energy. The Company utilized a \$452,000 capital contribution receivable to reduce its cash contribution to \$5,829,000. In addition, certain other investors in Hallwood Energy did not elect to fund their proportionate share of the additional capital contribution. The Company invested an additional \$425,000 in December 2006 in excess of its proportionate amount. These contributions were made from existing cash.

Hallwood Energy issued a \$25,000,000 equity call to its partners on April 14, 2007 (the April Call). Previously, Hallwood Energy received cash advances of \$7,000,000 each from the Company and an affiliate of the new lender. These advances were applied to the April Call. HIL and the new lender have each committed to fund one half of the April Call and potential additional equity or subordinated debt funding calls of \$55,000,000 by Hallwood Energy, to the extent other investors, including the Company, do not respond to a call.

Litigation. In early 2006, Hallwood Energy entered into two two-year contracts with Eagle Drilling, LLC (subsequently Eagle Drilling Operations, LLC), under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas at a daily rate of \$18,500, plus certain expenses for each rig. In August 2006, one of the rigs provided by the contractor collapsed. Hallwood Energy requested the contractor to provide assurances that the other rig, and any rig provided to replace the collapsed rig, were safe and met the requirements of the contracts. When the contractor refused to provide these assurances, Hallwood Energy notified the contractor that the contracts were terminated and on September 6, 2006, filed *Hallwood Petroleum, LLC and Hallwood Energy, L.P. v. Eagle Drilling, LLC and Eagle Domestic Drilling Operations, LLC*, in the 348th District Court of Tarrant County, Texas to recover approximately \$1,688,000 previously deposited with the contractor under the contracts. Eagle Domestic Drilling Operations, LLC has asserted damages in excess of \$22,000,000 against Hallwood Energy, principally for breach of contract. Eagle Domestic Drilling Operations, LLC and its parent have since filed for Chapter 11 bankruptcy protection. Hallwood Energy is currently unable to determine the impact of this matter on its results of operations and financial position.

Hallwood Energy II, L.P.

| Description of Investment | Cost as | Amount at Which | | Equity Income (Loss) for | | |
|---------------------------------|--------------|-----------------|--------------|--------------------------|--------|------|
| | of | Carried at | | the | | |
| | December 31, | December 31, | December 31, | Years Ended | | |
| | 2006 | 2006 | 2005 | 2006 | 2005 | 2004 |
| Hallwood Energy II, L.P. | | | | | | |
| Limited partner interest | | | | \$ 417 | \$ (6) | |

Effective December 31, 2005, HE II and Hallwood Exploration were consolidated into HE4, which was renamed Hallwood Energy. At December 31, 2005, prior to the energy consolidation, the Company owned approximately 24% (20% after consideration of profit interests) of HE II. It accounted for this investment using the equity method of accounting and recorded its pro rata share of HE II's net income (loss) and partner capital transactions. HE II was formed to explore various oil and gas exploration opportunities, primarily in Texas, and in areas not associated with HEC and HE III. In 2005 and 2006, the Company invested \$2,430,000 and \$10,691,000 in HE II, respectively.

In connection with the July 2005 disposition of HE III, the Company received a deemed distribution of its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$889,000, which was then deemed contributed to HE II as an additional capital investment. In addition in July 2005, HE II sold all of its 835 net acres lease holdings in Johnson County, Texas to Chesapeake for \$3,000,000. The Company included its pro rata share of the gain from this transaction in the 2005 third quarter.

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Certain of the Company's officers and directors were investors in HE II. In addition, as members of management of HE II, one director and officer and one officer of the Company held a profit interest in HE II.

Hallwood Exploration, L.P.

| Description of Investment | Cost as of December 31, | | Amount at Which Carried at December 31, | | Equity Income (Loss) for the Years Ended December 31, | |
|-----------------------------------|-------------------------------|------|---|------|--|----------|
| | 2006 | 2006 | 2005 | 2006 | 2005 | 2004 |
| Hallwood Exploration, L.P. | | | | | | |
| Limited partner interest | | | | | \$ (165) | \$ (228) |

Effective December 31, 2005, HE II and Hallwood Exploration were consolidated into HE4, which was renamed Hallwood Energy. At December 31, 2005, prior to the energy consolidation, the Company owned approximately 20% (17% after consideration of profit interests) of Hallwood Exploration. It accounted for this investment using the equity method of accounting and recorded its pro rata share of Hallwood Exploration's net income (loss) and partner capital transactions. Hallwood Exploration was formed to exploit a salt dome oil and gas opportunity in St. James, Ascension and Assumption Parishes in South Louisiana. In 2004 and 2005, the Company invested \$1,318,000 and \$3,244,000 in Hallwood Exploration, respectively.

Certain of the Company's officers and directors were investors in Hallwood Exploration. In addition, as members of management of Hallwood Exploration, one director and officer and one officer of the Company held a profit interest in Hallwood Exploration.

Hallwood Energy 4, L.P. (Renamed Hallwood Energy, L.P.)

| Description of Investment | Cost as of December 31, | | Amount at Which Carried at December 31, | | Equity Income (Loss) for the Years Ended December 31, | |
|--------------------------------|-------------------------------|------|---|------|--|------|
| | 2006 | 2006 | 2005 | 2006 | 2005 | 2004 |
| Hallwood Energy 4, L.P. | | | | | | |
| Limited partner interest | | | | | \$ (124) | |

At December 31, 2005, prior to the energy consolidation, the Company owned approximately 26% (21% after consideration of profit interests) of HE 4. It accounted for this investment using the equity method of accounting and

recorded its pro rata share of HE 4's net income (loss) and partner capital transactions. In the 2005 third quarter, HE 4 was formed to acquire, explore and develop oil and gas acreage in the Fayetteville Shale in Central Eastern Arkansas. In September 2005 and December 2005, the Company invested \$9,193,000 and \$13,130,000 in HE 4, respectively. Effective December 31, 2005, in connection with the energy consolidation, the name of this private energy affiliate was changed to Hallwood Energy, L.P.

Hallwood Energy III, L.P.

| Description of Investment | Cost as of December 31, 2006 | Amount at Which Carried at December 31, 2006 2005 | Equity Income (Loss) for the Years Ended December 31, | | |
|----------------------------------|---------------------------------------|---|---|------------|----------|
| | | | 2006 | 2005 | 2004 |
| Hallwood Energy III, L.P. | | | | | |
| Limited partner interest | | | | \$ (8,628) | \$ (223) |

Prior to the sale of HE III in July 2005 (discussed below), the Company owned approximately 28% (24% after consideration of profit interests) of HE III. It accounted for this investment using the equity method of accounting and recorded its pro rata share of HE III's net income (loss) and partner capital transactions. In 2004, the Company

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

invested \$4,705,000 in HE III, which was formed primarily to acquire and develop oil and gas lease holdings in the Barnett Shale formation of Johnson and Hill Counties, Texas. In March 2005, the Company invested an additional \$4,251,000.

In June 2004, HE III acquired from HEC approximately 15,000 acres of undeveloped leasehold, three proven developed, non-producing natural gas properties, a limited amount of gas transmission line and various other assets. As the purchase was from a related entity, for accounting purposes the assets were recorded at net carrying value of approximately \$4,400,000, of which the Company's proportionate share was approximately \$1,232,000. During July 2004, HE III entered into an agreement with Chesapeake, which owned approximately 12,000 net acres contiguous to that of HE III, wherein it assigned a 44% interest in its lease holdings to Chesapeake, which in turn assigned a 56% interest in its lease holdings to HE III. Under the joint operating agreement between the entities, HE III had been designated as operator for future development.

HE III commenced commercial production and sales of natural gas in June 2004.

In December 2004, in connection with the sale of HEC, the Company, as a shareholder in HEC, received its proportionate share of debt from HE III owed to HEC in the amount of \$1,995,000, which it contributed directly as an additional capital investment. In addition, the Company received its proportionate share of HEC's investment in its Hallwood SWD, Inc. subsidiary, with a carrying value of approximately \$1,250,000, which was contributed to HE III as an additional capital investment.

In March 2005, an agreement was entered into with a former officer of the energy affiliates, who is not otherwise affiliated with the Company, to purchase the officer's four percent profit interest in the energy affiliates for \$4,000,000, of which \$3,500,000 was ascribed to HE III and \$250,000 each to HE II and Hallwood Exploration. The purchase was settled by the energy affiliates on July 1, 2005. The energy affiliates recorded the purchase amount as compensation expense in the 2005 first quarter and the Company recorded its proportionate share, approximately \$1,100,000, through equity accounting.

The Company's proportionate share of HE III's 2005 loss was principally attributable to compensation expense in connection with the settlement of profit interests concurrent with the completion of the merger and sale in July 2005 discussed below.

Sale of HE III. On July 18, 2005, HE III completed a merger with Chesapeake. The merger agreement provided for a total price of \$246,500,000 for all of the HE III production and reserves, as well as the operational and administrative infrastructure in Johnson County, and was subject to reduction for outstanding debt, transaction costs, changes in working capital and certain other matters. After these reductions and adjustments, Chesapeake paid a total of approximately \$235,000,000 at the closing, including debt owed by HE III, and an additional \$3,300,000, as a result of the final working capital adjustment settled in October 2005.

In exchange for its interest in HE III, the Company received a cash payment of \$54,850,000 in July 2005 and received an additional \$799,000 in November 2005 from the final working capital adjustment. In addition, the Company received a distribution for its proportionate share of certain pipe inventory owned by HE III, with a proportionate carrying value of approximately \$889,000, which was contributed to HE II as an additional capital investment. The Company also recorded a receivable at December 31, 2005 in the amount of \$469,000 for the settlement of a working

capital adjustment with Hallwood Petroleum. The receivable, which was reduced to \$452,000 by certain post-closing adjustments, was contributed to Hallwood Energy in November 2006 as an additional capital investment.

Certain of the Company's officers and directors were investors in HE III. In addition, as members of management of HE III, one director and officer and one officer of the Company held a profit interest in HE III.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Hallwood Energy Corporation***

| Description of Investment | Amount at Which Carried at December 31, | | Equity Income (Loss) for Years Ended December 31, | | |
|------------------------------------|---|------|---|------|------------|
| | 2006 | 2005 | 2006 | 2005 | 2004 |
| Hallwood Energy Corporation | | | | | |
| Common stock | | | | | \$ (9,444) |

The Company owned approximately 28% (22% after consideration of stock options) of HEC. It accounted for the investment using the equity method of accounting and recorded its pro rata share of HEC's net income (loss) and stockholder's equity transactions. The Company invested \$6,063,000 in HEC from 2002 until its sale.

The Company's proportionate share of HEC's 2004 loss was principally attributable to compensation expense in connection with the settlement of stock options concurrent with the completion of the merger and sale in December 2004 discussed below.

Loan Participation Agreement. In September 2004, the Company entered into a \$6,000,000 *pari passu* Loan Participation Agreement in connection with HEC's \$36,000,000 loan facility. The Company advanced \$2,000,000 to HEC under the Loan Participation Agreement in September 2004 and the remainder of \$4,000,000 in October 2004. The loan was fully repaid in December 2004. The Company earned \$159,000 in interest and fees from the loan in 2004.

Sale of HEC. On December 15, 2004, HEC completed a merger with Chesapeake, under which Chesapeake acquired HEC. The merger agreement provided for a total price of \$292,000,000, which was subject to reduction for certain transaction costs, title discrepancies and other matters, and adjustments for changes in working capital. After these reductions and adjustments, Chesapeake paid a total of \$277,100,000 at the closing, including debt owed by HEC, and management of HEC anticipated that an additional amount would be paid upon final calculation of working capital. The amounts received by HEC stockholders were reduced by additional transaction costs. Accordingly, in exchange for its interest in HEC, the Company received a cash payment of \$53,793,000 in December 2004 and received an additional amount of \$387,000 in April 2005 from the settlement of HEC's working capital. The Company also received its proportionate share of the HE III debt in the amount of \$1,995,000, which it contributed to HE III as an additional capital contribution and its proportionate interest in Hallwood SWD, Inc., the former HEC subsidiary that owned the Worthington saltwater disposal well, with a carrying value of approximately \$1,250,000, which it contributed to HE III as an additional capital contribution. Certain of the Company's officers and directors were investors in HEC. In addition, as members of management of HEC, one director and officer and one officer of the Company held stock options in HEC.

Hallwood Petroleum, LLC

Hallwood Petroleum, LLC. The Company's former Hallwood Petroleum, LLC subsidiary (HPL) commenced operation in October 2004 as an administrative and management company to facilitate record keeping and processing for the energy affiliates and had no financial value. All revenues were credited to, and all costs were borne by, the other energy affiliates with no profit element. All assets nominally in the name of HPL were held solely for the benefit of the other energy affiliates. HPL was formed as a subsidiary of the Company as a convenience and it was not intended that it have any financial impact on the Company. In the 2005 second quarter, the Company determined that its ownership of this pass-through entity created unnecessary complexity, therefore HPL was transferred for nominal consideration to officers of the energy affiliates that are not officers of the Company. The transfer was completed on May 11, 2005. HPL was acquired by Hallwood Energy for nominal consideration in connection with the December 31, 2005 energy consolidation.

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The Company invested nominal amounts in other affiliated entities which served as general partners for the energy affiliates. These entities were included in the energy consolidation on December 31, 2005.

Note 7 Loans Payable

Loans payable at the balance sheet dates are as follows (in thousands):

| | December 31, | |
|---|---------------------|-------------|
| | 2006 | 2005 |
| Bank Debt | | |
| Revolving credit facility, interest at Libor + 1.25% 1.75% or Prime; due January 2010 | \$ 10,432 | \$ 6,000 |
| Equipment term loans, interest at various rates; due at various dates from March 2007 through February 2009 | 460 | 812 |
| Total | 10,892 | 6,812 |
| Current portion | (275) | (352) |
| Noncurrent portion | \$ 10,617 | \$ 6,460 |

Revolving Credit Facility. The Company's Brookwood subsidiary has a revolving credit facility in an amount up to \$22,000,000 with Key Bank National Association (the Key Working Capital Revolving Credit Facility). Borrowings are collateralized by accounts receivable, certain finished goods inventory, machinery and equipment and all of the issued and outstanding capital stock of Brookwood and its subsidiaries. The facility (after the renewal discussed below) bears interest at Brookwood's option of Prime or Libor + 1.25% 1.75% (variable depending on compliance ratios) and contains two quarterly covenants, including maintenance of a financial ratio, and restrictions on dividends and repayment of debt or cash transfers to the Company. The interest rate was a blended rate of 7.48% and 6.27% at December 31, 2006 and 2005, respectively. The outstanding balance was \$10,432,000 at December 31, 2006 and Brookwood had \$11,568,000 of borrowing availability under this facility.

Equipment Term Loans. Brookwood has a revolving equipment credit facility in an amount up to \$3,000,000 with Key Bank. Interest rates for the equipment loans varied between 5.60% and 8.60%, with a blended rate of 7.17% at December 31, 2006. Monthly principal and interest payments are required for each of the borrowings. The outstanding balance at December 31, 2006 was \$460,000 and Brookwood had \$2,540,000 of borrowing availability under this facility.

Loan Covenants. The Key Working Capital Revolving Credit Facility included a covenant regarding total debt to tangible net worth ratio covenant, a minimum net income requirement and a covenant that cash dividends and tax sharing payments are contingent upon Brookwood's compliance with the covenants contained in the loan agreement.

As of the end of all interim periods in 2006 and 2005 and as of December 31, 2006 and 2005, Brookwood was in compliance with its loan covenants.

Renewal of Credit Facilities. Both of the Key Bank facilities, which had original maturities of January 2007, were renewed in March 2006 for a period of three years with a new maturity of January 30, 2010. The amounts of the respective facilities and the loan covenants were unchanged; however, the interest rate on the Key Working Capital Revolving Credit Facility was reduced, at Brookwood's option, from Prime plus 0.25% or Libor + 1.75% 3.00% (variable depending on compliance ratios).

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Schedule of Maturities. Maturities of loans payable for the next five years and thereafter are presented below (in thousands):

| Years Ending December 31, | Amount |
|----------------------------------|---------------|
| 2007 | \$ 275 |
| 2008 | 158 |
| 2009 | 27 |
| 2010 | 10,432 |
| Total | \$ 10,892 |

Note 8 10% Collateralized Subordinated Debentures

Description. The Company had an issue of 10% Collateralized Subordinated Debentures (the 10% Debentures) outstanding, due July 31, 2005. The 10% Debentures were listed on The New York Stock Exchange. For financial reporting purposes, a pro rata portion of an unamortized gain in the original amount of \$353,000 was allocated to the 10% Debentures from a previous debenture issue and was amortized over its term. As a result, the effective interest rate was 8.9%. Prior to redemption, the 10% Debentures were secured by a junior lien on the capital stock of Brookwood.

Redemption. In August 2004, the Company called the 10% Debentures, with a principal amount of \$6,468,000, for redemption. In September 2004, the Company completed the redemption with debenture holders receiving payments for 100% of the principal amount plus interest through the redemption date.

Note 9 Deferred Revenue Noncompetition Agreement

In March 2001, the Company agreed to sell its investment in its former subsidiary, Hallwood Energy Corporation, which represented the Company's former energy operations, to Pure Resources II, Inc., an indirect wholly owned subsidiary of Pure Resources, Inc. The Company received \$18,000,000 for the tender of its 1,440,000 shares of common stock in May 2001 and received an additional amount of \$7,250,000, pursuant to terms of a noncompetition agreement that was paid by Pure upon the completion of the merger in June 2001.

The Company began amortizing the deferred revenue from the noncompetition agreement in the amount of \$7,250,000, over a three-year period commencing June 2001. The amortization was \$1,007,000 in the year ended December 31, 2004. The noncompetition agreement was fully amortized in May 2004.

Note 10 Redeemable Preferred Stock

The Company has outstanding 250,000 shares of preferred stock (the Series B Preferred Stock). The holders of Series B Preferred Stock are entitled to cash dividends in an annual amount of \$0.20 per share (total annual amount of

\$50,000), which were paid in each of the years beginning in 1996 through and including 2003. No dividend was paid during the three years ended December 31, 2006. For the first five years, dividends were cumulative and the payment of cash dividends on any common stock was prohibited before the full payment of any accrued dividends. Beginning in 2001, dividends accrue and are payable only if and when declared by the Board of Directors. The Series B Preferred Stock has dividend and liquidation preferences to the Company's common stock. The shares are subject to mandatory redemption on July 20, 2010, which is fifteen years from the date of issuance, at 100% of the liquidation preference of \$4.00 per share plus all accrued and unpaid dividends, and may be redeemed at any time on the same terms at the option of the Company. The holders of the shares of Series B Preferred Stock are not entitled to vote on matters brought before the Company's stockholders, except as otherwise provided by law.

Note 11 Stockholders Equity

Common Stock. The Company's Second Restated Certificate of Incorporation contained a provision that restricted transfers of the Company's common stock in order to protect certain federal income tax benefits. The

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

restriction prohibited any transfer of common stock to any person that resulted in ownership in excess of 4.75% of the then outstanding shares. At the May 2004 annual meeting for the Company, the shareholders of the Company voted to amend the Second Restated Certificate of Incorporation by deleting this restriction.

Preferred Stock. Under its Second Restated Certificate of Incorporation, the Company is authorized to issue 500,000 shares of preferred stock, par value \$0.10 per share, and did issue 250,000 shares of Redeemable Series B Preferred Stock.

Treasury Stock. During 2005, 184,875 shares of common stock were reissued out of treasury in connection with the exercise of stock options by certain directors and officers. The treasury stock account balance was reduced by the average cost per treasury share which aggregated \$2,753,000.

During 2006, the Company purchased 657 common shares from one officer for \$73,000, and 4,875 shares of common stock were reissued out of treasury, in connection with the exercise of stock options by two officers. The treasury stock account balance was reduced by the average cost per treasury share which aggregated \$73,000.

Stock Options. The Company established the 1995 Stock Option Plan for The Hallwood Group Incorporated which authorized the granting of nonqualified stock options to employees, directors and consultants of the Company. The 1995 Plan authorized options to purchase up to 244,800 shares of common stock of the Company. The exercise prices of all options granted were at the fair market value of the Company's stock on the date of grant, had an expiration date of ten years from date of grant and were fully vested on the date of grant. At December 31, 2006, there were 14,250 fully vested outstanding options, of which 9,750 expire in 2007 and 4,500 expire in 2010. The 1995 Stock Option Plan terminated on June 27, 2005. Options issued prior to the termination are not affected; however, no new options can be issued under the 1995 Plan.

On January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment* using a modified method of prospective application. Under SFAS No. 123(R), all forms of share-based payments to employees, including employee stock options, are treated the same as other forms of compensation by recognizing the related cost in the statement of operations. The expense of the award would generally be measured at fair value at the grant date. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25. All options were fully vested as of December 31, 2005. The Company granted no options in the three years ended December 31, 2006. Because all of the Company's stock options were fully vested, there was no impact on income before taxes or net income from adopting SFAS No. 123(R).

In May 2006, the estate of a former officer of the Company exercised its remaining options to purchase 3,375 shares of the Company's common stock. The Company received proceeds of \$56,000 from the exercise of these options and reissued the shares out of treasury stock. The difference between the option proceeds and the average cost of reissued treasury shares of was recorded as an increase in additional paid-in capital.

In December 2006, one officer of the Company exercised options to purchase 1,500 shares of the Company's common stock that were scheduled to expire in February 2007. The officer paid the exercise price and related tax withholding requirement by exchanging an equivalent number of common shares valued at the fair market value of the common stock at the time of exercise. The net result of the exercise and exchange was the issuance of 843 shares out of treasury.

In the 2005 second quarter, the Company's chairman and chief executive officer, and two directors exercised all of their options to purchase a total of 180,000 shares of the Company's common stock, and three officers exercised a portion of their options to purchase an additional 4,875 shares. The Company received proceeds of \$2,207,000 from the exercise of these 184,875 options. The \$546,000 difference between the option proceeds of \$2,207,000 and the average cost of reissued treasury shares of \$2,753,000 was recorded as a reduction in additional paid-in capital earnings.

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Option activity for the year ended December 31, 2006 and status of outstanding options are as follows:

| | Number of Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (In Years) | Aggregate Intrinsic Value |
|--|------------------------------|--|---|--|
| Outstanding, January 1, 2006 | 19,125 | \$ 15.10 | | |
| Granted Exercised | (4,875) | \$ 16.09 | | |
| Forfeited | | | | |
| Outstanding, December 31, 2006 | 14,250 | \$ 14.77 | 1.46 | \$ 1,535,000 |
| Options exercisable at December 31, 2006 | 14,250 | | 1.46 | \$ 1,535,000 |
| Vested at December 31, 2006 | 14,250 | | 1.46 | \$ 1,535,000 |

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the 2006 calendar year and the exercise price, multiplied by the number of options).

A summary of options granted and the changes therein for the 1995 Stock Option Plan during the three years ended December 31, 2006 are presented below:

| | Years Ended December 31, | | | | | |
|--------------------------------|----------------------------------|--|----------------------------------|--|----------------------------------|--|
| | 2006 | | 2005 | | 2004 | |
| | Number of Options | Weighted Average Exercise Price | Number of Options | Weighted Average Exercise Price | Number of Options | Weighted Average Exercise Price |
| Outstanding, beginning of year | 19,125 | \$ 15.10 | 204,000 | \$ 12.23 | 204,000 | \$ 12.23 |
| Granted Exercised | (4,875) | 16.09 | (184,875) | 11.94 | | |

Forfeited
Reacquired

| | | | | | | | | | |
|-------------------------------------|--------|----|-------|--------|----|-------|---------|----|-------|
| Outstanding, end of year | 14,250 | \$ | 14.77 | 19,125 | \$ | 15.10 | 204,000 | \$ | 12.23 |
| Options exercisable, at end of year | 14,250 | \$ | 14.77 | 19,125 | \$ | 15.10 | 204,000 | \$ | 12.23 |

The Company did not grant any stock options and all options outstanding were fully vested in the three year period ended December 31, 2006; therefore, no pro forma amounts are required to be reported.

Note 12 Separation Agreement

In 1999, the Company entered into a separation agreement (the Separation Agreement) with a former officer and director. The Separation Agreement provided that the former officer and director and related trust exchange their 24% stock ownership in the Company, for certain assets and future cash payments, contingent on the net cash flow from the Company's real estate management activities. The Company had an option to extinguish the future cash payments at any time prior to December 21, 2004 upon the payment of \$3,000,000. In June 2004, the Company exercised the option. The Company recognized a gain from extinguishment of the Separation Agreement in the amount of \$375,000, which was the excess of the recorded obligation over the \$3,000,000 exercise price.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 13 Income Taxes**

Following is a schedule of the income tax expense (benefit) (in thousands):

| Continuing Operations | Years Ended December 31, | | |
|------------------------------|---------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Federal | | | |
| Current | \$ (2,189) | \$ 13,688 | \$ 10,390 |
| Deferred | (1,032) | 3,933 | (900) |
| Sub-total | (3,221) | 17,621 | 9,490 |
| State | | | |
| Current | 242 | 779 | 1,783 |
| Deferred | (9) | 110 | (194) |
| Sub-total | 233 | 889 | 1,589 |
| Total | \$ (2,988) | \$ 18,510 | \$ 11,079 |

| Discontinued Operations | Years Ended December 31, | | |
|--------------------------------|---------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Federal | | | |
| Current | \$ | \$ | \$ 1,207 |
| Deferred | | | 5,143 |
| Sub-total | | | 6,350 |
| State | | | 212 |
| Total | \$ | \$ | \$ 6,562 |

Reconciliations of the expected tax or (benefit) at the statutory tax rate to the recorded tax or (benefit) are as follows (in thousands):

| Years Ended December 31, | | |
|---------------------------------|-------------|-------------|
| 2006 | 2005 | 2004 |

| | | | |
|--|------------|-----------|-----------|
| Expected tax expense (benefit) at the statutory tax rate | \$ (3,303) | \$ 15,698 | \$ 39,244 |
| State taxes | 154 | 578 | 1,297 |
| Permanent items | 120 | | |
| Other | 41 | 2,236 | (3,731) |
| Foreign loss not taxable | | (2) | (2) |
| Decrease in deferred tax asset valuation allowance | | | (19,167) |
| Recorded tax or (benefit) | \$ (2,988) | \$ 18,510 | \$ 17,641 |

The net deferred tax asset was \$1,655,000 and \$614,000 at December 31, 2006 and 2005, respectively. Prior to 2004, the deferred tax asset was principally attributable to the anticipated utilization of the Company's net operating loss carryforwards (NOLs), percentage depletion carryovers, tax credits and timing differences from the implementation of various tax planning strategies, which included anticipated gains from the potential sale of investments and projected income from operations. During 2004, the Company utilized all of its available NOLs of \$29,166,000, alternative minimum tax credits of \$2,249,000 and a depletion carryforward of \$6,323,000 to offset taxable income. At December 31, 2006, the deferred tax asset was comprised of \$1,124,000 attributable to timing differences, that upon reversal, can be utilized to offset income from operations and \$531,000 of alternative minimum tax credits. The 2005 amount was attributable solely to temporary differences.

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As a result of the appreciation in market value of the HRP limited partner units during 2004 and the establishment of a value for the general partner interest in HRP, principally due to the terms of the Agreement and Plan of Merger with HRPT, and an increase in projected income from operations due to improved results at Brookwood and the Company's energy investments, management determined that its valuation allowance should be eliminated to reflect the anticipated increase in utilization of NOLs and other tax attributes prior to their expiration. Deferred tax expense in 2004 was reduced by the elimination of the valuation allowance, which was \$19,167,000 at December 31, 2003. To the extent that the elimination of the valuation allowance was attributable to the appreciation in market value of the investments in HRP, the deferred tax benefit was allocated to discontinued operations. Accordingly, the Company recorded a deferred tax expense (benefit) of \$(1,041,000), \$4,043,000 and \$4,049,000 in 2006, 2005 and 2004, respectively.

The Company reported a taxable loss in 2006, principally attributable to significant amount of intangible drilling costs from its Hallwood Energy investment, and as a result recorded a federal current tax benefit of \$2,189,000. The Company reported significant taxable income in 2005, principally attributable to the gain from disposition of its investment in HE III and incurred federal current tax expense of \$13,688,000. In 2004, the Company reported taxable income principally as a result of gains from the disposition of its interests in HRP and HEC, net of the utilization of NOLs, depletion carryovers and tax credits and incurred federal current tax expense from continuing and discontinued operations of \$11,597,000.

The accrued federal income tax receivable was \$3,861,000 and \$1,322,000 and net state taxes receivable (payable) were \$200,000 and \$(9,000) at December 31, 2006 and 2005, respectively.

The Internal Revenue Service completed an examination of the Company's consolidated income tax returns for the years ended December 31, 2004 and 2005. The IRS proposed adjustments that resulted in a tax assessment of \$61,000 for 2004 and \$103,000 for 2005, with associated interest costs of \$15,000. The Company paid the assessed tax and interest in December 2006.

A schedule of the types and amounts of existing temporary differences and NOLs, at the blended statutory tax rate of 34% (35% at December 31, 2005), as of the balance sheet dates are as follows (in thousands):

| | Deferred Tax Asset, Net | | | |
|---|--------------------------------|--------------------|--------------------------|--------------------|
| | December 31, 2006 | | December 31, 2005 | |
| | Assets | Liabilities | Assets | Liabilities |
| Reserves recorded for financial statement purposes and not for tax purposes | \$ 1,024 | \$ | \$ 1,198 | \$ |
| Equity in earnings of unconsolidated affiliates | 696 | | | 53 |
| Depreciation and amortization | | 596 | | 531 |
| Tax credits | 531 | | | |
| Deferred tax assets and liabilities | 2,251 | \$ 596 | 1,198 | \$ 584 |

| | | |
|--------------------------------|----------|--------|
| Less: Deferred tax liabilities | (596) | (584) |
| Deferred tax asset, net | \$ 1,655 | \$ 614 |

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The Company's real estate business segment has been reclassified to discontinued operations as a result of the sale of its investments in HRP and the termination of the associated management contracts (discussed below). A summary of discontinued real estate operations is provided below (in thousands):

| | Years Ended December 31, | | |
|---|-------------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Revenues | | | |
| Fees | | | |
| Related parties | \$ | \$ | \$ 2,814 |
| Other | | | 247 |
| Equity income (loss) from investments in HRP | | | (2,769) |
| | | | 292 |
| Expenses | | | |
| Administrative expenses | | | 877 |
| Litigation costs | | | 50 |
| Amortization | | | |
| | | | 927 |
| Income (loss) from operations | | | (635) |
| Gain from sale | | | |
| Gain from sale of investments in HRP | | | 52,703 |
| Incentive compensation and transaction costs | | | (6,629) |
| | | | 46,074 |
| Income (loss) before income taxes | | | 45,439 |
| Income taxes | | | |
| Current federal and state income tax expense | | | 1,294 |
| Deferred federal income tax expense | | | 5,143 |
| | | | 6,437 |
| Income from discontinued real estate operations | \$ | \$ | \$ 39,002 |

Prior to its sale in July 2004, the Hallwood Realty and HWG, LLC, wholly owned subsidiaries of the Company, owned a 1% general partner interest and a 21% limited partner interest, respectively, in its HRP affiliate. The

Company accounted for its investment in HRP using the equity method of accounting. In addition to recording its share of HRP's net income (loss), the Company also recorded non-cash adjustments for the elimination of intercompany profits with a corresponding adjustment to equity income (loss), its pro rata share of HRP's partner capital transactions with corresponding adjustments to additional paid-in capital and its pro rata share of HRP's comprehensive income (loss).

Management of HRP. Prior to the HRP's sale to HRPT, the Company's real estate subsidiaries earned asset management, property management, leasing and construction supervision fees for their management of HRP's real estate properties. The management contracts with HRP, which were scheduled to expire on June 30, 2004, were

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amended in April 2004 to expire on the closing date of the merger with HRPT, which was completed July 16, 2004. A summary of the fees earned from HRP is detailed below (in thousands):

| | Years Ended December 31, | | |
|-------------------------------|-------------------------------------|-------------|--------------|
| | 2006 | 2005 | 2004 |
| Property management fees | \$ | \$ | \$ 1,127 |
| Leasing fees | | | 866 |
| Construction supervision fees | | | 486 |
| Asset management fees | | | 335 |
| Total | \$ | \$ | \$ 2,814 |

The management contracts with HRP were terminated on July 16, 2004 in connection with HRP's sale to HRPT. Hallwood Realty was also reimbursed for certain costs and expenses, at cost, for administrative level salaries and bonuses, employee and director insurance and allocated overhead costs. In addition, since HRP did not employ any individuals, the compensation and other costs related to approximately 90 employees rendering services on behalf of HRP and its properties were reimbursed to Hallwood Realty and HCRE by HRP.

Disposition. In July 2004, a merger with a subsidiary of HRPT was approved by the HRP unitholders at the special meeting of unitholders with holders of 53.74% of the outstanding units voting to approve the merger, and on July 16, 2004, HRP announced the completion of the merger. The total cash price HRPT paid under the merger agreement and the purchase agreement was approximately \$247,000,000. In addition, HRPT assumed or prepaid all of HRP's outstanding debt. In July 2004, the Company received proceeds of approximately \$66,060,000 from the sale of its interests, of which \$18,500,000 was placed into an escrow account pending the resolution of certain claims. In December 2004, the pending claims were resolved, and the Company received the full amount of the \$18,500,000 escrow deposit plus accrued interest. The Company used approximately \$14,400,000 of the proceeds to repay principal, accrued interest and fees associated with the Amended and Restated Credit Agreement. See Note 7.

In its announcement, HRP indicated that unitholders received an amount in cash equal to \$136.70 per unit of limited partnership. Of this amount \$0.31 per unit was withheld subject to the award of attorneys' fees to the class counsel in the *I.G. Holdings Inc. et al v. Hallwood Realty, LLC et al.* litigation. Proceeds were also reduced by approximately \$102,000 for the Company's share of the award of attorneys' fees to the class counsel in the *I.G. Holdings* litigation. In February 2005, the Company received approximately \$59,000, which was its allocable share of the remaining escrow account balance from the *I.G. Holdings* litigation.

Gain from Sale. The gain from sale of investments in HRP of \$52,703,000 resulted from the receipt of \$66,119,000 in the merger less the carrying value of the investments in the general partnership and limited partnership interests of approximately \$13,416,000. In connection with the sale of HRP and the substantial benefits the Company received from the operations of HRP over a number of years, a special committee, consisting of independent members of the board of directors of the Company, authorized an additional incentive compensation payment of \$1,622,000 to

Mr. Guzzetti, the Company's executive vice president and payments of \$1,908,000 to Mr. Gumbiner and \$3,000,000 to Hallwood Investments Limited, a corporation associated with Mr. Gumbiner. Transaction costs were \$99,000.

Dissolution. Following the board of directors' determination to discontinue the Company's real estate activities effective January 1, 2005, the Company completed a dissolution of all of its real estate subsidiaries during 2005.

Note 15 Discontinued Hotel Operations

In December 2000, the Company decided to discontinue its hotel operations and to dispose of its hotel segment, principally by allowing its non-recourse debtholders to assume ownership of the properties through foreclosure or by selling or otherwise disposing of its hotel properties. The Company's former hotel segment consisted of three owned properties and two leased properties.

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As of June 2002, the Company completed the disposition of four hotel properties it had previously designated as discontinued operations. The Company determined that it would retain its leasehold interest in the GuestHouse Suites hotel in Huntsville, Alabama. In December 2004, the Company's Brock Suites Huntsville, Inc. subsidiary entered into a Lease Termination and Mutual Release Agreement with the landlord of the GuestHouse Suites Plus hotel in Huntsville, Alabama. In connection with the lease termination, the remaining assets of the subsidiary were transferred to the landlord, and the Company obtained a release from any further obligations. The Company recognized a gain from extinguishment of debt of \$1,598,000. Operating results for the Huntsville hotel were reclassified as discontinued operations. A summary of discontinued hotel operations for the three years ended December 31, 2006 is provided below (in thousands):

| | Years Ended December 31, | | |
|---|-------------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Revenues | | | |
| Gain from extinguishment of debt | \$ | \$ | \$ 1,598 |
| Sales | | | 1,499 |
| | | | 3,097 |
| Expenses | | | |
| Operating expenses | | | 1,987 |
| Depreciation and amortization | | | 188 |
| Interest expense | | | 10 |
| Litigation and other disposition costs | | | 5 |
| | | | 2,190 |
| Income before income taxes | | | 907 |
| Income tax expense | | | 124 |
| Income from discontinued hotel operations | \$ | \$ | \$ 783 |

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The following transactions affected recognized assets or liabilities but did not result in cash receipts or cash payments (in thousands):

Supplemental Schedule of Non-Cash Investing and Financing Activities.

| | Years Ended December 31, | | |
|--|---------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Income tax effect from exercise of stock options: | | | |
| Income taxes payable | \$ (187) | \$ (1,466) | \$ |
| Additional paid-in capital | 187 | 1,466 | |
| | \$ | \$ | \$ |
| Contribution of receivable as investment in Hallwood Energy | \$ 452 | \$ | \$ |
| Change in accrued capital expenditures in accounts payable | \$ 162 | \$ | \$ |
| Other comprehensive income Increase in value of available for sale marketable securities | \$ 55 | \$ | \$ |
| Transfer of HPL net assets to officers of the energy affiliates: | | | |
| Restricted cash | \$ | \$ 218 | \$ |
| Prepays, deposits and other assets | | 85 | |
| Property, plant and equipment, net | | 588 | |
| Other noncurrent assets | | 138 | |
| Accounts payable | | (584) | |
| Accrued expenses and other current liabilities | | (445) | |
| | \$ | \$ | \$ |
| Proportionate share of partners capital transactions of equity investments | | | |
| Sale of real estate investments | \$ | \$ | \$ 257 |
| Amortization of interest rate swap | | | (30) |
| | \$ | \$ | \$ 227 |
| Hotel assets and liabilities relinquished in connection with debt extinguishment: | | | |
| Other liabilities, net | \$ | \$ | \$ 1,598 |

Supplemental disclosures of cash payments.

| | | | |
|-------------------|--------|--------|----------|
| Interest paid | \$ 594 | \$ 455 | \$ 1,299 |
| Income taxes paid | 608 | 15,158 | 12,903 |

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The following table reconciles weighted average shares outstanding from basic to assuming dilution and reconciles net income (loss) used in the computation of income per share for the basic and assuming dilution methods (in thousands):

| | Years Ended December 31, | | |
|--|---------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Weighted Average Shares Outstanding | | | |
| Basic | 1,514 | 1,446 | 1,326 |
| Potential shares from assumed exercise of stock options | | 88 | 204 |
| Potential repurchase of shares from stock options proceeds | | (26) | (43) |
| Assuming dilution | 1,514 | 1,508 | 1,487 |
| Net Income (Loss) | | | |
| Basic and assuming dilution | \$ (6,725) | \$ 26,342 | \$ 94,485 |

Due to the loss for the year ended December 31, 2006, potential shares from assumed exercise of stock options in the amount of 14,000 shares were antidilutive.

Note 18 Fair Value of Financial Instruments

Estimated fair value amounts have been determined using available market information or other appropriate valuation methodologies that require considerable judgment in interpreting market data and developing estimates. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The fair value of financial instruments that are short-term or reprice frequently and have a history of negligible credit losses are considered to approximate their carrying value. These include cash and cash equivalents, short term receivables, accounts payable and other liabilities.

Management has reviewed the carrying value of its loans payable in connection with interest rates currently available to the Company for borrowings with similar characteristics and maturities. Management has determined that the estimated fair value of the loans payable would be approximately \$10,881,000 and \$6,837,000 at December 31, 2006 and 2005, compared to the carrying value of \$10,892,000 and \$6,812,000, respectively.

The fair value information presented as of December 31, 2006 and 2005 is based on pertinent information available to management. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that

date and, therefore current estimates of fair value may differ significantly from the amounts presented herein.

Note 19 Related Party Transactions

Hallwood Investments Limited. The Company has entered into a financial consulting contract with Hallwood Investments Limited (HIL), a corporation associated with Mr. Anthony J. Gumbiner, the Company's chairman and principal stockholder. The contract provides for HIL to furnish and perform international consulting and advisory services to the Company and its subsidiaries, including strategic planning and merger activities, for annual compensation of \$996,000 (\$954,000 prior to March 2005 and \$795,000 prior to March 2004). The annual amount is payable in monthly installments. The contract automatically renews for one-year periods if not terminated by the parties beforehand. Additionally, HIL and Mr. Gumbiner are eligible for bonuses from the Company or its subsidiaries, subject to approval by the Company or its subsidiaries' board of directors. The Company also reimburses HIL for reasonable expenses in providing office space and administrative services and for travel and

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related expenses to and from the Company's United States office. In addition, the Company also reimbursed Mr. Gumbiner for services, meals and other personal expenses related to the office separately maintained by Mr. Gumbiner. At Mr. Gumbiner's recommendation, the Company's board of directors determined in 2006 that the reimbursement for personal expenses related to his office would not continue after November 2006. Prior to the disposition of HRP in July 2004, a significant portion of the office and administrative costs were paid by HRP.

A summary of the fees and expenses related to HIL and Mr. Gumbiner are detailed below (in thousands):

| | Years Ended December 31, | | |
|--|---------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Consulting fees | \$ 996 | \$ 989 | \$ 928 |
| Office space and administrative services | 463 | 557 | 324 |
| Travel expenses | 267 | 257 | 218 |
| Bonus | | 5,000 | 4,908 |
| Total | \$ 1,726 | \$ 6,803 | \$ 6,378 |

A special committee, consisting of independent members of the board of directors, awarded a \$5,000,000 bonus to Mr. Gumbiner, in consideration of the significant profits and long-term gains realized by the Company as a result of Mr. Gumbiner's performance over an extended period. The bonus was paid in July 2005.

In connection with the sale of HRP in July 2004 and the substantial benefits the Company received from the operations of HRP over a number of years, a special committee authorized additional incentive compensation payments of \$1,908,000 to Mr. Gumbiner and \$3,000,000 to HIL. The bonuses were paid in September 2004 and October 2004, respectively. As these incentive compensation payments related to HRP, the costs were reported within the discontinued real estate operations.

In addition, HIL and Mr. Gumbiner perform services for certain affiliated entities that are not subsidiaries of the Company, for which they receive consulting fees, bonuses, stock options, net profit interests or other forms of compensation and expenses. The Company recognizes a proportionate share of such compensation and expenses, based upon its ownership percentage in the affiliated entities through the utilization of the equity method of accounting.

Beginning January 1, 2005, HIL shares common offices, facilities and certain staff in its Dallas office with the Company. The Company pays certain common general and administrative expenses and charges HIL an overhead reimbursement fee for its allocable share of the expenses. For the years ended December 31, 2006 and 2005, HIL reimbursed the Company \$142,000 and \$113,000, respectively, for such expenses.

In April 2007, HIL committed to fund one-half of potential additional equity or subordinated debt funding calls of \$55,000,000 (or \$27,500,000) by Hallwood Energy, to the extent other investors, including the Company, do not respond to a call.

Hallwood Energy. Beginning August 1, 2005, Hallwood Energy and its predecessor entities shares common offices, facilities and certain staff in its Dallas office with the Company. Hallwood Energy reimburses the Company for its allocable share of the expenses. For the year ended December 31, 2006 and the five month period ended December 31, 2005, Hallwood Energy reimbursed the Company \$311,000 and \$59,000, respectively, for such expenses.

Hallwood Realty Partners, L.P. The Company's former Hallwood Realty and HCRE real estate subsidiaries earned asset management, property management, leasing and construction supervision fees from HRP prior to the sale of its investments in July 2004. See Note 14.

Note 20 Litigation, Contingencies and Commitments

Litigation. From time to time, the Company, certain of its affiliates and others have been named as defendants in lawsuits relating to various transactions in which it or its affiliated entities participated. In the

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company's opinion, no litigation in which the Company, subsidiaries or affiliates is a party is likely to have a material adverse effect on its financial condition, results of operations or cash flows.

High River and I.G. Holdings. In April 2003, an action was filed against HRP's general partner, Hallwood Realty (the General Partner), its directors and HRP as nominal defendant by High River Limited Partnership, which is indirectly wholly owned by Carl C. Icahn, in the Court of Chancery of the State of Delaware, styled *High River Limited Partnership v. Hallwood Realty, LLC, et al*, (C.A. No. 20276). The action related to a tender offer by High River for units of HRP. In addition, a putative class action lawsuit was filed against the General Partner, its directors and HRP as nominal defendant by three purported unitholders of HRP in the Court of Chancery of the State of Delaware, styled *I.G. Holdings, Inc., et al, v. Hallwood Realty LLC, et al*, (C.A. No. 20283) also relating to the High river tender offer.

Pursuant to a settlement agreement, HRP paid to the plaintiffs a total of \$2,255,000 for attorneys' fees and costs. The matter was concluded in October 2004.

Other. The Company was a defendant in two lawsuits regarding guarantees of certain obligations of the Embassy Suites and Holiday Inn hotels. In February 2003, the Company settled both matters. The Company agreed (i) to pay \$150,000 in cash and issue a non-interest bearing promissory note in the amount of \$250,000 payable in equal monthly installments over 18 months, in exchange for a full release regarding the Embassy Suites hotel in Oklahoma City, Oklahoma and (ii) to pay \$250,000 in cash in exchange for a full release regarding the Holiday Inn hotel in Sarasota, Florida. The Company made all scheduled payments in accordance with the settlement agreements and the final payment for the aforementioned promissory note was made in December 2004.

Hallwood Energy. As a significant investor in Hallwood Energy, the Company may be impacted by litigation involving Hallwood Energy. Refer to Note 6 for a further description of certain litigation involving Hallwood Energy.

Environmental Contingencies. A number of jurisdictions in which the Company operates have adopted laws and regulations relating to environmental matters. Such laws and regulations may require the Company to secure governmental permits and approvals and undertake measures to comply therewith. Compliance with the requirements imposed may be time-consuming and costly. While environmental considerations, by themselves, have not significantly affected the Company's business to date, it is possible that such considerations may have a significant and adverse impact in the future. The Company actively monitors its environmental compliance and while certain matters currently exist, management is not aware of any compliance issues which will significantly impact the financial position, operations or cash flows of the Company.

In August 2005, the Rhode Island Department of Health (RIDOH) issued a compliance order to Kenyon, alleging that Kenyon is a non-community water system and ordering Kenyon to comply with the RIDOH program for public water supply systems. Kenyon contested the compliance order and an administrative hearing was held in November 2005. No decision has been rendered. Complying with the RIDOH requirements would necessitate revamping of the plant's water supply system and associated costs of approximately \$100,000.

In August 2005, Kenyon received a Notice of Alleged Violation from The Rhode Island Department of Environmental Management (RIDEM) with notification that Kenyon had failed to comply timely with a requirement to test the destruction efficiency of a thermal oxidizer at its Kenyon plant and that when the test was conducted the equipment was not operating at the required efficiency. Since that time, Kenyon has upgraded and retested the equipment, which

met the requirements on the retest. RIDEM has requested additional information regarding the failed test and Kenyon's remedial actions, which Kenyon has provided. In February 2007, RIDEM issued a Notice of Violation (NOV) accompanied by a \$14,000 fine. Kenyon, requested an informal hearing to dispute the allegations in the NOV and the fine. As a result of the informal hearing held on March 30, 2007, a consent agreement was executed and a \$9,500 fine was remitted to RIDEM to close this matter.

In September 2005, Brookwood accrued \$250,000 for anticipated environmental remediation costs in connection with a plan to remove, dewater, transport and dispose of sludge from its lagoons. Brookwood accrued

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an additional \$35,000 for remediation costs in 2006. Brookwood received approval from RIDEM for the remediation activities, which were completed in July 2006.

In October 2005, Brookwood Laminating received a NOV from RIDEM alleging various violations of the Rhode Island Hazardous waste management program and seeking an administrative penalty of approximately \$20,000. Brookwood Laminating contested the NOV and in January 2006, settled the matter with a reduced penalty in the amount of \$12,750.

Commitments. Total lease expense for noncancelable operating leases was \$1,227,000, \$812,000 and \$1,515,000 for the years ended December 31, 2006, 2005 and 2004, respectively. The Company leases certain textile equipment and one hotel property (prior to its disposition in December 2004), including land, buildings and equipment. The leases generally require the Company to pay property taxes, insurance and maintenance of the leased assets. The Company shares certain executive office facilities with Hallwood Energy, HIL and HRP (prior to its disposition in July 2004) and pays a proportionate share of the lease expense.

At December 31, 2006 aggregate minimum annual rental commitments under noncancelable operating leases having an initial or remaining term of more than one year, were as follows (in thousands):

| Years Ending December 31, | Amount |
|--------------------------------------|-----------------|
| 2007 | \$ 1,086 |
| 2008 | 1,012 |
| 2009 | 659 |
| 2010 | 626 |
| 2011 | 349 |
| Thereafter | 1,697 |
| Total | \$ 5,429 |

Employment Contracts. The Company and its Brookwood subsidiary have compensation agreements with various personnel and consultants. Generally, the agreements extend for one-year terms and are renewable annually.

2005 Long-Term Incentive Plan for Brookwood. In December 2005, the Company adopted The Hallwood Group Incorporated 2005 Long-Term Incentive Plan for Brookwood Companies Incorporated (2005 Long-Term Incentive Plan for Brookwood) to attract, retain and motivate key personnel of Brookwood. The terms of the incentive plan provide for a total award amount to participants equal to 15% of the fair market value of consideration received by the Company in a change of control transaction, as defined, in excess of the sum of the liquidation preference plus accrued unpaid dividends on the Brookwood preferred stock (approximately \$23,730,000 at December 31, 2006). The base amount will fluctuate in accordance with a formula that increases by the amount of the annual dividend on the preferred stock, currently \$1,823,000, and decreases by the amount of the actual dividends paid by Brookwood to the Company. Provided certain circumstances are met, the minimum total award amount shall be \$2,000,000. In addition,

if certain members of Brookwood senior management do not have at least a two percent equity or debt interest in the entity with which the change of control transaction is completed, then the Company will be obligated to pay an additional \$2,600,000.

Note 21 Segment and Related Information

The Company is a holding company and classifies its continuing business operations into two reportable segments; textile products and energy. Both segments have different management teams and infrastructures that engage in different businesses and offer different services. See Notes 5 and 6.

The Company's discontinued operations are comprised of its former real estate and hotel segments. See Notes 14 and 15.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following represents the Company's reportable amounts by business segment and discontinued operations, as of and for the three years ended December 31, 2006 (in thousands):

| | Textile Products | Energy | Other | Discontinued Operations | Consolidated |
|---|-----------------------------|---------------|--------------|------------------------------------|---------------------|
| Year Ended December 31, 2006 | | | | | |
| Total revenue from external sources | \$ 112,154 | | | | \$ 112,154 |
| Operating income (loss) | \$ 5,588 | | \$ (4,816) | | \$ 772 |
| Other income (loss), net | \$ (602) | \$ (10,435) | \$ 552 | | (10,485) |
| Loss from continuing operations before income taxes | | | | | \$ (9,713) |
| Income from discontinued operations | | | | | |
| Identifiable assets, December 31, 2006 | \$ 51,720 | \$ 39,864 | | | \$ 91,584 |
| Cash allocable to segment | 387 | | \$ 9,667 | | 10,054 |
| | \$ 52,107 | \$ 39,864 | \$ 9,667 | | 101,638 |
| Corporate assets | | | \$ 5,959 | | 5,959 |
| Total assets, December 31, 2006 | | | | | \$ 107,597 |
| Depreciation and amortization | \$ 1,844 | \$ | \$ 20 | | \$ 1,864 |
| Capital expenditures/acquisitions | \$ 4,149 | \$ | \$ 48 | | \$ 4,197 |
| Year Ended December 31, 2005 | | | | | |
| Total revenue from external sources | \$ 133,108 | \$ 1,499 | | | \$ 134,607 |
| Operating income (loss) | \$ 11,677 | | \$ (11,624) | | \$ 53 |
| Other income (loss), net | \$ (545) | \$ 43,812 | \$ 1,532 | | 44,799 |
| Income from continuing operations before income taxes | | | | | \$ 44,852 |
| Income from discontinued operations | | | | | |

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| | | | | |
|--|-----------|-----------|-----------|------------|
| Identifiable assets, December 31, 2005 | \$ 48,132 | \$ 40,854 | | \$ 88,986 |
| Cash allocable to segment | 281 | | \$ 16,367 | 16,648 |
| | \$ 48,413 | \$ 40,854 | \$ 16,367 | 105,634 |
| Corporate assets | | | \$ 3,167 | 3,167 |
| Total assets, December 31, 2005 | | | | \$ 108,801 |
| Depreciation and amortization | \$ 1,738 | \$ 97 | \$ 15 | \$ 1,850 |
| Capital expenditures/acquisitions | \$ 2,654 | \$ 69 | \$ 3 | \$ 2,726 |

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Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

| | Textile Products | Energy | Other | Discontinued Operations | Consolidated |
|--|-----------------------------|---------------|--------------|------------------------------------|---------------------|
| Year Ended December 31, 2004 | | | | | |
| Total revenue from external sources | \$ 136,276 | \$ 1,004 | | | \$ 137,280 |
| Operating income (loss) | \$ 18,460 | | \$ (6,789) | | \$ 11,671 |
| Other income (loss), net | \$ (398) | \$ 52,387 | \$ 2,119 | | 54,108 |
| Income from continuing operations before income taxes | | | | | \$ 65,779 |
| Income from discontinued operations | | | | \$ 39,785 | \$ 39,785 |
| Identifiable assets, December 31, 2004 | \$ 60,238 | \$ 13,347 | | \$ 329 | \$ 73,914 |
| Cash allocable to segment | 228 | 218 | \$ 71,321 | | 71,767 |
| | \$ 60,466 | \$ 13,565 | \$ 71,321 | \$ 329 | 145,681 |
| Corporate assets | | | \$ 11,636 | | 11,636 |
| Total assets, December 31, 2004 | | | | | \$ 157,317 |
| Depreciation and amortization | \$ 1,618 | \$ 57 | \$ 7 | \$ 188 | \$ 1,870 |
| Capital expenditures/acquisitions | \$ 2,651 | \$ 689 | \$ 21 | | \$ 3,361 |

Note 22 Employee Benefit Retirement Plans

In August 1989, the Company established a contributory, tax-deferred 401(k) tax favored savings plan covering substantially all of its non-union employees. The plan provides that (i) eligible employees may contribute up to 15% of their compensation to the plan; (ii) the Company's matching contribution is discretionary, to be determined annually by the Company's Board of Directors; (iii) excludes the Company's hotel hourly employees from a matching contribution; and (iv) excludes highly compensated employees from a matching contribution, although this group receives a compensatory bonus in lieu of such contribution and diminution of related benefits. Amounts contributed by employees are 100% vested and non-forfeitable. The Company's matching contributions, which were 50% of its employees' contributions up to the first 6% contributed, for each of the years ended December 31, 2006 and 2005, vest at a rate of 20% per year of service and become fully vested after five years. The Company did not provide a matching contribution in 2004. Employees of Hallwood Realty, HCRE and salaried hotel employees also participated in the Company's 401(k) plan. Employer contributions paid on behalf of Hallwood Realty employees were substantially paid by HRP. Brookwood has a separate 401(k) plan which is similar to the Company's plan. Aggregate contributions to the

plans for the years ended December 31, 2006, 2005 and 2004, respectively, excluding contributions from HRP in 2004, were \$273,000, \$283,000 and \$205,000, respectively.

Brookwood's union employees belong to a pension fund maintained by their union. The Company contributes \$90 per month per employee to the fund. Total contributions for the three years ended December 31, 2006 were \$310,000, \$306,000 and \$302,000, respectively.

Note 23 Cash Dividends

May 2005. On April 22, 2005, the Company announced a cash distribution in partial liquidation to stockholders and an equivalent bonus to option holders. The cash distribution in the amount of \$37.70 per share, totaling approximately \$56,789,000, was paid on May 27, 2005 to stockholders of record as of May 20, 2005. The distribution was in partial liquidation of the Company, as a result of the Company's disposition of its real estate interests and partnership units relating to HRP in July 2004, and the board of directors' determination to discontinue the Company's real estate activities effective January 1, 2005. In connection with the plan of partial liquidation, the board of directors determined to review the cash position of the Company at any time through December 31, 2005,

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and consider declaring additional liquidating distributions not to exceed (together with the May distribution) the approximately \$66,119,000 received in the disposition of the HRP interests.

In connection with the cash distribution, a special committee of the board of directors of the Company declared a special bonus to those officers of the Company, other than Mr. Gumbiner, who held outstanding options to purchase common stock of the Company, in lieu of amounts such holders would have received if they had exercised their options prior to the record date. The special bonus was equal to the amount of the cash distribution per share on the number of shares subject to options that each individual held as of the record date, and totaled approximately \$905,000.

August 2005. On July 27, 2005 the Company announced an additional cash distribution in partial liquidation to stockholders and an equivalent bonus to option holders. This cash distribution in the amount of \$6.17 per share, totaling approximately \$9,324,000, was paid on August 18, 2005 to stockholders of record as of August 12, 2005. The two distributions approximate the total amount received from the disposition of its real estate interests and partnership units.

In connection with the additional cash distribution, the board of directors declared a special bonus to those officers of the Company who held outstanding options to purchase common stock of the Company, in lieu of amounts such holders would have received if they exercised their options prior to the record date. The special bonus was equal to the amount of the cash distribution per share on the number of shares subject to options that each individual held on the record date, and totaled approximately \$118,000.

Note 24 Subsequent Event

As previously discussed in Note 6, in April 2007, Hallwood Energy entered into a \$100,000,000 Credit Facility with an affiliate of one of the investors and drew \$65,000,000 from the Credit Facility. The proceeds were used to repay \$40,000,000 in an existing note payable, pay approximately \$10,300,000 for a make-whole fee and incremental interest to the original lender related to the \$40,000,000 note payable and transaction fees of approximately \$200,000. The remaining availability of \$35,000,000 may be drawn through July 31, 2008, contingent upon additional equity or subordinated debt funding from Hallwood Energy investors on a dollar for dollar basis. Borrowings under the Credit Facility are secured by Hallwood Energy's oil and gas leases, mature on February 1, 2010, and bear interest at a rate of the defined LIBOR rate plus 10.75% per annum. An additional 2% of interest is added upon continuance of any defaulting event. The new lender may demand that Hallwood Energy prepay the outstanding loans in the event of a defined change of control, qualified sale or event of default, including a material adverse event.

Note 25 Summary of Quarterly Financial Information (Unaudited)

Results of operations by quarter for the years ended December 31, 2006 and 2005, are summarized below (in thousands, except per share amounts):

| | Year Ended December 31, 2006 | | | |
|--|-------------------------------------|----------------|---------------------|--------------------|
| | March 31 | June 30 | September 30 | December 31 |

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| | | | | |
|-----------------------------------|-----------|-----------|-----------|-----------|
| Operating revenues | \$ 30,775 | \$ 28,698 | \$ 25,055 | \$ 27,626 |
| Other income (loss) | (359) | (692) | (670) | (8,764) |
| Gross profit | 5,956 | 4,700 | 4,120 | 4,244 |
| Income (loss) before income taxes | 947 | (624) | (1,254) | (8,782) |
| Net income (loss) | 464 | (499) | (848) | (5,842) |
| Comprehensive income | | | | 55 |
| Per share data: | | | | |
| Net income (loss) | | | | |
| Basic | 0.31 | (0.33) | (0.56) | (3.86) |
| Assuming dilution | 0.30 | (0.33) | (0.56) | (3.86) |
| | 80 | | | |

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

| | Year Ended December 31, 2005 | | | |
|-----------------------------------|-------------------------------------|----------------|---------------------|--------------------|
| | March 31 | June 30 | September 30 | December 31 |
| Operating revenues | \$ 37,326 | \$ 35,857 | \$ 30,239 | \$ 31,185 |
| Other income | 97 | 532 | 43,716 | 454 |
| Gross profit | 8,646 | 8,035 | 6,479 | 6,148 |
| Income (loss) before income taxes | 1,911 | (3,444) | 44,884 | 1,501 |
| Net income (loss) | 906 | (4,317) | 28,935 | 818 |
| Comprehensive income | | | | |
| Per share data: | | | | |
| Net income (loss) | | | | |
| Basic | 0.68 | (3.02) | 19.15 | 0.54 |
| Assuming dilution | 0.60 | (3.02) | 18.95 | 0.54 |

Year Ended December 31, 2006. In December 2006, Hallwood Energy recorded an impairment of \$28,408,000 associated with its oil and gas properties and accrued \$1,683,000 as a portion of a make-whole fee in connection with a subsequent prepayment of a loan. The make-whole fee was included in interest expense. The Company recorded its proportionate share of such impairment and interest expense in the approximate amount of \$7,560,000.

Year Ended December 31, 2005. In July 2005, the Company completed a sale of its investment in HE III and reported a gain from the sale of \$51,956,000. The gain was reported in continuing operations.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****SCHEDULE I****CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)****BALANCE SHEETS**
(In thousands)

| | December 31, | |
|--|---------------------|------------------|
| | 2006 | 2005 |
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 9,667 | \$ 16,310 |
| Prepaid income taxes | 3,861 | 1,322 |
| Deferred income tax, net | 860 | 945 |
| Receivables and other current assets | 242 | 728 |
| | 14,630 | 19,305 |
| Noncurrent Assets | | |
| Investments in Hallwood Energy, L.P. | 39,864 | 40,854 |
| Investments in subsidiaries | 28,156 | 31,056 |
| Deferred income tax, net | 751 | |
| Other noncurrent assets | 196 | 113 |
| | 68,967 | 72,023 |
| Total Assets | \$ 83,597 | \$ 91,328 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities | | |
| Accounts payable and accrued expenses | \$ 600 | \$ 1,375 |
| Income taxes payable | 31 | 94 |
| | 631 | 1,469 |
| Noncurrent Liabilities | | |
| Redeemable preferred stock | 1,000 | 1,000 |
| Deferred income tax | | 416 |
| | 1,000 | 1,416 |
| Total Liabilities | 1,631 | 2,885 |
| Stockholders Equity | | |
| Common stock | 240 | 240 |
| Additional paid-in capital | 56,451 | 56,258 |
| Accumulated other comprehensive income | 55 | |

| | | |
|--|------------------|------------------|
| Retained earnings | 38,401 | 45,126 |
| Treasury stock, at cost | (13,181) | (13,181) |
| Total Stockholders Equity | 81,966 | 88,443 |
| Total Liabilities and Stockholders Equity | \$ 83,597 | \$ 91,328 |

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .

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Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****SCHEDULE I (Continued)****CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)****STATEMENTS OF OPERATIONS****(In thousands)**

| | Years Ended December 31, | | |
|---|---------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Revenues | \$ | \$ | \$ |
| Expenses | 4,810 | 11,019 | 4,305 |
| Operating Loss | (4,810) | (11,019) | (4,305) |
| Other Income (Loss) | | | |
| Equity (loss) from investments in energy affiliates | (10,418) | (8,500) | (9,901) |
| Equity in net income of subsidiaries continuing operations | 3,159 | 5,764 | 8,511 |
| Interest and other income | 566 | 1,539 | 1,434 |
| Gain (loss) from disposition of investments in energy affiliates: | | | |
| HE III | (17) | 52,425 | |
| HEC | | (113) | 62,288 |
| Interest expense | (15) | | (504) |
| Amortization of deferred revenue noncompetition agreement | | | 1,007 |
| Separation Agreement income | | | 375 |
| | (6,725) | 51,115 | 63,210 |
| Income (loss) from continuing operations before income taxes | (11,535) | 40,096 | 58,905 |
| Income tax expense (benefit) | (4,810) | 13,754 | 4,205 |
| Income (loss) from continuing operations | (6,725) | 26,342 | 54,700 |
| Income from discontinued operations, net of tax | | | |
| Real estate | | | 39,002 |
| Hotels | | | 783 |
| | | | 39,785 |
| Net Income (Loss) | \$ (6,725) | \$ 26,342 | \$ 94,485 |

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .
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Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****SCHEDULE I (Continued)****CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)****STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(In thousands)**

| | Years Ended December 31, | | |
|---|---------------------------------|------------------|------------------|
| | 2006 | 2005 | 2004 |
| Net Income (Loss) | \$ (6,725) | \$ 26,342 | \$ 94,485 |
| Other Comprehensive Income (Loss) | | | |
| Unrealized increase in fair value of marketable securities | 55 | | |
| Pro rata share of other comprehensive income from equity investments: | | | |
| Sale of real estate investments | | | (105) |
| Amortization of interest rate swap | | | (30) |
| | | | (135) |
| Comprehensive Income (Loss) | \$ (6,670) | \$ 26,342 | \$ 94,350 |

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****SCHEDULE I (Continued)****CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)****STATEMENTS OF CASH FLOWS****(In thousands)**

| | Years Ended December 31, | | |
|--|---------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES | \$ 2,398 | \$ (6,174) | \$ (17,020) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Investments in energy affiliates | (8,975) | (40,556) | (11,032) |
| Return of (additional) investment in subsidiaries | (259) | (285) | 48,897 |
| Proceeds from sale of investment in HE III | | 55,648 | |
| Proceeds from sale of investment in HEC | | 387 | 55,788 |
| Net cash provided by (used in) investing activities | (9,234) | 15,194 | 93,653 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Excess tax benefits from share-based payment arrangement | 187 | | |
| Proceeds from exercise of stock options | 79 | 2,207 | |
| Purchase of common stock for treasury | (73) | | |
| Cash dividends on common stock | | (66,113) | |
| Redemption of 10% Debentures | | | (6,468) |
| Repayment of bank borrowings and loans payable | | | (730) |
| Net cash provided by (used in) financing activities | 193 | (63,906) | (7,198) |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (6,643) | (54,886) | 69,435 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 16,310 | 71,196 | 1,761 |
| CASH AND CASH EQUIVALENTS, END OF YEAR | \$ 9,667 | \$ 16,310 | \$ 71,196 |

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****SCHEDULE I (Continued)****CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)****STATEMENTS OF CASH FLOWS
(in thousands)**

Supplemental Schedule of Non-Cash Investing and Financing Activities. The following transactions affected recognized assets or liabilities but did not result in cash receipts or cash payments (in thousands):

| Description | Years Ended December 31, | | |
|---|--------------------------|------------|-----------|
| | 2006 | 2005 | 2004 |
| Income tax effect from exercise of stock options: | | | |
| Income taxes payable | \$ (187) | \$ (1,466) | \$ |
| Additional paid-in capital | 187 | 1,466 | |
| | \$ | \$ | \$ |
| Contribution of receivable as investment in Hallwood Energy | \$ 452 | \$ | \$ |
| Other comprehensive income | | | |
| Increase in value of available for sale marketable securities | \$ 55 | \$ | \$ |
| Proportionate share of partners' capital transactions of equity investments | | | |
| Sale of real estate investments | \$ | \$ | \$ 257 |
| Amortization of interest rate swap | | | (30) |
| | \$ | \$ | \$ 227 |
| <i>Supplemental disclosures of cash payments.</i> | | | |
| Income taxes paid | \$ 206 | \$ 14,620 | \$ 10,483 |
| Interest paid | 15 | | 594 |

The Notes to Consolidated Financial Statements of The Hallwood Group Incorporated and Subsidiaries are an integral part of these statements.

See accompanying Notes to Condensed Financial Information of Registrant .

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THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
SCHEDULE I (Continued)

CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY)

NOTES TO CONDENSED FINANCIAL STATEMENTS

Note 1 Basis of Presentation

Pursuant to the rules and regulations of the Securities and Exchange Commission, the condensed financial statements of the Registrant do not include all of the information and notes normally included with financial statements prepared in accordance with accounting principles generally accepted in the United States of America. In addition, for purposes of this schedule, the investments in majority owned subsidiaries are accounted for using the equity method of accounting which is not in accordance with accounting principles generally accepted in the United States of America. It is, therefore suggested that these condensed financial statements be read in conjunction with the consolidated financial statements and notes thereto included in the Registrant's annual report as referenced in Form 10-K, Part II, Item 8.

Note 2 Dividends From Subsidiary

The Company received dividends from its Brookwood subsidiary of \$6,000,000, \$8,000,000 and \$3,000,000 in 2006, 2005 and 2004, respectively. The Company also received dividend payments totaling \$3,000,000 through April 30, 2007.

Note 3 Income From Discontinued Operations

In July 2004, the Company sold its real estate business segment. Accordingly, results for the real estate operations have been reclassified to discontinued operations. Discontinued real estate operations for the three years ended December 31, 2006 consist of the following (in thousands):

| | Years Ended December 31, | | |
|--|-------------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Equity in net income of real estate subsidiaries | \$ | \$ | \$ 51,908 |
| Income tax (expense) benefit | | | (6,226) |
| Incentive compensation and transaction costs | | | (6,629) |
| Provision for loss | | | (51) |
| Income from discontinued real estate operations | \$ | \$ | \$ 39,002 |

In December 2000, the Company decided to discontinue its hotel operations and to dispose of its hotel segment, principally by allowing its non-recourse debt holders to assume ownership of the properties through foreclosure or by selling or otherwise disposing of its hotel properties. The Company's former hotel segment consisted of three owned properties and two leased properties. The Company determined that it would retain its leasehold interest in the GuestHouse Suites Plus hotel in Huntsville, Alabama. The Company continued to operate the hotel, subject to a lease concession, from the owner, until it entered into a lease termination agreement in December 2004. Discontinued hotel

operations for the three years ended December 31, 2006 consists of the following (in thousands):

| | Years Ended December 31, | | |
|---|-------------------------------------|-------------|-------------|
| | 2006 | 2005 | 2004 |
| Gain from lease termination | \$ | \$ | \$ 1,598 |
| Equity in net loss of hotel subsidiaries | | | (686) |
| Income tax expense | | | (124) |
| Litigation and other disposition costs | | | (5) |
| Income from discontinued hotel operations | \$ | \$ | \$ 783 |

Note 4 Litigation, Contingencies and Commitments

See Note 20 to the consolidated financial statements.

Table of Contents**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES****SCHEDULE II****VALUATION AND QUALIFYING ACCOUNTS AND RESERVES
(In thousands)**

| | Balance, Beginning of Year | Charged to (Recovery of) Costs and Expenses | Charged to Other Accounts | Deductions | Balance, End of Year |
|--|---|--|--|-------------------|-------------------------------------|
| Textile Products | | | | | |
| Allowance for losses – accounts receivable | | | | | |
| Year ended December 31, 2006 | \$ 64 | \$ 68 | \$ | \$ (60) | \$ 72 |
| Year ended December 31, 2005 | 253 | (189) | | | 64 |
| Year ended December 31, 2004 | 509 | 29 | | (285)(a) | 253 |
| | | | | | |
| Obsolescence reserve – inventories | | | | | |
| Year ended December 31, 2006 | \$ 574 | \$ 283 | \$ | \$ | \$ 857 |
| Year ended December 31, 2005 | 1,101 | (527) | | | 574 |
| Year ended December 31, 2004 | 883 | 218 | | | 1,101 |
| | | | | | |
| Deferred Tax Asset | | | | | |
| Valuation allowance | | | | | |
| Year ended December 31, 2006 | \$ | \$ | \$ | \$ | \$ |
| Year ended December 31, 2005 | | | | | |
| Year ended December 31, 2004 | 19,167 | (19,167) | | | |

Notes:

(a) Write-offs, net of recoveries

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Hallwood Energy, L.P. and Subsidiaries

**Consolidated Financial Statements
Years Ended December 31, 2006,
2005, and 2004 (Unaudited),
and Report of Independent Registered
Public Accounting Firm**

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Partners of
Hallwood Energy, L.P.
Dallas, Texas

We have audited the accompanying consolidated balance sheets of Hallwood Energy, L.P. and subsidiaries (the Partnership) as of December 31, 2006 and 2005, and the related consolidated statements of operations, partners capital, and cash flows for each of the two years in the period ended December 31, 2006. These financial statements are the responsibility of the Partnership s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Partnership is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Partnership s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Partnership as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2006. in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP
Dallas, Texas
May 8, 2007

Table of Contents**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2006 AND 2005**

| | 2006 | 2005 |
|---|-----------------------|-----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 25,978,205 | \$ 91,235,979 |
| Accounts receivable | 57,111 | 168,571 |
| Prepaid expenses | 382,318 | 101,066 |
| Restricted cash | | 76,884 |
| Total current assets | 26,417,634 | 91,582,500 |
| PROPERTY AND EQUIPMENT: | | |
| Oil and gas properties, full-cost method of accounting: | | |
| Unevaluated properties | 150,289,300 | 57,300,562 |
| Work in progress | 29,179,694 | 4,094,434 |
| Evaluated properties | 28,420,359 | |
| Office equipment, facilities, and other | 991,083 | 505,694 |
| | 208,880,436 | 61,900,690 |
| Accumulated depreciation, depletion, amortization, and impairment | (28,893,958) | (243,880) |
| Total property and equipment | 179,986,478 | 61,656,810 |
| OTHER ASSETS: | | |
| Tubular inventory | 7,263,621 | 11,002,225 |
| Loan costs net | 607,424 | |
| Deposits | 86,500 | 98,110 |
| Total other assets | 7,957,545 | 11,100,335 |
| TOTAL | \$ 214,361,657 | \$ 164,339,645 |

LIABILITIES AND PARTNERS CAPITAL

| | | |
|---|--------------|--------------|
| CURRENT LIABILITIES: | | |
| Accrued additions to property and equipment | \$ 9,662,449 | \$ 5,154,863 |
| Accounts payable and accrued expenses | 2,119,112 | 426,621 |
| Advances from third parties | 222,715 | 310,177 |
| Advances from limited partners | 76,000 | 1,966,164 |
| Accounts payable to affiliate | 23,173 | |
| Total current liabilities | 12,103,449 | 7,857,825 |

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| | | |
|---|----------------|----------------|
| NOTE PAYABLE (net of unamortized discount of \$981,000) | 39,019,000 | |
| MAKE WHOLE FEE | 3,086,000 | |
| COMMITMENTS AND CONTINGENCIES (Note 6) | | |
| PARTNERS' CAPITAL: | | |
| Limited partners | 160,137,193 | 156,466,172 |
| General partner | 16,015 | 15,648 |
| Total partners' capital | 160,153,208 | 156,481,820 |
| TOTAL | \$ 214,361,657 | \$ 164,339,645 |

See notes to consolidated financial statements.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004 (UNAUDITED)

| | 2006 | 2005 | 2004 |
|---|-----------------|-------------|-------------|
| REVENUES | | | |
| Natural gas sales | \$ 774,046 | \$ | \$ |
| EXPENSES: | | | |
| Lease operating expenses | 497,785 | | |
| Other operating expense | 1,577,742 | | |
| General and administrative | 5,587,261 | 2,062,056 | 47,312 |
| Depreciation, depletion, and amortization | 553,827 | 211,199 | 157,679 |
| Impairment of oil and gas properties | 28,408,359 | | |
| Accretion | 1,450 | | |
| Total expenses | 36,626,424 | 2,273,255 | 204,991 |
| OPERATING LOSS | (35,852,378) | (2,273,255) | (204,991) |
| OTHER INCOME (EXPENSE): | | | |
| Interest expense | (7,204,469) | | |
| Interest income | 1,657,785 | 357,228 | 105,752 |
| Gain (loss) from sale of office equipment and other | 7,501 | (208,801) | |
| Gain from sale of oil and gas properties | | 2,751,090 | |
| Total other income (expenses) | (5,539,183) | 2,899,517 | 105,752 |
| NET (LOSS) INCOME | \$ (41,391,561) | \$ 626,262 | \$ (99,239) |

See notes to consolidated financial statements.

Table of Contents**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF PARTNERS' CAPITAL
YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004 (UNAUDITED)**

| | Limited Partners | General Partner | Total |
|---|-----------------------------|----------------------------|----------------|
| BALANCE January 1, 2004 (unaudited) | \$ | \$ | \$ |
| Net loss (unaudited) | (98,823) | (416) | (99,239) |
| Partners' capital contributions (unaudited) | 16,335,482 | 64,583 | 16,400,065 |
| | | | |
| BALANCE December 31, 2004 (unaudited) | 16,236,659 | 64,167 | 16,300,826 |
| Net income | 626,199 | 63 | 626,262 |
| Partners' capital contributions | 139,540,777 | 13,955 | 139,554,732 |
| Adjustment to general partner and limited partner split upon merger of predecessor partnerships | 62,537 | (62,537) | |
| | | | |
| BALANCE December 31, 2005 | 156,466,172 | 15,648 | 156,481,820 |
| Net loss | (41,387,422) | (4,139) | (41,391,561) |
| Partners' capital contributions | 45,058,443 | 4,506 | 45,062,949 |
| | | | |
| BALANCE December 31, 2006 | \$ 160,137,193 | \$ 16,015 | \$ 160,153,208 |

See notes to consolidated financial statements.

Table of Contents**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004 (UNAUDITED)**

| | 2006 | 2005 | 2004 |
|---|-----------------|--------------|-------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | \$ (41,391,561) | \$ 626,262 | \$ (99,239) |
| Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities: | | | |
| Depreciation, depletion, and amortization | 553,827 | 211,199 | 157,679 |
| Accretion | 1,450 | | |
| Loan cost amortization | 134,555 | | |
| Loan discount amortization | 422,000 | | |
| Change in fair value of make whole fee | 1,683,000 | | |
| Impairment of oil and gas properties | 28,408,359 | | |
| (Gain) loss from sale of office equipment and other | (7,501) | 208,801 | |
| Gain from sale of oil and gas properties | | (2,751,090) | |
| Changes in assets and liabilities: | | | |
| Accounts receivable and other assets | (158,182) | (41,582) | (326,165) |
| Accounts payable and accrued expenses | 1,692,491 | (372,250) | 798,871 |
| Accounts payable to affiliate | 23,173 | (637,008) | 637,008 |
| Advances from third parties | (87,462) | 310,177 | |
| Net cash (used in) provided by operating activities | (8,725,851) | (2,445,491) | 1,168,154 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Additions to oil and gas properties | (179,088,972) | (53,355,013) | (3,174,886) |
| Additions to office equipment, facilities, and other | (492,541) | (148,021) | (749,566) |
| Proceeds from sale of oil and gas properties | 36,795,795 | 3,000,000 | |
| Proceeds from sale of office equipment and other | 7,501 | 98,950 | |
| Proceeds from sale of tubular inventory | 2,856,920 | | |
| Decrease (increase) in tubular inventory, net of asset sale | 881,684 | (7,344,164) | |
| Decrease (increase) in restricted cash | 76,884 | (26,884) | (50,000) |
| Net cash used in investing activities | (138,962,729) | (57,775,132) | (3,974,452) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Proceeds from note payable | 40,000,000 | | |
| Loan fees | (741,979) | | |
| Partners' capital contributions | 45,062,949 | 135,896,671 | 16,400,065 |
| (Decrease) increase in advances from limited partners | (1,890,164) | 1,966,164 | |
| Net cash provided by financing activities | 82,430,806 | 137,862,835 | 16,400,065 |
| (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (65,257,774) | 77,642,212 | 13,593,767 |

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| | | | | |
|---------------------------|-------------------|---------------|---------------|---------------|
| CASH AND CASH EQUIVALENTS | Beginning of year | 91,235,979 | 13,593,767 | |
| CASH AND CASH EQUIVALENTS | End of year | \$ 25,978,205 | \$ 91,235,979 | \$ 13,593,767 |

See notes to consolidated financial statements.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004 (UNAUDITED)**

1. ORGANIZATION AND NATURE OF OPERATIONS

Formation Hallwood Energy, L.P. (the Partnership) is a privately held independent oil and gas limited partnership organized in the state of Delaware. On December 31, 2005, Hallwood Energy was formed from the consolidation of three privately held energy partnerships: Hallwood Energy II, L.P. (HE II); Hallwood Energy 4, L.P. (HE 4); and Hallwood Exploration, L.P. (Hallwood Exploration). The board of directors and management of the three partnerships recommended the consolidation because they believed it would simplify the structure and operations of the affiliated partnerships, align all the investors' interests, improve potential debt and financing opportunities, and facilitate future exit strategies. Following the completion of the consolidation, all energy activities are conducted by the Partnership from its corporate office located in Dallas, Texas, and production offices in Searcy, Arkansas, and Lafayette, Louisiana.

Principles of Consolidation The Partnership fully consolidates all majority-owned entities into its financial statements. All intercompany balances and transactions have been eliminated in consolidation. As of December 31, 2006 and 2005, the Partnership had two wholly owned subsidiaries:

Hallwood Petroleum, LLC (HPL) is a wholly owned subsidiary that serves as the drilling operations entity on behalf of the Partnership. HPL is an administrative and management company to facilitate recordkeeping and processing; it has no financial value.

Hallwood Gathering, L.P. is a wholly owned subsidiary that will hold pipelines and other related facilities to gather and transport production to market locations.

For presentation purposes, the consolidated financial statements for the years ended December 31, 2005 and 2004 include the combined activities of HE II, HE 4, and Hallwood Exploration. The consolidated financial statements are not indicative of the financial position and results of operations that might have occurred had the entities been combined and operated as a single entity during the period presented. The consolidation was accounted for as a reorganization of entities under common control and common management. The consolidated financial statements reflect the historical costs of the combined entities.

Operations The Partnership is an upstream energy partnership engaging in the acquisition, development, exploration, production, and sale of hydrocarbons, with a primary focus on natural gas assets. The Partnership had no proved reserves at December 31, 2006. The Partnership's results of operations are and will be largely dependent on a variety of variable factors, including, but not limited to fluctuations in natural gas prices; success of its exploratory drilling activities; the ability to transport and sell its natural gas; regional and national regulatory matters; and the ability to secure, and price of, goods and services necessary to develop its oil and gas leases.

As of December 31, 2006, the Partnership's management has energy investments in three geographical areas, as follows:

Central and Eastern Arkansas primary target is the Fayetteville Shale formation

South Louisiana various projects on and around the LaPice Salt Dome

West Texas the Barnett Shale and Woodford Shale formations in the Delaware Basin

The Partnership is or will be involved in the drilling, gathering, and sale of oil and natural gas in each of these areas.

2. SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities at

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the date of the financial statements and the reported amounts of revenues and expenses during each reporting period. Management believes its estimates and assumptions will be reasonable; however, such estimates and assumptions will be subject to a number of risks and uncertainties, which may cause actual results to differ materially from the Partnership's estimates.

Significant estimates underlying these consolidated financial statements include the estimated quantities of proved oil and natural gas reserves used to compute depletion of natural gas properties and the related present value of estimated future net cash flows therefrom, estimates of production receivable based upon expectations for actual deliveries and prices received, and the estimated fair value of asset retirement obligations. Proved oil and natural gas reserves, which are the basis for unit-of-production depletion and the ceiling test, have numerous inherent uncertainties. The accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. Results of drilling, testing, and production subsequent to the date of the estimate may justify revision of such estimate. Accordingly, reserve estimates are often different from the quantities of oil and natural gas that are ultimately recovered. In addition, reserve estimates are vulnerable to changes in wellhead prices of crude oil and natural gas. Such prices have been volatile in the past and can be expected to be volatile in the future.

The significant estimates are based on current assumptions that may be materially affected by changes to future economic conditions, such as the market prices received for sales of volumes of oil and natural gas. Future changes to these assumptions may affect these significant estimates materially in the near term.

Property and Equipment The Partnership follows the full cost method of accounting for oil and gas properties. Accordingly, all costs associated with the acquisition, exploration, and development of oil and gas properties, including costs of undeveloped leaseholds, geological and geophysical expenses, dry holes, leasehold equipment, and overhead charges directly related to acquisition, exploration, and development activities are capitalized. There were no capitalized internal costs associated with acquisition, exploration, and development activities for the three years ended December 31, 2006.

Dispositions of oil and natural gas properties are accounted for as adjustments to capitalized costs with no gain or loss recognized, unless such adjustments and proceeds are significant and would alter the relationship between capitalized costs and proved reserves.

The sum of net capitalized costs, including estimated costs to develop proved reserves and estimated dismantlement and abandonment costs, net of estimated salvage values, are depleted on the equivalent unit-of-production method, based on proved oil and gas reserves as determined by independent petroleum engineers. Excluded from amounts subject to depletion are costs associated with the acquisition and evaluation of unproved properties. Such unproved properties are assessed for impairment at least annually, and any impairment provision is transferred to the full cost amortization base.

Net capitalized costs are limited to the lower of unamortized cost, net of deferred tax, or the cost center ceiling. The cost center ceiling is defined as the sum of (i) estimated future net revenues, discounted at 10% per annum, from proved reserves, based on unescalated year-end prices and costs, adjusted for contract provisions; (ii) the cost of properties not being amortized; (iii) the lower of cost or market value of unproved properties included in the cost being amortized; less (iv) income tax effects related to differences between the book and tax basis of the natural gas and crude oil properties.

Property and equipment, such as gathering systems and salt water disposal facilities, are stated at original cost and depreciated using the straight-line method based on estimated useful lives from 10 to 15 years. Property and equipment, such as office furniture and equipment, are stated at original cost and depreciated using the straight-line method based on estimated useful lives from three to five years.

Asset Retirement Obligations In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 143, *Accounting for Asset Retirement Obligations*.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SFAS No. 143 requires that an asset retirement obligation (ARO) associated with the retirement of a tangible long-lived asset be recognized as a liability in the period in which a legal obligation is incurred and becomes determinable, with an offsetting increase in the carrying amount of the associated asset. The cost of the tangible asset, including the initially recognized ARO, is depleted such that the cost of the ARO is recognized over the useful life of the asset. The ARO is recorded at fair value, and accretion expense is recognized over time as the discounted liability is accreted to its expected settlement value. The fair value of the ARO is measured using expected future cash outflows discounted at the Partnership's credit-adjusted, risk-free interest rate.

In accordance with the provisions of SFAS No. 143, the Partnership will record an abandonment liability associated with its oil and natural gas wells when those assets are placed in service.

Inherent in the fair value calculation of ARO are numerous assumptions and judgments, including the ultimate settlement amounts; inflation factors; credit-adjusted discount rates; timing of settlement; and changes in the legal, regulatory, environmental, and political environments. To the extent that future revisions to these assumptions affect the fair value of the existing ARO liability, a corresponding adjustment is made to the oil and natural gas property balance. Settlements greater than or less than amounts accrued with the ARO are recovered as a gain or loss upon settlement.

In March 2005, the FASB issued Interpretation No. (FIN) 47, *Accounting for Conditional Asset Retirement Obligations* an interpretation of FASB Statement No. 143. FIN 47 requires an entity to recognize a liability for the fair value of a conditional ARO if the fair value can be reasonably estimated. FIN 47 states that a conditional ARO is a legal obligation to perform an asset retirement activity in which the timing or method of settlement is conditional upon a future event that may or may not be within control of the entity. FIN 47 is effective no later than the end of the first fiscal year ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on the Partnership's financial position or results of operations.

Oil and Natural Gas Reserve Estimates The process of estimating quantities of proved reserves is inherently uncertain. Reserve engineering is a subjective process of estimating underground accumulations of hydrocarbons that cannot be measured in an exact manner. The process relies on interpretation of available geologic, geophysical, engineering, and production data. The extent, quality, and reliability of this data can vary. The process also requires certain economic assumptions, some of which are mandated, regarding drilling and operating expense, capital expenditures, taxes, and availability of funds.

Proved reserve estimates prepared by others may be substantially higher or lower than the Partnership's estimates. Because these estimates depend on many assumptions, all of which may differ from actual results, reserve quantities actually recovered may be significantly different than estimated. Material revisions to reserve estimates may be made depending on the results of drilling, testing, and rates of production. One should not assume that the present value of future net cash flows is the current market value of the Partnership's estimated proved reserves.

The Partnership's rate of recording depreciation, depletion, and amortization expense for proved properties is dependent on the Partnership's estimate of proved reserves. If reserve estimates decline, the rate at which the Partnership records these expenses will increase. The Partnership's full cost ceiling test will also depend on the Partnership's estimate of proved reserves. If reserve estimates decline, the Partnership may be subjected to a full cost ceiling write-down.

Cash and Cash Equivalents and Supplemental Cash Flow Information The Partnership considers highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents. Cash paid for interest was \$4,962,164, \$0, and \$0 in 2006, 2005, and 2004, respectively. A supplemental disclosure of noncash investing and financing activities is as follows:

As of December 31, 2006, 2005, and 2004, the Partnership had accounts payable for property and equipment costs of \$9,662,449, \$5,154,863, and \$802,809, respectively.

During 2005, partners contributed \$3,658,061, at cost, of tubular inventory to the Partnership.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Tubular Inventory Inventory consists of various sizes and types of oil field tubular pipes and casings, used in the ordinary course of the Partnership's drilling activities, and is carried on a first-in, first-out basis at the lower of cost or market.

Revenue Recognition Revenues are recognized when title to the products transfers to the purchaser. The Partnership follows the sales method of accounting for its commodity revenue so that the Partnership recognizes sales revenue on all commodities sold to its purchasers, regardless of whether the sales are proportionate to the Partnership's ownership in the property.

Income Taxes Currently, the Partnership is a nontaxable entity. Federal and state income taxes, if any, are the responsibility of the individual partners. Accordingly, the consolidated financial statements do not include a provision for income taxes. However, certain business and franchise taxes are the responsibility of the Partnership and its subsidiaries. These business and franchise taxes, included in general and administrative expenses, were \$1,513, \$24,680, and \$0 in 2006, 2005, and 2004, respectively. The Partnership's tax returns are subject to examination by federal and state taxing authorities. If the Partnership's taxable income is ultimately changed by the taxing authorities, the tax liability of the partners could be changed accordingly.

Disclosure of Fair Value of Financial Instruments The Partnership's financial instruments include cash, time deposits, accounts receivable, accounts payable, note payable, and accrued make whole fee. The carrying amounts reflected in the consolidated balance sheets for financial assets classified as current assets and the carrying amounts for financial liabilities classified as current liabilities and the note payable approximate fair value due to the short maturity of such instruments.

Derivative Instruments and Hedging Activities The Partnership has not entered into financial derivative instruments to hedge the price risk for the sale of its natural gas, although the Partnership may, in the future, enter into such financial instruments. The Partnership will not enter into financial derivatives for trading or speculative purposes. The Partnership will sell some of its natural gas production under long-term contracts. These contracts qualify for the normal purchase and sale exception and are not recognized at fair value.

All freestanding derivative financial instruments, including the derivative instruments embedded in other contracts if certain criteria are met, are recognized at fair value on the consolidated balance sheets. Derivative instruments that are not recognized as hedges must be adjusted to fair value through the consolidated statements of operations. Changes in the fair value of derivative instruments that are designated as cashflow hedges are deferred in other comprehensive operations until such time as the hedged items are recognized in operations. The ineffective portion of a change in value of a derivative instrument is recognized in operations immediately.

Credit Risk Credit risk is the risk of loss as a result of nonperformance by counterparties of their contractual obligations. The Partnership had little production in 2006 and no production in either 2005 or 2004, but it is currently reviewing markets and alternatives for production expected in 2007. The Partnership monitors its exposure to counterparties by reviewing credit ratings, financial statements and credit service reports. Each customer and/or counterparty of the Partnership is reviewed as to creditworthiness prior to the extension of credit and on a regular basis thereafter. Further assurances, including, but not limited to letters of credit are required as necessary. In this manner, the Partnership manages its credit risk.

New Accounting Pronouncements In July 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes*. FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a comprehensive model for the financial statement recognition, measurement, presentation, and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Partnership is currently evaluating the impact of FIN 48 and does not believe FIN 48 will have a material impact on its financial position or results of operations.

The FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 and 140, in February 2006. SFAS No. 155 addresses accounting for beneficial interests in

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

securitized financial instruments. The guidance allows fair value remeasurement for any hybrid financial instrument containing an embedded derivative that would otherwise require bifurcation and it clarifies which interest-only and principal-only strips are not subject to SFAS No. 133. SFAS No. 155 also established a requirement to evaluate interests in securitized financial assets to identify any interests that either are freestanding derivatives or contain an embedded derivative requiring bifurcation. The statement is effective for all financial instruments issued or acquired after the beginning of the first fiscal year that begins after September 15, 2006. The Partnership is currently evaluating the impact of this statement.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America and expands disclosure related to the use of fair value measures in financial statements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Partnership is currently evaluating the timing of adoption and the impact that adoption might have on its financial position or results of operations.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and it did not have a material impact on the Partnership's financial position or results of operations.

On May 18, 2006, the State of Texas passed a bill to replace the current franchise tax with a new margin tax to be effective January 1, 2008. The Partnership estimates the new margin tax will not have a significant impact on tax expense or deferred tax assets and liabilities.

On February 15, 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The FASB believes the statement will improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Use of the statement will expand the use of fair value measurements for accounting for financial instruments. The Partnership does not believe SFAS No. 159 will have a material impact on its financial position, results of operations, or cash flows.

3. OIL AND GAS PROPERTIES

Impairment An annual assessment is performed on unevaluated leasehold costs to ensure that there is no impairment of these assets. Considered in this assessment are the current acquisitions of similar leaseholds within the geographic area, as well as drilling activities performed by other operators in those areas. Additionally, a review of the remaining term of the leases is performed to ensure that there is ample time to evaluate the leasehold prior to expiration.

At December 31, 2006, the unamortized cost of the Partnership's U.S. oil and gas properties exceeded the full cost ceiling limitation by \$28,408,359. An impairment charge for such amount was recorded in 2006. There is no tax effect, since the Partnership is a non-taxable entity.

Gain from Sale of Undeveloped Leaseholds In July 2005, HE II completed a purchase-and-sale agreement with Chesapeake Energy Corporation (Chesapeake) that included undeveloped leaseholds in Johnson County, Texas, for \$3,000,000. The sale was consideration in exchange for 66 individual leases covering 863 gross (835 net) acres with a cost basis of \$249,000, yielding a gain on sale of \$2,751,000.

Table of Contents**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In July 2006, the Partnership completed the sale of a 60% undivided working interest in 37 oil and gas leases (43,285 net acres) in Reeves and Culberson Counties in West Texas and a 100% ownership in seven leases (1,203 net acres) in Parker, Hood, and Tarrant Counties in North Texas to Chesapeake. Chesapeake assumed operation of these properties. The sales price of \$39,652,715, including reimbursement of certain development and drilling costs, exceeded the proportionate book value of the assets by \$10,160,030. No gain was recognized as required by the Partnership's accounting policies set forth in Note 2, and accordingly, the excess amount was credited to oil and gas property. Completion of the transaction enabled the Partnership to increase its operational focus on its properties in East Arkansas and South Louisiana and reduce its capital requirements in West Texas while retaining a significant interest in the economic potential of the West Texas properties.

Participation Agreement During the first quarter of 2006, the Partnership entered into a participation agreement (the Participation Agreement) with Activa Resources, Ltd (Activa). Under the Participation Agreement, Activa paid \$4,960,000 to the Partnership in April 2006, and the Partnership transferred to Activa an undivided 25% interest in oil and gas leases with respect to 44,219 net acres that the Partnership currently holds in East Arkansas. No gain was recognized as required by the Partnership's accounting policies set forth in Note 2 and, accordingly, the amount was credited to oil and gas property. During the term of the Participation Agreement, the Partnership is designated as operator of the leases. As operator, the Partnership was required to commence actual drilling operations before June 2006 for the first of two initial wells. the Partnership commenced this drilling. Activa agreed to participate to the extent of its participation interest in the two initial wells and paid 50% of the first \$750,000 incurred for costs associated with the drilling, completion, and equipping operations in connection with each of the initial wells.

In addition, the Participation Agreement establishes an area of mutual interest (the AMI) potentially covering an area of approximately 184,000 gross acres, which area includes the 44,219 acres. Pursuant to the AMI, the Partnership will have the right to an undivided 75% participation interest, and Activa will have the right to an undivided 25% participation interest in any additional leases acquired by either of the parties within the AMI. If either party acquires any additional leases covering lands within the AMI, it must offer the other party the right to acquire its participation interest in the leases acquired. The agreement related to the acquisition of additional leases expires in December 2007.

4. NOTE PAYABLE

In February 2006, the Partnership entered into a \$65,000,000 loan facility and immediately drew \$40,000,000 from this facility. The proceeds were primarily used to acquire oil and gas leases and fund exploration and drilling activities. The loan is secured by the Partnership's oil and gas leases, matures on January 31, 2009, and has an interest rate of LIBOR plus 8.75% per annum (14.12% as of December 31, 2006). An additional 2% of interest is added upon continuance of any defaulting event.

The loan facility contains various financial covenants, including maximum general and administrative expenditures and current and proved collateral coverage ratios. Nonfinancial covenants restrict the ability of the Partnership to dispose of assets; incur additional indebtedness; prepay other indebtedness or amend certain debt instruments; pay dividends; create liens on assets; enter into sale and leaseback transactions; make investments, loans, or advances; make acquisitions; engage in mergers or consolidations or engage in certain transactions with affiliates; and otherwise restrict certain partnership activities.

During 2006, the loan facility was amended twice. First, it was amended to allow for the sale of undeveloped leaseholds to Chesapeake in July 2006 (see Note 3). Second, it was amended in December 2006 to address and cure several technical loan defaults because of, among other things, the Partnership's general and administrative expenses exceeding the maximum amount permitted under the loan facility and to extend the test dates for proved collateral coverage ratios and the make whole payment period.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Subsequent to December 31, 2006, the Partnership was not in compliance with the proved collateral coverage ratio (see Note 8).

There is a make whole provision in the facility whereby the Partnership is required to pay the lender the present value amount of interest that would have been payable on the principal balance of the loan from the date of any prepayment through February 8, 2009. At the time of the initial drawing in February 2006, the make whole fee was recorded at its estimated fair value of \$1,403,000, and the note payable was discounted by that amount. Amortization of the discount was \$422,000 during 2006 and was charged to interest expense. The note payable is presented on the December 31, 2006 consolidated balance sheet net of the unamortized discount of \$981,000. At December 31, 2006, the make whole fee has been recorded at its estimated fair value of \$3,086,000. The change in the fair value of the make whole fee of \$1,683,000 during 2006 has been recorded in interest expense.

5. PARTNERS CAPITAL

Partners capital (including allocation of income and loss, cash contributions, and distributions) is allocated 99.99% to limited partners and 0.01% to the general partner. See Notes 7 and 8 for information about the general partner and related parties.

In December 2005, the Partnership solicited an equity cash call totaling \$90,000,000 from its partners to fund the 2006 capital drilling program, of which \$9,197,607 remained uncollected as of December 31, 2005. However, the remaining funds were received in January 2006, and partners capital increased accordingly.

In April 2006, the Partnership sold a 5% limited partner interest to an affiliate of its lender for \$10,865,343.

In December 2006, the Partnership solicited and collected an equity cash call totaling \$25,000,000 from its partners to replenish cash and to partially fund the 2007 capital drilling program.

6. COMMITMENTS AND CONTINGENCIES

Litigation In early 2006, the Partnership entered into two two-year contracts with Eagle Drilling, LLC (subsequently Eagle Domestic Drilling Operations, LLC) under which the contractor was to provide drilling rigs and crews to drill wells in Arkansas at a daily rate of \$18,500, plus certain expenses for each rig. In August 2006, one of the rigs provided by the contractor collapsed. The Partnership requested the contractor to provide assurances that the other rig, and any rig provided to replace the collapsed rig, were safe and met the requirements of the contracts. When the contractor refused to provide these assurances, Hallwood Energy notified the contractor that the contracts were terminated and on September 6, 2006 filed *Hallwood Petroleum, LLC and Hallwood Energy, L.P. v. Eagle Drilling, LLC and Eagle Domestic Drilling Operations, LLC*, in the 348th District Court of Tarrant County, Texas to recover approximately \$1,688,000 previously deposited with the contractor under the contracts. Eagle Domestic Drilling Operations, LLC has asserted damages in excess of \$22,000,000 against the Partnership, principally for breach of contract. Eagle Domestic Drilling Operations, LLC and its parent have since filed for Chapter 11 bankruptcy protection. The Partnership is currently unable to determine the impact of this matter on its results of operations and financial position.

In *Roddy Harrison as Trustee for the Harrison Trust v. Hallwood Energy, L.P.*, the plaintiffs are alleging a breach of contract related to purchase of caliche and water on their property for \$300,000. This property is currently operated by Chesapeake, who acquired 60% of this property and has the responsibility to litigate or resolve this claim. Under the terms of the purchase and sale agreement with Chesapeake in July 2006, the Partnership has agreed to pay the first \$300,000 of any liability in this matter and to pay its pro-rata share (40%) of any additional liability. Management does not believe that the resolution will have a material adverse effect on the Partnership.

The Partnership is subject to various possible contingencies, that arise primarily from interpretation of federal and state laws and regulations affecting the natural gas and crude oil industry. Such contingencies include differing interpretations as to the prices at which natural gas and crude oil sales may be made and the prices at which royalty

Table of Contents**HALLWOOD ENERGY, L.P. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

owners may be paid for production from their leases, environmental issues, and other matters. Although management believes it has complied with the various laws and regulations, administrative rulings, and interpretations thereof, adjustments could be required as new interpretations and regulations are issued. In addition, production rates, marketing, and environmental matters are subject to regulation by various federal and state agencies.

Sales Agreement On May 1, 2006, the Partnership entered into a gas sales contract whereby the Partnership is to sell its natural gas production in certain counties and parishes of Arkansas and Louisiana, respectively, to a third-party reseller, with the purchase price based on a percentage of the buyer's resale price. Quantities will depend upon the amount of gas that is both received by a gathering or pipeline company and purchased by the buyer's resale market. The term of the contract is five years and will automatically renew and extend annually until such annual extensions are canceled by either party. There is a buyout provision with a minimum exercise price of \$100,000 at the option of the Partnership. During 2006, no natural gas was sold under the contract and is not expected to be until after July 2007.

Contractual Obligations and Commercial Commitments The Partnership has entered into various contractual obligations and commercial commitments in the ordinary course of conducting its business operations, which, as of December 31, 2006, are as follows:

| Contractual Obligations | Payments Due During the Years Ending December 31, | | | | Total |
|-------------------------|--|---------------|---------------|------------|----------------|
| | 2007 | 2008 | 2009 | Thereafter | |
| Long-term debt | \$ | \$ | \$ 40,000,000 | \$ | \$ 40,000,000 |
| Interest | 5,648,000 | 5,648,000 | 470,667 | | 11,766,667 |
| Long-term rig contracts | 45,228,000 | 47,031,000 | 6,019,000 | | 98,278,000 |
| Operating leases | 42,000 | 20,000 | 2,000 | | 64,000 |
| Total | \$ 50,918,000 | \$ 52,699,000 | \$ 46,491,667 | \$ | \$ 150,108,667 |

The long-term debt obligation is attributable to the Partnership's loan facility (see Notes 4 and 8). The rig contracts consist of six rigs from Union Drilling for the Arkansas area and one Grey Wolf rig operating in South Louisiana. The day rates range from \$19,000 per day to \$25,700 per day. Rig contract payments were approximately \$17,950,000 and \$1,062,000 for the years ended December 31, 2006 and 2005, respectively. The Partnership has operating leases that cover real property and certain office equipment, expire at various dates through 2009, and in some cases, have options to extend their terms. Rent expense was approximately \$209,000 and \$41,900 for the years ended December 31, 2006 and 2005, respectively.

7. RELATED-PARTY TRANSACTIONS

The general partner is Hallwood Energy Management, LLC (HEM). HEM is owned equally by three entities, including The Hallwood Group Incorporated (Hallwood) (see Note 8).

Hallwood is a Delaware corporation formed in September 1981 and is publicly traded on the American Stock Exchange under the ticker symbol HWG. Hallwood is a holding company that operates in the textile products and energy business segments.

Two directors and officers of HEM are also directors or officers of Hallwood, which holds 25% (20% after consideration of profits interests) of the Class A limited partnership interests in the Partnership and, as previously mentioned, 33% interest in the general partner. In addition, certain officers and directors of Hallwood are investors in the Partnership, and as members of management of the Partnership, one director and officer and one officer of Hallwood hold a Class B limited partnership profit interest in the Partnership. Each of these individuals held similar positions with the general partners of the predecessor entities and interests in the predecessor entities.

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HALLWOOD ENERGY, L.P. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Beginning August 1, 2005, the Partnership and its predecessor entities have shared leased office space, facilities, and certain staff with Hallwood in Dallas, Texas. The Partnership reimburses Hallwood for its allocable share of such expenses. The Partnership reimbursed Hallwood approximately \$309,000 for such expenses for 2006. For the five-month period ended December 31, 2005, the Partnership reimbursed Hallwood approximately \$59,000 for such expenses.

In 2005, HPL entered into a financial consulting contract with Anthony J. Gumbiner to furnish and perform consulting and advisory services to the Partnership and its subsidiaries, including strategic planning and merger activities, for annual compensation of \$200,000. Mr. Gumbiner is chairman and chief executive officer of both Hallwood and the Partnership, as well as a Class B limited partner of the Partnership. The annual amount is payable in quarterly installments. The contract automatically renews for one-year periods, if not terminated by the parties beforehand.

As of December 31, 2005, the Partnership held approximately \$1,966,000 of funds from certain limited partners, of which \$1,900,000 was applied to the December 2006 equity cash call. The remaining \$66,000 has been retained to resolve a claim filed against HPL while operating HE II properties in 2005.

8. SUBSEQUENT EVENTS (UNAUDITED)

In April 2007, the Partnership entered into a \$100,000,000 senior secured credit facility (the Facility) with an affiliate of the Partnership (the New Lender) and drew \$65,000,000 from the facility. The proceeds were used to repay \$40,000,000 in an existing note payable and pay approximately \$10,300,000 for a make whole fee and incremental interest to the original lender related to the \$40,000,000 note payable and transaction fees of approximately \$200,000. Provided that the Partnership raises an additional \$25,000,000 through an equity call or through debt subordinate to the New Lender's secured interest, the New Lender will match subsequent amounts raised in excess of the \$25,000,000, with increased availability up to the remaining \$35,000,000 under the Facility through the availability termination date of July 31, 2008.

In conjunction with executing the Facility, the New Lender resigned its position on the board of directors and assigned its general partner interest to the remaining members.

The Partnership issued a \$25,000,000 equity call to its partners on April 14, 2007 (the April Call). Previously in April 2007, the Partnership received cash advances of \$7,000,000 each from Hallwood and an affiliate of the New Lender. These advances will be applied to the April Call. Affiliates of Hallwood and the New Lender have each committed to fund one-half of the April Call and potential additional equity or subordinated debt funding calls of \$55,000,000 by the Partnership, to the extent other investors do not respond to a call.

Borrowings under the Facility are secured by substantially all of the Partnership's assets, mature on February 1, 2010, and bear interest at a defined LIBOR rate, plus 10.75% per annum. An additional 2% of interest is added upon continuance of any defaulting event. The New Lender may demand that the Partnership prepay the outstanding loans in the event of a defined change of control, qualified sale, or event of default, including a material adverse event. The Partnership has also entered into a deposit account control agreement.

The Facility contains various financial covenants, including maximum general and administrative expenditures and current and proved collateral coverage ratios. The proved collateral coverage ratio is effective June 30, 2008. Nonfinancial covenants restrict the ability of the Partnership to dispose of assets; incur additional indebtedness; prepay other indebtedness or amend certain debt instruments; pay dividends; create liens on assets; enter into sale and leaseback transactions; make investments, loans, or advances; make acquisitions; engage in mergers or consolidations or engage in certain transactions with affiliates; and otherwise restrict certain partnership activities.

The Facility contains a make whole provision whereby the Partnership is required to pay the New Lender the amount by which the present value of interest and principal payable from the date of prepayment through January 31, 2009, exceeds the principal amount at the prepayment date.

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The New Lender is entitled to warrants exercisable for 2.5% of the Partnership interests at an exercise price of 2.5% of 125% of the total capital contributed to the Partnership at December 31, 2006.

In connection with the repayment of the existing note payable, the Partnership wrote off the remaining related deferred financing costs of \$481,000 in April 2007.

9. SUPPLEMENTAL INFORMATION (UNAUDITED)

There were no proven reserves as of December 31, 2006, 2005, or 2004.

Costs incurred in connection with the acquisition, exploration, and development of the Partnership's natural gas properties for the years ended December 31, 2006, 2005, and 2004, were as follows:

| | 2006 | 2005 | 2004 |
|---------------------------|----------------|---------------|--------------|
| Acquisition of properties | \$ 111,244,664 | \$ 50,349,956 | \$ 3,977,695 |
| Exploration costs | 64,690,902 | 6,101,177 | |
| Development costs | 7,660,992 | 1,255,934 | |
| Total | \$ 183,596,558 | \$ 57,707,067 | \$ 3,977,695 |

Results of operations from producing activities for the years ended December 31, 2006, 2005, and 2004, were as follows:

| | 2006 | 2005 | 2004 |
|---|-------------|-------------|-------------|
| Natural gas revenues | \$ 774,046 | \$ | \$ |
| Natural gas production expense | 497,785 | | |
| Depletion expense | 312,108 | | |
| Results from producing activities | \$ (35,847) | \$ | \$ |
| Average sales price of natural gas, per thousand cubic feet | \$ 7.03 | \$ | \$ |

There was no oil production for 2006, 2005, or 2004.

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**THE HALLWOOD GROUP INCORPORATED AND SUBSIDIARIES
INDEX TO EXHIBITS**

| Exhibit Number | Description |
|---------------------------|---|
| 23.1 | INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM S CONSENT |
| 31.1 | CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER, PURSUANT TO SECTION 302 OF SARBANES-OXLEY ACT OF 2002 |
| 31.2 | CERTIFICATION OF THE CHIEF FINANCIAL OFFICER, PURSUANT TO SECTION 302 OF SARBANES-OXLEY ACT OF 2002 |
| 32.1 | CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 906 OF SARBANES-OXLEY ACT OF 2002 |