

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

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2010

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number 1-33146

KBR, Inc.

(a Delaware Corporation)
20-4536774

601 Jefferson Street
Suite 3400

Houston, Texas 77002

(Address of Principal Executive Offices)

Telephone Number – Area Code (713) 753-3011

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 at least the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of October 22, 2010, 150,961,902 shares of KBR, Inc. common stock, \$0.001 par value per share, were outstanding.

[Table of Contents](#)

KBR, Inc.

Index

	<u>Page No.</u>
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	4
Condensed Consolidated Statements of Income	4
Condensed Consolidated Balance Sheets	5
Condensed Consolidated Statements of Comprehensive Income	6
Condensed Consolidated Statements of Cash Flows	7
Notes to Condensed Consolidated Financial Statements	9
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	31
Item 3. Quantitative and Qualitative Disclosures About Market Risk	51
Item 4. Controls and Procedures	52
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	52
Item 1A. Risk Factors	52
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	53
Item 3. Defaults Upon Senior Securities	53
Item 4. (Removed and Reserved)	53
Item 5. Other Information	53
Item 6. Exhibits	54
SIGNATURES	55

Forward-Looking and Cautionary Statements

This report contains certain statements that are, or may be deemed to be, “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Private Securities Litigation Reform Act of 1995 provides safe harbor provisions for forward looking information. Some of the statements contained in this quarterly report are forward-looking statements. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements. The words “believe,” “may,” “estimate,” “continue,” “anticipate,” “intend,” “plan,” “expect” and similar expressions are intended to identify forward-looking statements. Forward-looking statements include information concerning our possible or assumed future financial performance and results of operations.

We have based these statements on our assumptions and analyses in light of our experience and perception of historical trends, current conditions, expected future developments and other factors we believe are appropriate in the circumstances. Forward-looking statements by their nature involve substantial risks and uncertainties that could significantly affect expected results, and actual future results could differ materially from those described in such statements. While it is not possible to identify all factors, factors that could cause actual future results to differ materially include the risks and uncertainties disclosed in our 2009 Annual Report on Form 10-K contained in Part I under “Risk Factors”.

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

[Table of Contents](#)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Revenue:				
Services	\$ 2,432	\$ 2,841	\$ 7,658	\$ 9,095
Equity in earnings (losses) of unconsolidated affiliates, net	23	(1)	99	46
Total revenue	<u>2,455</u>	<u>2,840</u>	<u>7,757</u>	<u>9,141</u>
Operating costs and expenses:				
Cost of services	2,238	2,648	7,136	8,567
General and administrative	53	54	157	157
Impairment of goodwill	—	6	—	6
Loss (gain) on disposition of assets, net	1	1	3	(1)
Total operating costs and expenses	<u>2,292</u>	<u>2,709</u>	<u>7,296</u>	<u>8,729</u>
Operating income	163	131	461	412
Interest income (expense), net	(3)	—	(12)	1
Foreign currency gains (losses), net	1	—	(4)	1
Other non-operating expense	(1)	(1)	(1)	(2)
Income before income taxes and noncontrolling interests	160	130	444	412
Provision for income taxes	(43)	(33)	(146)	(137)
Net Income	117	97	298	275
Less: Net income attributable to noncontrolling interests	(20)	(24)	(49)	(58)
Net income attributable to KBR	<u>\$ 97</u>	<u>\$ 73</u>	<u>\$ 249</u>	<u>\$ 217</u>
Net income attributable to KBR per share:				
Basic	<u>\$ 0.62</u>	<u>\$ 0.46</u>	<u>\$ 1.57</u>	<u>\$ 1.35</u>
Diluted	<u>\$ 0.62</u>	<u>\$ 0.45</u>	<u>\$ 1.56</u>	<u>\$ 1.35</u>
Basic weighted average common shares outstanding	155	160	158	160
Diluted weighted average common shares outstanding	156	161	159	161
Cash dividends declared per share	<u>\$ 0.05</u>	<u>\$ 0.05</u>	<u>\$ 0.10</u>	<u>\$ 0.10</u>

See accompanying notes to condensed consolidated financial statements.

[Table of Contents](#)

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

	<u>September 30,</u> <u>2010</u>	<u>December 31,</u> <u>2009</u>
Assets		
Current assets:		
Cash and equivalents	\$ 1,175	\$ 941
Receivables:		
Accounts receivable, net of allowance for bad debts of \$28 and \$26	1,383	1,243
Unbilled receivables on uncompleted contracts	478	657
Total receivables	1,861	1,900
Deferred income taxes	194	192
Other current assets	377	608
Total current assets	3,607	3,641
Property, plant, and equipment, net of accumulated depreciation of \$326 and \$264 (including \$83 and \$0, net, owned by a variable interest entity – see Note 11)	348	251
Goodwill	697	691
Intangible assets, net	75	58
Equity in and advances to related companies	217	164
Noncurrent deferred income taxes	117	120
Noncurrent unbilled receivables on uncompleted contracts	321	321
Other assets	84	81
Total assets	\$ 5,466	\$ 5,327
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 938	\$ 1,045
Due to former parent, net	49	53
Advance billings on uncompleted contracts	526	407
Reserve for estimated losses on uncompleted contracts	29	40
Employee compensation and benefits	248	191
Current non-recourse project-finance debt of a variable interest entity (See Note 11)	9	—
Other current liabilities	432	552
Current liabilities related to discontinued operations, net	—	3
Total current liabilities	2,231	2,291
Noncurrent employee compensation and benefits	451	469
Noncurrent non-recourse project-finance debt of a variable interest entity (See Note 11)	98	—
Other noncurrent liabilities	106	106
Noncurrent income tax payable	113	43
Noncurrent deferred tax liability	119	122
Total liabilities	3,118	3,031
KBR Shareholders' equity:		
Preferred stock, \$0.001 par value, 50,000,000 shares authorized, 0 shares issued and outstanding	—	—
Common stock, \$0.001 par value, 300,000,000 shares authorized, 171,215,837 and 170,686,531 shares issued, and 151,519,458 and 160,363,830 shares outstanding	—	—
Paid-in capital in excess of par	2,111	2,103
Accumulated other comprehensive loss	(428)	(444)
Retained earnings	1,087	854
Treasury stock, 19,696,379 shares and 10,322,701 shares, at cost	(439)	(225)
Total KBR shareholders' equity	2,331	2,288
Noncontrolling interests	17	8
Total shareholders' equity	2,348	2,296
Total liabilities and shareholders' equity	\$ 5,466	\$ 5,327

See accompanying notes to condensed consolidated financial statements.

KBR, Inc.
Condensed Consolidated Statements of Comprehensive Income
(In millions)
(Unaudited)

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Net income	\$ 117	\$ 97	\$ 298	\$ 275
Other comprehensive income (loss), net of tax benefit (provision):				
Net cumulative translation adjustments	15	4	9	14
Pension liability adjustments	4	1	10	11
Net unrealized gain (loss) on derivatives	(5)	1	(1)	(1)
Total other comprehensive income (loss), net of tax	<u>14</u>	<u>6</u>	<u>18</u>	<u>24</u>
Comprehensive income	131	103	316	299
Less: Comprehensive income attributable to noncontrolling interests	(23)	(23)	(51)	(64)
Comprehensive income attributable to KBR	<u>\$ 108</u>	<u>\$ 80</u>	<u>\$ 265</u>	<u>\$ 235</u>

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended	
	September 30,	
	2010	2009
Cash flows from operating activities:		
Net income	\$ 298	\$ 275
Adjustments to reconcile net income to net cash provided by (used in) operations:		
Depreciation and amortization	45	41
Equity in earnings of unconsolidated affiliates	(99)	(46)
Deferred income taxes	(9)	(14)
Impairment of goodwill	—	6
Other	31	10
Changes in operating assets and liabilities:		
Receivables	(151)	(191)
Unbilled receivables on uncompleted contracts	168	94
Accounts payable	(125)	(233)
Advanced billings on uncompleted contracts	137	(68)
Accrued employee compensation and benefits	59	(24)
Reserve for loss on uncompleted contracts	(11)	(23)
Collection (repayment) of advances from (to) unconsolidated affiliates, net	(5)	(1)
Distribution of earnings from unconsolidated affiliates	45	35
Other assets	61	25
Other liabilities	97	87
Total cash flows provided by (used in) operating activities	541	(27)
Cash flows from investing activities:		
Capital expenditures	(39)	(22)
Investment in equity method joint ventures	(14)	—
Investment in licensing arrangement	(20)	—
Acquisition of business, net of cash acquired	(10)	—
Other investing activities	—	2
Total cash flows used in investing activities	(83)	(20)
Cash flows from financing activities:		
Payments to reacquire common stock	(217)	(27)
Payments of dividends to shareholders	(24)	(24)
Distributions to noncontrolling shareholders, net	(37)	(30)
Net proceeds from issuance of stock	3	1
Excess tax benefits from stock-based compensation	—	(1)
Payments on short-term and long-term borrowings	(9)	—
Return (funding) of cash collateral on letters of credit, net	26	(11)
Total cash flows used in financing activities	(258)	(92)
Effect of exchange rate changes on cash	12	14
Increase (decrease) in cash and equivalents	212	(125)
Cash increase due to consolidation of a variable interest entity	22	—
Cash and equivalents at beginning of period	941	1,145
Cash and equivalents at end of period	\$1,175	\$ 1,020

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

	<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2010</u>	<u>2009</u>
Noncash activities:		
Noncash operating activities		
Other assets (see Note 7)	\$ 130	\$ 369
Other liabilities (see Note 7)	<u>\$(130)</u>	<u>\$(369)</u>
Noncash investing activities		
Purchase of computer software	<u>\$ (19)</u>	<u>\$ —</u>
Noncash financing activities		
Dividends payable	<u>\$ 8</u>	<u>\$ 8</u>

See accompanying notes to condensed consolidated financial statements.

Note 1. Description of Business and Basis of Presentation

KBR, Inc. and its subsidiaries (collectively, “KBR”) is a global engineering, construction and services company supporting the energy, petrochemicals, government services, industrial and civil infrastructure sectors. We offer a wide range of services through four business segments: Infrastructure, Government and Power (“IGP”), Hydrocarbons, Services and Ventures. See Note 4 for financial information about our reportable business segments.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules of the United States Securities and Exchange Commission (“SEC”) for interim financial statements and do not include all annual disclosures required by accounting principles generally accepted in the United States. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 filed with the SEC. We believe that the presentation and disclosures herein are adequate to make the information not misleading, and the condensed consolidated financial statements reflect all normal adjustments that management considers necessary for a fair presentation of our consolidated results of operations, financial position and cash flows. Operating results for interim periods are not necessarily indicative of results to be expected for the full fiscal year 2010 or any other future periods.

The preparation of our condensed consolidated financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenue and costs during the reporting periods. Actual results could differ materially from those estimates. On an ongoing basis, we review our estimates based on information currently available, and changes in facts and circumstances may cause us to revise these estimates.

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

Effective January 1, 2010, we elected to change our annual goodwill impairment testing to the fourth quarter of every year based on carrying values of our reporting units as of October 1 from our previous method of using our reporting unit carrying values as of September 30. An annual goodwill impairment test date of October 1 better aligns with our annual budgetary process which is completed during the fourth quarter of each year. In addition, performing our annual goodwill impairment test during the fourth quarter will allow for a more thorough consideration of the valuations of our reporting units subsequent to the completion of our annual budgetary process but prior to our financial year end reporting date. As a result of this accounting change, there are no required adjustments to any of the financial statement line items in the accompanying financial statements.

Note 2. Income per Share

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

<u>Millions of shares</u>	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>September 30,</u>	<u>September 30,</u>	<u>September 30,</u>	<u>September 30,</u>
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Basic weighted average common shares outstanding	<u>155</u>	<u>160</u>	<u>158</u>	<u>160</u>
Dilutive effect of:				
Stock options and restricted shares	<u>1</u>	<u>1</u>	<u>1</u>	<u>1</u>
Diluted weighted average common shares outstanding	<u>156</u>	<u>161</u>	<u>159</u>	<u>161</u>

For purposes of applying the two-class method in computing earnings per share, net earnings allocable to participating securities was approximately \$1 million for the three and nine months ended September 30, 2010. Net earnings allocable to participating securities did not have a material impact on earnings

[Table of Contents](#)

per share for the three months ended September 30, 2009, and was approximately \$1 million for the nine months ended September 30, 2009. The diluted earnings per share calculation did not include 1 million anti-dilutive weighted average shares for both the three and nine months ended September 30, 2010. The diluted earnings per share calculation did not include 1.4 million and 1.7 million antidilutive weighted average shares for the three and nine months ended September 30, 2009, respectively.

In October 2010, our Board of Directors declared a quarterly cash dividend of \$0.05 per share of common stock. Any future dividend declarations will be at the discretion of our Board of Directors. We repurchased approximately 7 million shares and 9.5 million shares of our common stock during the three and nine months ended September 30, 2010, respectively. Additionally, in October 2010, we repurchased an additional 0.6 million shares of our outstanding common stock under our share repurchase program.

Note 3. Percentage-of-Completion Contracts

Unapproved claims

The amounts of unapproved claims and change orders included in determining the profit or loss on contracts and recorded in current and non-current unbilled receivables on uncompleted contracts are as follows:

<u>Millions of dollars</u>	<u>September 30, 2010</u>	<u>December 31, 2009</u>
Probable unapproved claims	\$ 33	\$ 33
Probable unapproved change orders	13	61
Probable unapproved change orders related to unconsolidated subsidiaries	4	2

As of September 30, 2010, the probable unapproved claims related to two completed projects. See Note 6 for a discussion of U.S. government contract claims, which are not included in the table above.

Included in the table above are amounts that will likely not be settled within one year totaling \$19 million at September 30, 2010, and \$20 million at December 31, 2009, which are reflected as a non-current asset in "Noncurrent unbilled receivables on uncompleted contracts" on the condensed consolidated balance sheets. Other probable unapproved claims and change orders that we believe will be settled within one year, have been recorded as a current asset in "Unbilled receivables on uncompleted contracts" on the condensed consolidated balance sheets.

PEMEX Arbitration. In 1997 and 1998 we entered into three contracts with PEMEX, the project owner, to build offshore platforms, pipelines and related structures in the Bay of Campeche offshore Mexico. The three contracts were known as Engineering, Procurement and Construction ("EPC") 1, EPC 22 and EPC 28. All three projects encountered significant schedule delays and increased costs due to problems with design work, late delivery and defects in equipment, increases in scope and other changes. PEMEX took possession of the offshore facilities of EPC 1 in March 2004 after having achieved oil production but prior to our completion of our scope of work pursuant to the contract.

We filed for arbitration with the International Chamber of Commerce ("ICC") in 2004 claiming recovery of damages of \$323 million for EPC 1 and PEMEX subsequently filed counterclaims totaling \$157 million. The EPC 1 arbitration hearings were held in November 2007. In December 2009, the ICC ruled in our favor and we were awarded a total of approximately \$351 million including legal and administrative recovery fees as well as interest. PEMEX was awarded approximately \$6 million on counterclaims, plus interest on a portion of that sum. The amount of the award exceeded the book value of our claim receivable resulting in our recognition of a \$183 million of operating income and \$117 million of net income in the fourth quarter of 2009. The arbitration award is legally binding and we have filed a proceeding in U.S. Federal Court to recognize the award pursuant to which hearings were held in July 2010. PEMEX has attempted to challenge jurisdiction of the U.S. Federal Court and to nullify the award in Mexican court. The Mexican trial court rejected PEMEX's nullification petition. We will respond to further efforts by PEMEX to nullify our award as may be required. We believe the timing of the collection of the award is uncertain and therefore, we have classified the amount due from PEMEX for EPC 1 as a long term receivable included in "Noncurrent unbilled receivable on uncompleted contracts" as of September 30, 2010.

LNG Project. During the third quarter of 2010, primarily as a result of actions and in certain instances, inactions on the part of the customer, we identified increases in the estimated cost to complete one of our LNG projects due to a schedule delay. The estimated cost increases were identified during an update to the overall project schedule that was completed in the third quarter of 2010 and includes additional labor, equipment, subcontractor, bonding and other project costs. We continue to evaluate our legal entitlement to an extension of time under the contract with our customer and will vigorously pursue all other available remedies which may reduce our exposure to the estimated project cost increases in future periods. As a result of the increases in estimated project costs, we recognized a non-cash charge of approximately \$42 million to job income in the third quarter of 2010. As of September 30, 2010, the project is approximately 71% complete. Also within our Hydrocarbons segment, a gain was recognized in the third quarter of 2010 related to a settlement agreement with a commercial agent and this non-cash gain substantially offsets the cost growth discussed above. Refer to Note 7 for further discussion of the settlement agreement.

[Table of Contents](#)

Note 4. Business Segment Information

We provide a wide range of services, but the management of our business is heavily focused on major projects within each of our reportable segments. At any given time, a relatively few number of projects and joint ventures represent a substantial part of our operations. Our equity in earnings and losses of unconsolidated affiliates that are accounted for using the equity method of accounting is included in revenue of the applicable segment.

Operating segment performance is evaluated by our chief operating decision maker using operating segment income which is defined as operating segment revenue less the cost of services and segment overhead directly attributable to the operating segment. Intersegment revenues are eliminated from operating segment revenues. Operating segment income excludes certain cost of services directly attributable to the operating segment that is managed and reported at the corporate level, and corporate general and administrative expenses. Labor cost absorption represents costs incurred by our central service labor and resource groups (above)/under the amounts charged to the operating segments.

The table below presents information on our reportable business segments.

<i>Millions of dollars</i>	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenue:				
Hydrocarbons	\$ 974	\$ 884	\$ 2,900	\$ 2,701
Infrastructure, Government and Power	983	1,479	3,454	4,960
Services	480	464	1,347	1,437
Other	18	13	56	43
Total revenue	<u>\$2,455</u>	<u>\$ 2,840</u>	<u>\$7,757</u>	<u>\$9,141</u>
Operating segment income:				
Hydrocarbons	\$ 93	\$ 65	\$ 285	\$ 225
Infrastructure, Government and Power	83	104	234	275
Services	26	21	72	64
Other	11	(1)	26	11
Operating segment income	213	189	617	575
Unallocated amounts:				
Labor cost absorption	4	(3)	4	(5)
Corporate loss on disposition of assets	(1)	(1)	(3)	(1)
Corporate general and administrative	(53)	(54)	(157)	(157)
Total operating income	<u>\$ 163</u>	<u>\$ 131</u>	<u>\$ 461</u>	<u>\$ 412</u>

Balance Sheet Information by Operating Segment

<u>Millions of dollars</u>	<u>September 30, 2010</u>
Total assets:	
Hydrocarbons	\$ 2,155
Infrastructure, Government and Power	2,797
Services	639
Other	(125)
Total assets	<u>\$ 5,466</u>
Goodwill:	
Hydrocarbons	\$ 249
Infrastructure, Government and Power	149
Services	286
Other	13
Total	<u>\$ 697</u>
Equity in/advances to related companies:	
Hydrocarbons	\$ 49
Infrastructure, Government and Power	13
Services	44
Other	111
Total	<u>\$ 217</u>

Note 5. Committed and Restricted Cash

Cash and equivalents include cash related to contracts in progress as well as cash held by our joint ventures that we consolidate for accounting purposes. Joint venture cash balances are limited to joint venture activities and are not available for other projects, general cash needs, or distribution to us without approval of the board of directors of the respective joint ventures. Cash held by our joint ventures that we consolidate for accounting purposes totaled approximately \$253 million at September 30, 2010 and \$236 million at December 31, 2009. We expect to use the cash on these projects to pay project costs.

Included in "Other current assets" and "Other assets" at September 30, 2010 is restricted cash in the amounts of \$11 million and \$10 million, respectively. Restricted cash primarily consists of amounts held in deposit with certain banks to collateralize standby letters of credit.

Note 6. United States Government Contract Work

We provide substantial work under our government contracts to the United States Department of Defense and other governmental agencies. These contracts include our worldwide United States Army logistics contracts, known as LogCAP, and the U.S. Army Europe ("USAREUR") contract.

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

We have experienced and expect to be a party to various claims against us by employees, third parties, soldiers, subcontractors and others that have arisen out of our work in Iraq such as claims for wrongful termination, assaults against employees, personal injury claims by third parties and army personnel, and subcontractor claims. While we believe we conduct our operations safely, the environments in which we operate often lead to these types

[Table of Contents](#)

of claims. We believe the vast majority of these types of claims are governed by the Defense Base Act or precluded by other defenses. We have a dispute resolution program under which most employment claims are subject to binding arbitration. However, as a result of amendments to the Department of Defense Appropriations Act of 2010, certain types of employee claims cannot be compelled to binding arbitration. An unfavorable resolution or disposition of these matters could have a material adverse effect on our business, results of operations, financial condition and cash flow.

Award Fees

In accordance with the provisions of the LogCAP III contract, we earn profits on our services rendered based on a combination of a fixed fee plus award fees granted by our customer. Both fees are measured as a percentage rate applied to estimated and negotiated costs. The LogCAP III customer is contractually obligated to periodically convene Award-Fee Boards, which are comprised of individuals who have been designated to assist the Award Fee Determining Official (“AFDO”) in making award fee determinations. Award fees are based on evaluations of our performance using criteria set forth in the contract, which include non-binding monthly evaluations made by our customers in the field of operations. Although these criteria have historically been used by the Award-Fee Boards in reaching their recommendations, the amounts of award fees are determined at the sole discretion of the AFDO.

On February 19, 2010, KBR was notified by the AFDO that a determination had been made regarding the Company’s performance for the period January 2008 to April 2008 in Iraq. The notice stated that based on information received from various Department of Defense individuals and organizations after the date of the evaluation board held in June 2008, the AFDO made a unilateral decision to grant no award fees for the period of performance from January 2008 to April 2008.

As a result of the AFDO’s adverse determination, in the fourth quarter of 2009, we reversed award fees that had previously been estimated as earned and recognized as revenue. Until we are able to reliably estimate fees to be awarded in the future, we will recognize award fees on the LogCAP III contract in the period they are awarded. In May 2010, we received an award fee of approximately \$60 million representing approximately 47% of the available award fee pool for the period of performance from May 2008 through August 2009 which we recorded as an increase to revenue in the second quarter of 2010. In September 2010, we received an award fee of approximately \$34 million representing approximately 66% of the available award fee pool for the period of performance from September 2009 through February 2010 on task orders in Iraq and from September 2009 through May 2010 on task orders in Afghanistan, which was recorded as an increase to revenue in the third quarter of 2010.

Prior to the fourth quarter of 2009, we recognized award fees on the LogCAP III contract using an estimated accrual of the amounts to be awarded. Once task orders underlying the work are definitized and award fees are granted, we adjust our estimate of award fees to the actual amounts earned. We used 72% as our accrual rate through the third quarter of 2009.

Government Compliance Matters

The negotiation, administration, and settlement of our contracts with the U.S. Government, consisting primarily of Department of Defense contracts, are subject to audit by the Defense Contract Audit Agency (“DCAA”), which serves in an advisory role to the Defense Contract Management Agency (“DCMA”) which is responsible for the administration of our contracts. The scope of these audits include, among other things, the allowability, allocability, and reasonableness of incurred costs, approval of annual overhead rates, compliance with the Federal Acquisition Regulation (“FAR”) and Cost Accounting Standard (“CAS”) Regulations, compliance with certain unique contract clauses, and audits of certain aspects of our internal control systems. Issues identified during these audits are typically discussed and reviewed with us, and certain matters are included in audit reports issued by the DCAA, with its recommendations to our customer’s administrative contracting officer. We attempt to resolve all issues identified in audit reports by working directly with the DCAA and the administrative contracting officer. When agreement cannot be reached, DCAA may issue a Form 1, “Notice of Contract Costs Suspended and/or Disapproved,” which recommends withholding the previously paid amounts or it may issue an advisory report to the administrative contracting officer. KBR is permitted to respond to these documents and provide additional support. At September 30, 2010, open Form 1’s from DCAA recommending suspension of payments totaling approximately \$340 million associated with our contract costs incurred in prior years, of which approximately \$164 million has been withheld from our current billings. As a consequence, for certain of these matters, we have withheld approximately \$116 million from our subcontractors under the payment terms of those contracts. In addition, we have outstanding demand letters received from our customer requesting that we remit a total of \$96 million of disapproved costs for which we currently do not intend to pay. We continue to work with our administrative contracting officers, the DCAA and our subcontractors to resolve these issues. However, for certain of these matters, we have filed claims with the Armed Services Board of Contract Appeals or the United States Court of Federal Claims.

[Table of Contents](#)

KBR excludes from billings to the U.S. Government costs that are expressly unallowable, or mutually agreed to be unallowable, or not allocable to government contracts per applicable regulations. Revenue recorded for government contract work is reduced for our estimate of potentially refundable costs related to issues that may be categorized as disputed or unallowable as a result of cost overruns or the audit process. Our estimates of potentially unallowable costs are based upon, among other things, our internal analysis of the facts and circumstances, terms of the contracts and the applicable provisions of the FAR, quality of supporting documentation for costs incurred, and subcontract terms as applicable. From time to time, we engage outside counsel to advise us on certain matters in determining whether certain costs are allowable. We also review our analysis and findings with the DCMA Administrative Contracting Officer (“ACO”) as appropriate. In some cases, we may not reach agreement with the DCAA or the ACO regarding potentially unallowable costs which may result in our filing of claims in various courts. We only include amounts in revenue related to disputed and potentially unallowable costs when we determine it is probable that such costs will result in revenue. We generally do not recognize additional revenue for disputed or potentially unallowable costs for which revenue has been previously reduced until we reach agreement with the DCAA and/or the ACO that such costs are allowable.

Certain issues raised as a result of contract audits and other investigations are discussed below.

Private Security. In February 2007, we received a Form 1 notice from the Department of the Army informing us of their intent to adjust payments under the LogCAP III contract associated with the cost incurred for the years 2003 through 2006 by certain of our subcontractors to provide security to their employees. Based on that notice, the Army withheld its initial assessment of \$20 million. The Army based its initial assessment on one subcontract wherein, based on communications with the subcontractor, the Army estimated 6% of the total subcontract cost related to the private security costs. The Army previously indicated that not all task orders and subcontracts have been reviewed and that they may make additional adjustments. In August 2009, we received a Form 1 notice from the DCAA disapproving an additional \$83 million of costs incurred by us and our subcontractors to provide security during the same periods. Since that time, the Army withheld an additional \$24 million in payments from us bringing the total payments withheld to approximately \$44 million as of September 30, 2010 out of the Form 1 notices issued to date of \$103 million.

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

In 2007, we provided at the Army’s request information that addresses the use of armed security either directly or indirectly charged to LogCAP III. In October 2007, we filed a claim to recover the original \$20 million that was withheld which was deemed denied as a result of no response from the contracting officer. To date, we have filed appeals to the Armed Services Board of Contract Appeals (“ASBCA”) to recover \$44 million of the amounts withheld from us. We believe these sums were properly billed under our contract with the Army. At this time, we believe the likelihood that a loss related to this matter has been incurred is remote. We have not adjusted our revenues or accrued any amounts related to this matter. This matter is also the subject of a separate claim filed by the Department of Justice (“DOJ”) for alleged violation of the False Claims Act as discussed further below under the heading “Investigations, Qui Tams and Litigation.” Our appeal to the ASBCA is effectively stayed pending the resolution of the separate claim filed by the DOJ.

Containers. In June 2005, the DCAA recommended withholding certain costs associated with providing containerized housing for soldiers and supporting civilian personnel in Iraq. The DCMA agreed that the costs be withheld pending receipt of additional explanation or documentation to support the subcontract costs. We have not received a final determination by the DCMA and continue to provide information as requested by the DCMA. As of September 30, 2010, approximately \$26 million of costs have been suspended under Form 1 notices and withheld from us by our customer related to this matter of which \$28 million has been withheld by us from our subcontractors. In April 2008, we filed a counterclaim in arbitration against one of our LogCAP III subcontractors,

[Table of Contents](#)

First Kuwaiti Trading Company, to recover approximately \$51 million paid to the subcontractor for containerized housing as further described under the caption First Kuwaiti Trading Company arbitration below. We will continue working with the government and our subcontractors to resolve the remaining amounts. We believe that the costs incurred associated with providing containerized housing are reasonable and we intend to vigorously defend ourselves in this matter and we do not believe that we face a risk of significant loss from any disallowance of these costs in excess of the amounts we have withheld from subcontractors and the loss accruals we have recorded. At this time, the likelihood that a loss in excess of the amount accrued for this matter is remote.

Dining facilities. In 2006, the DCAA raised questions regarding our billings and price reasonableness of costs related to dining facilities in Iraq. We responded to the DCMA that our costs are reasonable. As of September 30, 2010, we have outstanding Form 1 notices from the DCAA disapproving \$178 million in costs related to these dining facilities until such time we provide documentation to support the price reasonableness of the rates negotiated with our subcontractor and demonstrate that the amounts billed were in accordance with the contract terms. We believe the prices obtained for these services were reasonable and intend to vigorously defend ourselves on this matter. We filed claims in the U.S. Court of Federal Claims to recover \$57 million of the \$80 million withheld from us by the customer. With respect to questions raised regarding billing in accordance with contract terms, as of September 30, 2010, we believe it is reasonably possible that we could incur losses in excess of the amount accrued for possible subcontractor costs billed to the customer that were possibly not in accordance with contract terms. However, we are unable to estimate an amount of possible loss or range of possible loss in excess of the amount accrued related to any costs billed to the customer that were not in accordance with the contract terms. We believe the prices obtained for these services were reasonable, we intend to vigorously defend ourselves in this matter and we do not believe we face a risk of significant loss from any disallowance of these costs in excess of amounts withheld from subcontractors. As of September 30, 2010, we had withheld \$79 million in payments from our subcontractors pending the resolution of these matters with our customer.

Additionally, one of our subcontractors, Tamimi, has filed for arbitration to recover approximately \$35 million for payments we have withheld from them pending the resolution of the Form 1 notices with our customer. Should we not reach a favorable resolution of the Form 1 notices, the subcontract terms allow us to offset the amounts owed to our subcontractor to the extent we do not receive payment from our customer related to these questioned costs. The arbitration hearings were held in May 2010 but no decision has been issued.

Transportation costs. The DCAA, in performing its audit activities under the LogCAP III contract, raised a question about our compliance with the provisions of the Fly America Act. Subject to certain exceptions, the Fly America Act requires Federal employees and others performing U.S. Government-financed foreign air travel to travel by U.S. flag air carriers. There are times when we transported personnel in connection with our services for the U.S. military where we may not have been in compliance with the Fly America Act and its interpretations through the Federal Acquisition Regulations and the Comptroller General. As of September 30, 2010, we have accrued an estimate of the cost incurred for these potentially non-compliant flights with a corresponding reduction to revenue. The DCAA may consider additional flights to be noncompliant resulting in potential larger amounts of disallowed costs than the amount we have accrued. At this time, we cannot estimate a range of reasonably possible losses that may have been incurred, if any, in excess of the amount accrued. We will continue to work with our customer to resolve this matter.

Construction services. As of September 30, 2010, we have outstanding Form 1 notices from the DCAA disapproving approximately \$25 million in costs related to work performed under our CONCAP III contract with the U.S. Navy to provide emergency construction services primarily to Government facilities damaged by Hurricanes Katrina and Wilma. The DCAA claims the costs billed to the U.S. Navy primarily related to subcontract costs that were either inappropriately bid, included unallowable profit markup or were unreasonable. In April 2010, we met with the U.S. Navy in an attempt to settle the potentially unallowable costs. As a result of the meeting, approximately \$7 million of the potentially unallowable costs was agreed in principle to be allowable and approximately \$1 million unallowable. We are working with the ACO to finalize a settlement of this position. Settlement of the remaining disputed amounts is pending further discussions with the customer regarding the applicable provisions of the FAR and interpretations thereof, as well as providing additional supporting documentation to the customer. As of September 30, 2010, the U.S. Navy has withheld approximately \$10 million from us. We believe we undertook adequate and reasonable steps to ensure that proper bidding procedures were followed and the amounts billed to the customer were reasonable and not in violation of the FAR. As of September 30, 2010, we have accrued our estimate of probable loss related to this matter; however, it is reasonably possible we could incur additional losses.

Investigations, Qui Tams and Litigation

The following matters relate to ongoing litigation or investigations involving U.S. government contracts.

McBride Qui Tam suit. In September 2006, we became aware of a qui tam action filed against us by a former employee alleging various wrongdoings in the form of overbillings of our customer on the LogCAP III contract. This case was originally filed pending the government's decision whether or not to participate in the suit. In June 2006, the government formally declined to participate. The principal allegations are that our compensation for the provision of Morale, Welfare and Recreation ("MWR") facilities under LogCAP III is based on the volume of usage of those facilities and that we deliberately overstated that usage. In accordance with the contract, we charged our customer based on actual cost, not based on the number of users. It was also alleged that, during the period from November 2004 into mid-December 2004, we continued to bill the customer for lunches, although the dining facility was closed and not serving lunches. There are also allegations regarding housing containers and our provision of services to our employees and contractors. On July 5, 2007, the court granted our motion to dismiss the qui tam claims and to compel arbitration of employment claims including a claim that the plaintiff was unlawfully discharged. The majority of the plaintiff's claims were dismissed but the plaintiff was allowed to pursue limited claims pending discovery and future motions. Substantially all employment claims were sent to arbitration under the Company's dispute resolution program and were subsequently resolved in our favor. In January 2009, the relator filed an amended complaint which is nearing completion of the discovery process. Trial for this matter is expected in early 2011. We believe the relator's claim is without merit and that the likelihood that a loss has been incurred is remote. As of September 30, 2010, no amounts have been accrued.

Godfrey Qui Tam suit. In December 2005, we became aware of a qui tam action filed against us and several of our subcontractors by a former employee alleging that we violated the False Claims Act by submitting overcharges to the government for dining facility services provided in Iraq under the LogCAP III contract. As required by the False Claims Act, the lawsuit was filed under seal to permit the government to investigate the allegations. In early April 2007, the court denied the government's motion for the case to remain under seal, and on April 23, 2007, the government filed a notice stating that it was not participating in the suit. In August 2007, the relator filed an amended complaint which added an additional contract to the allegations and added retaliation claims. We filed motions to dismiss and to compel arbitration which were granted on March 13, 2008 for all counts except as to the employment issues which were sent to arbitration. The relator filed an appeal and our position was upheld at the Appellate Court level as of January 6, 2010. As no further actions was taken by the relator with regard to the remaining employment issues sent to arbitration, we consider this matter to be concluded.

First Kuwaiti Trading Company arbitration. In April 2008, First Kuwaiti Trading Company, one of our LogCAP III subcontractors, filed for arbitration of a subcontract under which KBR had leased vehicles related to work performed on our LogCAP III contract. First Kuwaiti alleged that we did not return or pay rent for many of the vehicles and sought initial damages in the amount of \$39 million. We filed a counterclaim to recover amounts which may ultimately be determined due to the Government for the \$51 million in suspended costs as discussed in the preceding section of this footnote titled "Containers." First Kuwaiti subsequently responded by adding additional subcontract claims, increasing its total claim to approximately \$133 million. The first of several arbitration hearings were held during the first quarter of 2010 involving unpaid rents and damages on vehicles and lost vehicles representing approximately \$65 million of First Kuwaiti's total claim. In the second quarter of 2010, the arbitration panel rejected the majority of First Kuwaiti's claims which primarily related to unpaid rents beyond the expiration of the contractual lease term. The arbitration panel rendered a partial award to First Kuwaiti for damages of approximately \$6 million plus an unquantified amount for repair costs on certain vehicles, damages suffered as a result of late vehicle returns, and interest thereon, to be determined at a later date. Subsequent hearings have taken place during the second and third quarters regarding additional subcontracts totaling approximately \$8 million upon which the arbitration panel rejected the majority of First Kuwaiti's claims. No payments are expected to occur until all claims are arbitrated and awards finalized. The remaining arbitration hearings are scheduled to occur in the fourth quarter of 2010 and we believe any damages ultimately awarded to First Kuwaiti will be billable under the LogCAP III contract. Accordingly, we have accrued amounts payable and a related unbilled receivable for the amounts awarded to First Kuwaiti pursuant to the terms of the contract.

Paul Morell, Inc. d/b/a The Event Source vs. KBR, Inc. TES is a former LogCAP III subcontractor who provided DFAC services at six sites in Iraq from mid-2003 to early 2004. TES sued KBR in Federal Court in Virginia for breach of contract and tortious interference with TES's subcontractors by awarding subsequent DFAC contracts to the subcontractors. In addition, the Government withheld funds from KBR that KBR had submitted for reimbursement of TES invoices, and at that time, TES agreed that it was not entitled to payment until KBR was paid by the Government. Eventually KBR and the Government settled the dispute, and in turn KBR and TES agreed that

[Table of Contents](#)

TES would accept, as payment in full with a release of all other claims, the amount the Government paid to KBR for TES's services. TES filed a suit to overturn that settlement and release, claiming that KBR misrepresented the facts. The trial was completed in June 2009 and in January 2010, the Federal Court issued an order against us in favor of TES in the amount of \$15 million in actual damages and interest and \$4 million in punitive damages relating to the settlement and release entered into by the parties in May 2005. As of September 30, 2010, we have recorded un-reimbursable expenses of \$19 million for the judgment received for the full amount of the awarded damages. We have filed a notice of appeal with the Court.

Electrocution litigation. During 2008, a lawsuit was filed against KBR alleging that the Company was responsible for an electrical incident which resulted in the death of a soldier. This incident occurred at the Radwaniyah Palace Complex. It is alleged in the suit that the electrocution incident was caused by improper electrical maintenance or other electrical work. We intend to vigorously defend this matter. KBR denies that its conduct was the cause of the event and denies legal responsibility. The case was removed to Federal Court where motion to dismiss was filed. The court has issued a stay in the discovery of the case. The case is pending an appeal of certain pre-trial motions to dismiss that were previously denied. Hearings on the appeal were held in June 2010 and the court has taken the arguments under advisement. We are unable to determine the likely outcome nor can we estimate a range of potential loss, if any, related to this matter at this time. As of September 30, 2010, no amounts have been accrued.

Burn Pit litigation. KBR has been served with over 40 lawsuits in various states alleging exposure to toxic materials resulting from the operation of burn pits in Iraq or Afghanistan in connection with services provided by KBR under the LogCAP III contract. Each lawsuit has multiple named plaintiffs who purport to represent a large class of unnamed persons. The lawsuits primarily allege negligence, willful and wanton conduct, battery, intentional infliction of emotional harm, personal injury and failure to warn of dangerous and toxic exposures which has resulted in alleged illnesses for contractors and soldiers living and working in the bases where the pits are operated. All of the pending cases have been removed to Federal Court, the majority of which have been consolidated for multi-district litigation treatment. In the second quarter of 2010, we filed various motions including a motion to strike an amended consolidated petition filed by the plaintiffs and a motion to dismiss which the court has taken under advisement. In the September 2010, our motion to dismiss was denied. However, our motion to strike an amended consolidated petition filed by the plaintiffs was granted. The Court directed the parties to propose a plan for limited jurisdictional discovery. We intend to vigorously defend these matters. Due to the inherent uncertainties of litigation and because the litigation is at a preliminary stage, we cannot at this time accurately predict the ultimate outcome nor can we estimate a range of potential loss, if any, related to this matter at this time. Accordingly, as of September 30, 2010, no amounts have been accrued.

Convoy Ambush litigation. In April 2004, a fuel convoy in route from Camp Anaconda to Baghdad International Airport for the U.S. Army under our LogCAP III contract was ambushed resulting in deaths and severe injuries to truck drivers hired by KBR. In 2005, survivors of the drivers killed and those that were injured in the convoy, filed suit in state court in Houston, Texas against KBR and several of its affiliates, claiming KBR deliberately intended that the drivers in the convoy would be attacked and wounded or killed. The suit also alleges KBR committed fraud in its hiring practices by failing to disclose the dangers associated with working in the Iraq combat zone. In September 2006, the case was dismissed based upon the court's ruling that it lacked jurisdiction because the case presented a non-justiciable political question. Subsequently, three additional suits were filed, arising out of insurgent attacks on other convoys that occurred in 2004 and were likewise dismissed as non-justiciable under the Political Question Doctrine.

The plaintiffs in all cases appealed the dismissals to the Fifth Circuit Court of Appeals which reversed and remanded the remaining cases to trial court. In July 2008, the trial court directed substantive discovery to commence including the re-submittal of dispositive motions on various grounds including the Defense Base Act and Political Question Doctrine. In February 2010, the trial court ruled in favor of the plaintiffs, denying two of our motions to dismiss the case. In March 2010, the trial court granted in part and denied in part our third motion to dismiss the case. We filed appeals on all issues with the Fifth Circuit Court of Appeals and have moved to stay all proceedings in the trial court pending the resolution of these appeals. The cases were removed from the trial docket and the Fifth Circuit Court of Appeals has heard all previous motions filed by both parties. In September 2010, the DOJ filed a brief in support of KBR's position that the cases should be dismissed in their entirety based upon the exclusive provisions in the Defense Base Act. We are unable to determine the likely outcome of these cases at this time. As of September 30, 2010, no amounts have been accrued nor can we estimate the amount of potential loss, if any.

[Table of Contents](#)

DOJ False Claims Act complaint. On April 1, 2010, the DOJ filed a complaint in the U.S. District Court in the District of Columbia alleging certain violations of the False Claims Act related to the use of private security firms. The complaint alleges, among other things, that we made false or fraudulent claims for payment under the LogCAP III contract because we allegedly knew that they contained costs of services for or that included improper use of private security. We believe these sums were properly billed under our contract with the Army and that the use of private security was not prohibited under LogCAP III. We have filed motions to dismiss the complaint which are currently pending. We have not adjusted our revenues or accrued any amounts related to this matter.

Other Matters

Claims. Included in unbilled receivables in the accompanying balance sheets are unapproved claims for costs incurred under various government contracts totaling \$160 million at September 30, 2010 and \$113 million at December 31, 2009. Unapproved claims relate to contracts where our costs have exceeded the customer's funded value of the task order. The unapproved claims at September 30, 2010 include approximately \$122 million resulting from the de-obligation of 2004 and 2005 funding on certain task orders that were also subject to Form 1 notices relating to certain DCAA audit issues discussed above. This balance includes \$71 million that was de-obligated in the third quarter of 2010 which consists of funds nearing the 5-year expiration date. We believe such disputed costs will be resolved in our favor at which time the customer will be required to obligate funds from appropriations for the year in which resolution occurs. The remaining unapproved claims balance of approximately \$38 million represents primarily costs for which incremental funding is pending in the normal course of business. The majority of costs in this category are normally funded within several months after the costs are incurred. The unapproved claims outstanding at September 30, 2010 are considered to be probable of collection and have been recognized as revenue.

Note 7. Other Commitments and Contingencies

Foreign Corrupt Practices Act ("FCPA") investigations

On February 11, 2009 KBR LLC, entered a guilty plea related to the Bonny Island investigation in the United States District Court, Southern District of Texas, Houston Division (the "Court"). KBR LLC pled guilty to one count of conspiring to violate the FCPA and four counts of violating the FCPA, all arising from the intent to bribe various Nigerian officials through commissions paid to agents working on behalf of TSKJ on the Bonny Island project. The plea agreement reached with the DOJ resolves all criminal charges in the DOJ's investigation into the conduct of KBR LLC relating to the Bonny Island project, so long as the conduct was disclosed or known to DOJ before the settlement, including previously disclosed allegations of coordinated bidding. The plea agreement called for the payment of a criminal penalty of \$402 million, of which Halliburton was obligated to pay \$382 million under the terms of the indemnity in the master separation agreement, while we were obligated to pay \$20 million. We also agreed to a period of organizational probation of three years, during which we retain a monitor who assesses our compliance with the plea agreement and evaluate our FCPA compliance program over the three year period, with periodic reports to the DOJ.

On the same date, the SEC filed a complaint and we consented to the filing of a final judgment against us in the Court. The complaint and the judgment were filed as part of a settled civil enforcement action by the SEC, to resolve the civil portion of the government's investigation of the Bonny Island project. The complaint alleges civil violations of the FCPA's antibribery and books-and-records provisions related to the Bonny Island project. The complaint enjoins us from violating the FCPA's antibribery, books-and-records, and internal-controls provisions and requires Halliburton and KBR, jointly and severally, to make payments totaling \$177 million, all of which has been paid by Halliburton pursuant to the indemnification under the master separation agreement. The judgment also requires us to retain an independent monitor on the same terms as the plea agreement with the DOJ.

Under both the plea agreement and judgment, we agreed to cooperate with the SEC and DOJ in their investigations of other parties involved in TSKJ and the Bonny Island project.

As a result of the settlement, in the fourth quarter 2008 we recorded the \$402 million obligation to the DOJ and, accordingly, recorded a receivable from Halliburton for the \$382 million that Halliburton was obligated to pay to the DOJ on our behalf. The resulting charge of \$20 million to KBR was recorded in cost of sales of our Hydrocarbons business unit in the fourth quarter of 2008. Likewise, we recorded an obligation to the SEC in the amount of \$177 million and a receivable from Halliburton in the same amount. As of September 30, 2010 Halliburton has paid all installments to the DOJ and SEC, and such payments totaled \$559 million. Of the payments mentioned above, Halliburton paid \$142 million in the first nine months of 2010 and \$369 million in the first nine months of 2009, which have been reflected in the accompanying statement of cash flows as noncash operating activities. On October 1, 2010, we made the final payment to the DOJ related to our portion of the settlement agreement.

[Table of Contents](#)

As part of the settlement of the FCPA matters, we agreed to the appointment of a corporate monitor for a period of up to three years. We proposed the appointment of a corporate monitor and received approval from the DOJ in the third quarter of 2009. We are responsible for paying the fees and expenses related to the monitor's review and oversight of our policies and activities relating to compliance with applicable anti-corruption laws and regulations.

Because of the guilty plea by KBR LLC, we are subject to possible suspension or debarment of our ability to contract with governmental agencies of the United States and of certain foreign countries. We received written confirmation from the U.S. Department of the Army stating that it does not intend to suspend or debar KBR from DoD contracting as a result of the guilty plea by KBR LLC. The U.K. Ministry of Defence ("MoD") has indicated that it does not have any grounds to debar the KBR subsidiary with which it contracts under its public procurement regulations. Although there has been a threat to challenge the MOD's decision not to debar KBR, no formal proceedings have been issued since the threat was made. Therefore, we believe the risk of being debarred from contracting with the MOD is low. Although we do not believe we will be suspended or debarred of our ability to contract with other governmental agencies of the United States or any other foreign countries, suspension or debarment from the government contracts business would have a material adverse effect on our business, results of operations, and cash flow.

Under the terms of the Master Separation Agreement, Halliburton has agreed to indemnify us, and any of our greater than 50%-owned subsidiaries, for our share of fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of claims made or assessed by a governmental authority of the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria or a settlement thereof relating to FCPA and related corruption allegations, which could involve Halliburton and us through the M. W. Kellogg Company, M. W. Kellogg Limited ("MWKL"), or their or our joint ventures in projects both in and outside of Nigeria, including the Bonny Island, Nigeria project. Halliburton's indemnity will not apply to any other losses, claims, liabilities or damages assessed against us as a result of or relating to FCPA matters and related corruption allegations or to any fines or other monetary penalties or direct monetary damages, including disgorgement, assessed by governmental authorities in jurisdictions other than the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria, or a settlement thereof, or assessed against entities such as TSKJ, in which we do not have an interest greater than 50%. As of September 30, 2010, we are not aware of any uncertainties related to the indemnity from Halliburton or any material limitations on our ability to recover amounts due to us for matters covered by the indemnity from Halliburton.

We are aware that the U.K. Serious Fraud Office ("SFO") is conducting an investigation of activities conducted by current or former employees of MWKL regarding the Bonny Island project. Violations of corruption laws in the U.K. could result in fines, restitution and confiscation of revenues, among other penalties. MWKL has self reported to the SFO its corporate liability for corruption-related offenses arising out of the Bonny Island project and expects to enter into a plea negotiation process under the "Attorney General's Guidelines on Plea Discussions in Cases of Serious and Complex Fraud" issued by the Attorney General for England and Wales. MWKL is in the process of responding to inquiries and providing information as requested by the SFO. As a result of the unique factors associated with this matter and in light of MWKL's cooperation, the SFO has confirmed it will treat MWKL as having made an early self report in accordance with the SFO's guidelines. Whether the SFO pursues criminal prosecution or civil recovery, and the amount of any fines, restitution, confiscation of revenues or other penalties that could be assessed will depend on, among other factors, the SFO's findings regarding the amount, timing, nature and scope of any improper payments or other activities, whether any such payments or other activities were authorized by or made with knowledge of MWKL, the amount of revenue involved, and the level of cooperation provided to the SFO during the investigations. Our indemnity from Halliburton under the master separation agreement with respect to MWKL is limited to our 55% beneficial ownership in MWKL. Due to the indemnity from Halliburton, we believe any outcome of this matter will not have a material adverse impact to our operating results or financial position.

Investigations by other foreign governmental authorities are continuing. We have learned that charges have been filed in Nigeria against various parties including KBR and TSKJ Nigeria Limited. Although we have not been served with a suit, we do know that the allegations arise out of the facts associated with our settlement of the DOJ's FCPA investigation of the Bonny Island project. We are seeking information about the process and procedures in Nigeria. We currently do not have sufficient information to determine the outcome or estimate any liability associated with these charges. We believe any unfavorable outcome of these charges would be covered by our indemnity from Halliburton under the Master Separation Agreement.

Commercial Agent Fees

We have both before and after the separation from our former parent used commercial agents on some of our large-scale international projects to assist in understanding customer needs, local content requirements, vendor selection criteria and processes and in communicating information from us regarding our services and pricing. Prior to separation, it was identified by our former parent in performing its investigation of anti-corruption activities that certain of these agents may have engaged in activities that were in violation of anti-corruption laws at that time and the terms of their agent agreements with us. Accordingly, we have ceased the receipt of services from and payment of fees to these agents. Fees for these agents are included in the total estimated cost for these projects at their completion. In connection with actions taken by U.S. Government authorities, we have removed certain unpaid agent fees from the total estimated costs in the period that we obtained sufficient evidence to conclude such agents clearly violated the terms of their contracts with us. In the first and third quarters of 2009, we reduced project cost estimates by \$16 million and \$5 million, respectively, as a result of making such determinations. In September 2010, we executed a final settlement agreement with one of our agents in question after the agent was reviewed and approved under our policies on business conduct. Under the terms of the settlement agreement, the agent had, among other things, confirmed their understanding of and compliance with KBR's policies on business conduct and represented that they have complied with anti-corruption laws as they relate to prior services provided to KBR. We negotiated final payment for fees to this agent on several projects in our Hydrocarbons segment resulting in an overall reduction of estimated project costs of approximately \$60 million in the third quarter of 2010. As of September 30, 2010, the remaining unpaid agent fees of approximately \$8 million are included in the estimated costs related to a completed project.

Barracuda-Caratinga Project Arbitration

In June 2000, we entered into a contract with Barracuda & Caratinga Leasing Company B.V., the project owner, to develop the Barracuda and Caratinga crude oilfields, which are located off the coast of Brazil. Petrobras is a contractual representative that controls the project owner. In November 2007, we executed a settlement agreement with the project owner to settle all outstanding project issues except for the bolts arbitration discussed below.

At Petrobras' direction, we replaced certain bolts located on the subsea flowlines that failed through mid-November 2005, and we understand that additional bolts failed thereafter, which were replaced by Petrobras. These failed bolts were identified by Petrobras when it conducted inspections of the bolts. In March 2006, Petrobras notified us they submitted this matter to arbitration claiming \$220 million plus interest for the cost of monitoring and replacing the defective stud bolts and, in addition, all of the costs and expenses of the arbitration including the cost of attorneys' fees. The arbitration is being conducted in New York under the guidelines of the United Nations Commission on International Trade Law ("UNCITRAL"). Petrobras contends that all of the bolts installed on the project are defective and must be replaced.

During the time that we addressed outstanding project issues and during the conduct of the arbitration, KBR believed the original design specification for the bolts was issued by Petrobras, and as such, the cost resulting from any replacement would not be our responsibility. A hearing on legal and factual issues relating to liability with the arbitration panel was held in April 2008. In June 2009, we received an unfavorable ruling from the arbitration panel on the legal and factual issues as the panel decided the original design specification for the bolts originated with KBR and its subcontractors. The ruling concluded that KBR's express warranties in the contract regarding the fitness for use of the design specifications for the bolts took precedence over any implied warranties provided by the project owner. Our potential exposure would include the costs of the bolts replaced to date by Petrobras, any incremental monitoring costs incurred by Petrobras and damages for any other bolts that are subsequently found to be defective. We believe that it is probable that we have incurred some liability in connection with the replacement of bolts that have failed during the contract warranty period which expired June 30, 2006. In May 2010, the arbitration tribunal heard arguments from both parties regarding various damage scenarios and estimates of the amount of KBR's overall liability in this matter. The final arbitration arguments were made in August of 2010. Based on the damage estimates presented at this hearing, we estimate our minimum exposure, excluding interest, to be approximately \$12 million representing our estimate for replacement of bolts that failed during the warranty period and were not replaced. During the second quarter of 2010, we recorded a liability of \$12 million. Likewise, we recorded an indemnification receivable from Halliburton in the amount of \$12 million. The amount of any remaining liability will be dependent upon the legal and factual issues to be determined by the arbitration tribunal in the final arbitration hearings. For the remaining bolts at dispute, we can not determine that we have liability nor determine the amount of any such liability and no additional amounts have been accrued.

[Table of Contents](#)

Any liability incurred by us in connection with the replacement of bolts that have failed to date or related to the remaining bolts at dispute in the bolt arbitration is covered by an indemnity from our former parent Halliburton. Under the master separation agreement, Halliburton has agreed to indemnify us and any of our greater than 50%-owned subsidiaries as of November 2006, for all out-of-pocket cash costs and expenses (except for ongoing legal costs), or cash settlements or cash arbitration awards in lieu thereof, we may incur after the effective date of the master separation agreement as a result of the replacement of the subsea flowline bolts installed in connection with the Barracuda-Caratinga project. As of September 30, 2010, we are not aware of any uncertainties related to the indemnity from Halliburton or any material limitations on our ability to recover amounts due to us for matters covered by the indemnity from Halliburton. We do not believe any outcome of this matter will have a material adverse impact to our operating results or financial position.

Foreign tax laws

We conduct operations in many tax jurisdictions throughout the world. Tax laws in certain of these jurisdictions are not as mature as those found in highly developed economies. As a consequence, although we believe we are in compliance with such laws, interpretations of these laws could be challenged by the foreign tax authorities. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on our operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with accounting principles generally accepted in the United States of America, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of September 30, 2010, we adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be adversely impacted if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

Environmental

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

In addition to federal and state laws and regulations, other countries where we do business often have numerous environmental regulatory requirements by which we must abide in the normal course of our operations. The portions of our business to which these requirements apply primarily relates to our Gas Monetization, Oil & Gas, Downstream and Services business units where we perform construction and industrial maintenance services or operate and maintain facilities. For certain locations, including our property at Clinton Drive, we have not completed our analysis of the site conditions and until further information is available, we are only able to estimate a possible range of remediation costs. These locations were primarily utilized for manufacturing or fabrication work and are no longer in operation. The use of these facilities created various environmental issues including deposits of metals, volatile and semi-volatile compounds, and hydrocarbons impacting surface and subsurface soils and groundwater. The range of remediation costs could change depending on our ongoing site analysis and the timing and techniques used to implement remediation activities. We do not expect costs related to environmental matters will have a material adverse effect on our condensed consolidated financial position or results of operations. Based on the information presently available to us, we have accrued approximately \$7 million for the assessment and remediation costs associated with all environmental matters, which represents the low end of the range of possible costs that could be as much as \$14 million.

Letters of credit

In connection with certain projects, we are required to provide letters of credit, surety bonds or other financial and performance guarantees to our customers. As of September 30, 2010, we had approximately \$496 million in letters of credit and financial guarantees outstanding, of which \$308 million were issued under our Revolving Credit Facility and \$188 million issued under uncommitted bank lines. We have an additional \$200 million of letters of credit that were issued under various other facilities and are irrevocably and unconditionally guaranteed by Halliburton.

Liquidated damages

Many of our engineering and construction contracts have milestone due dates that must be met or we may be subject to penalties for liquidated damages if claims are asserted and we were responsible for the delays. These generally relate to specified activities that must be met within a project by a set contractual date or achievement of a specified level of output or throughput of a plant we construct. Each contract defines the conditions under which a customer may make a claim for liquidated damages. However, in some instances, liquidated damages are not asserted by the customer, but the potential to do so is used in negotiating claims and closing out the contract.

We have not accrued for liquidated damages related to several projects, including the exposure described in the above paragraph, totaling \$28 million at September 30, 2010 and \$18 million at December 31, 2009 (including amounts related to our share of unconsolidated subsidiaries), that we could incur based upon completing the projects as forecasted.

Leases

We are obligated under operating leases, principally for the use of land, offices, equipment, field facilities, and warehouses. We recognize minimum rental expenses over the term of the lease. When a lease contains a fixed escalation of the minimum rent or rent holidays, we recognize the related rent expense on a straight-line basis over the lease term and record the difference between the recognized rental expense and the amounts payable under the lease as deferred lease credits. We have certain leases for office space where we receive allowances for leasehold improvements. We capitalize these leasehold improvements as property, plant, and equipment and deferred lease credits. Leasehold improvements are amortized over the shorter of their economic useful lives or the lease term.

Eldridge Park I Building Lease. On September 30, 2010, we executed a lease agreement for office space located in a high-rise office building in Houston, Texas for the purpose of expanding our leased office space. The non-cancelable lease term expires on December 31, 2018. The lease term includes a rent holiday from the beginning of the lease through December 31, 2011; and a total combined leasehold improvement allowance of \$4 million. Annual base rent, excluding termination fees, based on currently planned occupancy ranges from \$1.6 million to \$1.8 million.

In February 2010, we executed two lease amendments for office space located in two separate high-rise office buildings in Houston, Texas for the purpose of significantly expanding our current leased office space and to extend the original term of the leases to June 30, 2030. These amendments did not change our historical accounting for these agreements as operating leases. The essential provisions of the lease amendments are as follows:

601 Jefferson Building Lease. The lease amendment extends the original term of the lease to June 30, 2030 and includes renewal options for three consecutive additional periods from 5 to 10 years each at prevailing market rates. Annual base rent for the leased office space escalates ratably over the lease term from \$9 million to \$14 million. The lease amendment includes a leasehold improvement allowance of \$29 million primarily for the construction of leasehold improvements. The lease may be terminated under a one-time option in March 2022 for all, or a portion, of the leased premises subject to a termination fee. The 601 Jefferson building is owned by a joint venture in which KBR owns 50% interest with an unrelated party owning the remaining 50% interest. The joint venture is currently evaluating options to finance the leasehold improvement allowance including debt that is non-recourse to the joint venture partners or capital contributions from each partner on a pro-rata basis according to ownership interest. The nature of the funding for the leasehold improvement allowance has not yet been determined.

500 Jefferson Building Lease. The lease amendment extends the original term of the lease to June 30, 2030 and includes renewal options for three consecutive additional periods from 5 to 10 years each at prevailing market rates. The lease terms include a rent holiday for the first six months of the lease beginning July 1, 2010. Annual base rent for the leased office space escalates ratably over the lease term from \$2 million to \$3 million. The lease amendment includes a leasehold improvement allowance of \$6 million primarily for the construction of leasehold improvements. The lease may be terminated under a one-time option in March 2022 for all, or a portion, of the leased premises subject to a termination fee.

[Table of Contents](#)

Other

We had commitments to provide funds to our privately financed and other projects of \$43 million as of September 30, 2010 and \$52 million as of December 31, 2009. Commitments to fund these projects are supported by letters of credit as described above. At September 30, 2010, approximately \$17 million of the \$43 million in commitments will become due within one year.

Effective December 24, 2009, we entered into a collaboration agreement with BP p.l.c. to market and license certain technology. In conjunction with this arrangement, we acquired a license granting us the exclusive right to the technology. In January 2010, as partial consideration for the license, we paid an initial fee of \$20 million, which will be amortized on a straight-line basis over the 25-year life of the arrangement.

Note 8. Income Taxes

Our effective tax rate was approximately 27% for the three months ended September 30, 2010. Our effective tax rate was 25% for the three months ended September 30, 2009. Our effective tax rate for the three months ended September 30, 2010 was lower than our statutory rate of 35% primarily due to favorable rate differentials on foreign earnings, benefits associated with income from unincorporated joint ventures and several favorable discrete tax items including the true-up of prior year U.S. income taxes and utilization of additional U.S. foreign tax credits during the third quarter of 2010. Our effective tax rate for the three months of 2009 was lower than our statutory rate of 35% primarily due to the final determination of previously estimated 2008 domestic and foreign taxable income, made in connection with the preparation and filing of our 2008 consolidated tax returns as well as benefits associated with income on unincorporated joint ventures.

[Table of Contents](#)

Note 9. Shareholders' Equity

The following tables summarize our shareholders' equity activities in the nine months of 2010:

<u>Millions of dollars</u>	<u>Total</u>	<u>KBR Shareholders</u>				<u>Noncontrolling Interests</u>
		<u>Paid-in Capital in Excess of par</u>	<u>Retained Earnings</u>	<u>Treasury Stock</u>	<u>Accumulated Other Comprehensive Loss</u>	
Balance at December 31, 2009	\$2,296	\$ 2,103	\$ 854	(225)	\$ (444)	\$ 8
Stock-based compensation	13	13	—	—	—	—
Common stock issued upon exercise of stock options	3	3	—	—	—	—
Dividends declared to shareholders	(16)	—	(16)	—	—	—
Adjustments pursuant to tax sharing agreement with former parent	(8)	(8)	—	—	—	—
Repurchases of common stock	(217)	—	—	(217)	—	—
Issuance of ESPP shares	3	—	—	3	—	—
Dividends paid to noncontrolling interests	(54)	—	—	—	—	(54)
Investment by noncontrolling partner, net	16	—	—	—	—	16
Consolidation of Fasttrax Limited	(4)	—	—	—	—	(4)
Comprehensive income:						
Net income	298	—	249	—	—	49
Other comprehensive income, net of tax (provision):						
Net cumulative translation adjustment	9	—	—	—	9	—
Pension liability adjustment, net of tax	10	—	—	—	8	2
Net unrealized gains (losses) on derivatives	(1)	—	—	—	(1)	—
Total	316					
Balance at September 30, 2010	\$ 2,348	\$2,111	\$1,087	\$ (439)	\$ (428)	\$ 17

The following tables summarize our shareholders' equity activities for the nine months of 2009:

<u>Millions of dollars</u>	<u>Total</u>	<u>KBR Shareholders</u>				<u>Noncontrolling Interests</u>
		<u>Paid-in Capital in Excess of par</u>	<u>Retained Earnings</u>	<u>Treasury Stock</u>	<u>Accumulated Other Comprehensive Loss</u>	
Balance at December 31, 2008	\$ 2,034	\$2,091	\$ 596	(196)	\$ (439)	\$ (18)
Stock-based compensation	13	13	—	—	—	—
Common stock issued upon exercise of stock options	1	1	—	—	—	—
Tax benefit related to stock-based plans	(1)	(1)	—	—	—	—
Dividends declared to shareholders	(16)	—	(16)	—	—	—
Repurchases of common stock	(27)	—	—	(27)	—	—
Issuance of ESPP shares	2	—	—	2	—	—
Distributions to noncontrolling interests	(42)	—	—	—	—	(42)
Investments by noncontrolling interests	12	—	—	—	—	12
Comprehensive income:						
Net income	275	—	217	—	—	58
Other comprehensive income, net of tax (provision):						
Net cumulative translation adjustment	14	—	—	—	11	3
Pension liability adjustment, net of tax	11	—	—	—	8	3
Net unrealized gains (losses) on derivatives	(1)	—	—	—	(1)	—
Total	299					
Balance at September 30, 2009	\$2,275	\$ 2,104	\$ 797	\$ (221)	\$ (421)	\$ 16

Accumulated other comprehensive loss consisted of the following balances:

<u>Millions of dollars</u>	<u>September 30, 2010</u>	<u>December 31, 2009</u>
Cumulative translation adjustments	\$ (45)	\$ (54)
Pension liability adjustments	(378)	(386)
Unrealized losses on derivatives	(5)	(4)
Total accumulated other comprehensive loss	\$ (428)	\$ (444)

Note 10. Fair Value Measurements

The financial assets and liabilities measured at fair value on a recurring basis are included below:

<u>Millions of dollars</u>	Fair Value Measurements at Reporting Date Using			
	September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Marketable securities	\$ 15	\$ 11	\$ 4	\$ —
Derivative assets	\$ 7	\$ —	\$ 7	\$ —
Derivative liabilities	\$ 5	\$ —	\$ 5	\$ —

Derivative instruments. Currency derivative instruments are carried on the condensed consolidated balance sheet at fair value and are primarily based upon market observable inputs and significant other observable inputs. We manage our currency exposures through the use of foreign currency derivative instruments denominated in our major currencies, which are generally the currencies of the countries for which we do the majority of our international business. We utilize derivative instruments to manage the foreign currency exposures related to specific assets and liabilities that are denominated in foreign currencies, and to manage forecasted cash flows denominated in foreign currencies generally related to long-term engineering and construction projects. The purpose of our foreign currency risk management activities is to protect us from the risk that the eventual dollar cash flow resulting from the sale and purchase of products and services in foreign currencies will be adversely affected by changes in exchange rates.

Marketable securities. We use quoted market prices and other observable inputs to determine the fair value of our marketable securities. These financial instruments primarily consist of mutual funds, exchange-traded fixed income securities and money market accounts.

Note 11. Equity Method Investments and Variable Interest Entities

We conduct some of our operations through joint ventures which are in partnership, corporate, undivided interest and other business forms and are principally accounted for using the equity method of accounting. Additionally, the majority of our joint ventures are also variable interest entities which are further described under “Variable Interest Entities.”

Equity Method Investments

Brown & Root Condor Spa (“BRC”) BRC is a joint venture in which we owned 49% interest. During the third quarter of 2007, we sold our 49% interest and other rights in BRC to Sonatrach for approximately \$24 million resulting in a pre-tax gain of approximately \$18 million which is included in “Equity in earnings (losses) of unconsolidated affiliates”. As of September 30, 2010, we have not collected the remaining \$18 million due from Sonatrach for the sale of our interest in BRC, which is included in “Accounts receivable.” In the fourth quarter of 2008, we filed for arbitration in an attempt to force collection. The next arbitration hearing is scheduled for January 2011. We believe the amount owed to us is probable of recovery.

Variable Interest Entities

We account for variable interest entities (“VIEs”) in accordance with FASB ASC 810. As a result of the adoption of ASU 2009-17, Consolidations (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities, effective January 1, 2010, FASB ASC 810 requires the consolidation of VIEs in which a company has both the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance and the obligation to absorb losses or the right to receive the benefits from the VIE that could potentially be significant to the VIE. If a reporting enterprise meets these conditions then it has a controlling financial interest and is the primary beneficiary of the VIE. We have applied the requirements of FASB ASC 810 on a prospective basis from the date of adoption.

[Table of Contents](#)

We assess all newly created entities and those with which we become involved to determine whether such entities are VIEs and, if so, whether or not we are their primary beneficiary. Most of the entities we assess are incorporated or unincorporated joint ventures formed by us and our partner(s) for the purpose of executing a project or program for a customer, such as a governmental agency or a commercial enterprise, and are generally dissolved upon completion of the project or program. Many of our long-term energy-related construction projects in our Hydrocarbons business group are executed through such joint ventures. Typically, these joint ventures are funded by advances from the project owner, and accordingly, require little or no equity investment by the joint venture partners but may require subordinated financial support from the joint venture partners such as letters of credit, performance and financial guarantees or obligations to fund losses incurred by the joint venture. Other joint ventures, such as privately financed initiatives in our Ventures business unit, generally require the partners to invest equity and take an ownership position in an entity that manages and operates an asset post construction.

As required by ASC 810-10, we perform a qualitative assessment to determine whether we are the primary beneficiary once an entity is identified as a VIE. A qualitative assessment begins with an understanding of the nature of the risks in the entity as well as the nature of the entity's activities including terms of the contracts entered into by the entity, ownership interests issued by the entity and how they were marketed, and the parties involved in the design of the entity. We then identify all of the variable interests held by parties involved with the VIE including, among other things, equity investments, subordinated debt financing, letters of credit, and financial and performance guarantees, and significant, contracted service providers. Once we identify the variable interests, we determine those activities which are most significant to the economic performance of the entity and which variable interest holder has the power to direct those activities. Though infrequent, some of our assessments reveal no primary beneficiary because the power to direct the most significant activities that impact the economic performance is held equally by two or more variable interest holders who are required to provide their consent prior to the execution of their decisions. Most of the VIEs with which we are involved have relatively few variable interests and are primarily related to our equity investment, significant service contracts, and other subordinated financial support.

Unconsolidated VIEs

The following is a summary of the significant variable interest entities in which we have a significant variable interest, but we are not the primary beneficiary:

U.K. Road Projects. We are involved in four privately financed projects, executed through joint ventures, to design, build, operate, and maintain roadways for certain government agencies in the United Kingdom. We have a 25% ownership interest in each of these joint ventures and account for them using the equity method of accounting. The joint ventures have obtained financing through third parties that is nonrecourse to the joint venture partners. These joint ventures are variable interest entities; however, we are not the primary beneficiary of these joint ventures. As of September 30, 2010, these joint ventures had total assets and liabilities of \$1.5 billion and \$1.6 billion, respectively. As of December 31, 2009, these joint ventures had total assets of \$1.7 billion and total liabilities of \$1.6 billion. Our maximum exposure to loss was \$32 million at September 30, 2010, which represents our investment in these ventures.

Fermoy Road Project. We participate in a privately financed project executed through certain joint ventures formed to design, build, operate, and maintain a toll road in southern Ireland. The joint ventures were funded through debt and were formed with minimal equity. These joint ventures are variable interest entities; however, we are not the primary beneficiary of the joint ventures. We have up to a 25% ownership interest in the project's joint ventures, and we are accounting for these interests using the equity method of accounting. As of September 30, 2010 and December 31, 2009, the joint ventures had combined total assets of \$244 million and \$271 million, and total liabilities of \$273 million and \$295 million, respectively. Our maximum exposure to loss was \$3 million at September 30, 2010.

Allenby & Connaught Project. In April 2006, Aspire Defence, a joint venture between us, Carillion Plc. and two financial investors, was awarded a privately financed project contract, the Allenby & Connaught project, by the MoD to upgrade and provide a range of services to the British Army's garrisons at Aldershot and around Salisbury Plain in the United Kingdom. In addition to a package of ongoing services to be delivered over 35 years, the project includes a nine-year construction program to improve soldiers' single living, technical and administrative accommodations, along with leisure and recreational facilities. Aspire Defence manages the existing properties and is responsible for design, refurbishment, construction and integration of new and modernized facilities. We indirectly own a 45% interest in Aspire Defence, the project company that is the holder of the 35-year concession contract. In addition, we own a 50% interest in each of two joint ventures that provide the construction and the related support services to Aspire Defence. Our performance through the construction phase is supported by \$90

[Table of Contents](#)

million in letters of credit and surety bonds totaling approximately \$16 million as of September 30, 2010, both of which have been guaranteed by Halliburton. Furthermore, our financial and performance guarantees are joint and several, subject to certain limitations, with our joint venture partners. The project is funded through equity and subordinated debt provided by the project sponsors and the issuance of publicly held senior bonds which are nonrecourse to us. The entities we hold an interest in are variable interest entities; however, we are not the primary beneficiary of these entities. We account for our interests in each of the entities using the equity method of accounting. As of September 30, 2010, the aggregate total assets of the variable interest entities were \$3.1 billion and total liabilities were \$3.1 billion. As of December 31, 2009, the aggregate total assets and total liabilities of the variable interest entities were both \$3.0 billion. Our maximum exposure to project company losses as of September 30, 2010 was \$71 million. Our maximum exposure to construction and operating joint venture losses is limited to the funding of any future losses incurred by those entities under their respective contracts with the project company. As of September 30, 2010, our assets and liabilities associated with our investment in this project, within our condensed consolidated balance sheet, were \$29 million and \$3 million, respectively. The \$68 million difference between our recorded liabilities and aggregate maximum exposure to loss was primarily related to our equity investments and \$43 million remaining commitment to fund subordinated debt to the project in the future.

EBIC Ammonia Project. We have an investment in a development corporation that has an indirect interest in the Egypt Basic Industries Corporation (“EBIC”) ammonia plant project located in Egypt. We are performing the engineering, procurement and construction (“EPC”) work for the project and operations and maintenance services for the facility. We own 65% of this development corporation and consolidate it for financial reporting purposes. The development corporation owns a 25% ownership interest in a company that consolidates the ammonia plant which is considered a variable interest entity. The development corporation accounts for its investment in the company using the equity method of accounting. The variable interest entity is funded through debt and equity. Indebtedness of EBIC under its debt agreement is non-recourse to us. We are not the primary beneficiary of the variable interest entity. As of September 30, 2010, the variable interest entity had total assets of \$587 million and total liabilities of \$410 million. As of December 31, 2009, the variable interest entity had total assets of \$598 million and total liabilities of \$489 million. Our maximum exposure to loss related to our involvement with this project at September 30, 2010 was \$44 million. As of September 30, 2010, our assets and liabilities associated with our investment in this project, within our condensed consolidated balance sheet, were \$54 million and \$10 million, respectively. The \$34 million difference between our recorded liabilities and aggregate maximum exposure to loss was related to our investment balance and other receivables in the project as of September 30, 2010.

Other Liquefied Natural Gas (“LNG”) Projects. We have equity ownership in two joint ventures to execute EPC projects. Our equity ownership ranges from 33% to 50%, and these joint ventures are variable interest entities. We are not the primary beneficiary and thus account for these joint ventures using the equity method of accounting. At September 30, 2010 and December 31, 2009, these joint ventures had aggregate assets of \$299 million and \$410 million and aggregate liabilities of \$285 million and \$467 million, respectively. As of September 30, 2010, total assets and liabilities recorded within our balance sheets were \$27 million and \$3 million, respectively. Our aggregate, maximum exposure to loss related to these entities was \$27 million at September 30, 2010, and comprises primarily our equity investment and contract receivables with both joint ventures.

Consolidated VIEs

The following is a summary of the significant VIEs where we are the primary beneficiary:

Fastrax Limited Project. In December 2001, the Fastrax Joint Venture (the “JV”) was created to provide to the United Kingdom Ministry of Defense (“MOD”) a fleet of 92 new heavy equipment transporters (“HETs”) capable of carrying a 72-ton Challenger II tank. The JV owns, operates and maintains the HET fleet and provides heavy equipment transportation services to the British Army. The purchase of the assets was completed in 2004, and the operating and service contracts related to the assets extend through 2023. The JV’s entity structure includes a parent entity and its 100%-owned subsidiary, Fastrax Ltd (the “SPV”). KBR and its partner own each 50% of the parent entity.

The JV’s purchase of the assets was funded through the issuance of several series guaranteed secured bonds totaling approximately £84.9 million issued by the SPV including £12.2 million which was replaced in 2005 when the shareholders funded combined equity and subordinated debt of approximately £12.2 million. The bonds are guaranteed by Ambac Assurance U.K. Ltd under a policy that guarantees the schedule of principle and interest payments to the bond trustee in the event of non-payment by Fastrax. The total amount of debt consolidated at September 30, 2010, was approximately \$107 million of which \$9 million was classified as “Current non-recourse project-finance debt of a variable interest entity” and \$98 million was classified as “Noncurrent non-recourse project-finance debt of a variable interest entity” on KBR’s condensed consolidated balance sheet.

[Table of Contents](#)

The guaranteed secured bonds were issued in two classes consisting of Class A 3.5% Index Linked Bonds in the amount of £56 million and Class B 5.9% Fixed Rate Bonds in the amount of £16.7 million. Principal payments on both classes of bonds commenced in March 2005 and are due in semi-annual installments over the term of the bonds which end in 2021. Subordinated notes payable to our 50% partner initially bear interest at 11.25% increasing to 16% over the term of the note through 2025. Payments on the subordinated debt commenced in March 2006 and are due in semi-annual installments over the term of the note.

The combined principal installments for both classes of bonds and subordinated notes, including inflation adjusted bond indexation, due for the years ended December 31, 2010, 2011 and 2012 and thereafter total approximately £3 million, £6 million, £6 million and £67 million, respectively.

Effective January 1, 2010, upon the adoption of the newly issued guidance in FASB ASC 810 – Consolidation, we determined that we are the primary beneficiary of this project entity because we control the activities that most significantly impact economic performance of the entity. This variable interest entity, in which we have a 50% ownership interest, was previously accounted for using the equity method of accounting because no party absorbed the majority of the expected losses which was the determining factor under the superceded standard. We have applied the requirements of FASB ASC 810 on a prospective basis from the date of adoption. Upon consolidation of this joint venture, consolidated current assets increased by \$26 million primarily related to cash and equivalents, consolidated noncurrent assets increased by \$89 million related to property, plant and equipment, consolidated current liabilities increased by \$10 million primarily related to accounts payable, and noncurrent liabilities increased by \$112 million related to the outstanding senior bonds and subordinated debt issued to finance the JV's operations. No gain or loss was recognized by KBR upon consolidation of this VIE. As of September 30, 2010 and December 31, 2009, the joint venture had total assets of \$109 million and \$117 million, and total liabilities of \$110 million and \$124 million, respectively. Assets collateralizing the JV's senior bonds include cash and equivalents of \$25 million and property, plant, and equipment of approximately \$83 million, net of accumulated depreciation of \$38 million as of September 30, 2010. The bonds of the SPV, being non-recourse to KBR, are shown on the face of our condensed consolidated balance sheet as "Non-recourse project-finance debt."

Esgravos Gas-to-Liquids ("GTL") Project. During 2005, we formed a joint venture to engineer and construct a gas monetization facility. We own 50% equity interest and determined that we are the primary beneficiary of the joint venture which is consolidated for financial reporting purposes. At September 30, 2010 and December 31, 2009, the joint venture had \$339 million and \$387 million in total assets and \$408 million and \$482 million in total liabilities, respectively. There are no consolidated assets that collateralize the joint venture's obligations. However, at September 30, 2010 and December 31, 2009, the joint venture had approximately \$65 million and \$128 million of cash, respectively, which mainly relate to advanced billings in connection with the joint venture's obligations under the EPC contract.

Pearl GTL Project. In July 2006, we were awarded, through a 50%-owned joint venture, a contract with Qatar Shell GTL Limited to provide project management and cost-reimbursable engineering, procurement and construction management services for the Pearl GTL project in Ras Laffan, Qatar. The project, which is expected to be completed by 2011, consists of gas production facilities and a GTL plant. The joint venture is considered a VIE. We consolidate the joint venture for financial reporting purposes because we are the primary beneficiary. As of September 30, 2010, the Pearl joint venture had total assets of \$172 million and total liabilities of \$162 million. As of December 31, 2009, the Pearl joint venture had total assets of \$157 million and total liabilities of \$138 million.

Gorgon LNG Project. We have a 30% ownership in an Australian joint venture which was awarded a contract by Chevron for cost-reimbursable FEED and EPCM services to construct a LNG plant. The joint venture is considered a VIE, and, as a result of our being the primary beneficiary, we consolidate this joint venture for financial reporting purposes. As of September 30, 2010, the joint venture had both total assets and liabilities of \$239 million. As of December 31, 2009, the joint venture had total assets and total liabilities of \$109 million.

[Table of Contents](#)

Note 12. Retirement Plans

The components of net periodic benefit cost related to pension benefits for the three and nine months ended September 30, 2010 and 2009 were as follows:

<i>Millions of dollars</i>	Three Months Ended September 30,			
	2010		2009	
	United States	International	United States	International
Components of net periodic benefit cost:				
Interest cost	\$ 1	\$ 22	\$ 1	\$ 20
Expected return on plan assets	(1)	(24)	—	(23)
Recognized actuarial loss	—	5	—	2
Net periodic benefit cost	<u>\$—</u>	<u>\$ 3</u>	<u>\$ 1</u>	<u>\$ (1)</u>

<i>Millions of dollars</i>	Nine Months Ended September 30,			
	2010		2009	
	United States	International	United States	International
Components of net periodic benefit cost:				
Service cost	\$—	\$ 1	\$—	\$ 2
Interest cost	3	66	3	57
Expected return on plan assets	(3)	(70)	(2)	(63)
Recognized actuarial loss	1	14	1	8
Curtailment	—	—	—	(4)
Net periodic benefit cost	<u>\$ 1</u>	<u>\$ 11</u>	<u>\$ 2</u>	<u>\$ —</u>

For the nine months ended September 30, 2010, we contributed approximately \$11 million of the \$15 million we currently expect to contribute in 2010 to our international plans, and \$5 million of the \$6 million we currently expect to contribute to our domestic plans in 2010. During the second quarter of 2010, we agreed with the trustees of one of our international plans to contribute £34 million over a 10-year period beginning in 2010 at an annual rate of approximately £5.5 million during the first three years and £2.5 million thereafter.

In March 2009, we amended the terms and conditions of one of our international pension plans and ceased future service and benefit accruals for all plan participants. This action meets the definition of a curtailment under FASB ASC 715 - Compensation - Retirement Benefits, and resulted in a curtailment gain of approximately \$4 million during the first quarter of 2009.

The components of net periodic benefit cost related to other postretirement benefits were immaterial for the three and nine months ended September 30, 2010 and 2009.

Note 13. Acquisitions

On April 5, 2010, we acquired 100% of the outstanding common stock of Houston-based Energo Engineering (“Energo”) for approximately \$16 million in cash, subject to an escrowed holdback amount of \$6 million to secure working capital adjustments, indemnification obligations of the sellers, and other contingent obligations related to the operation of the business. As a result of the acquisition, we recognized goodwill of \$6 million and other intangible assets of \$3 million. Energo provides Integrity Management (IM) and advanced structural engineering services to the offshore oil and gas industry. Energo will be integrated into our Hydrocarbons segment, which will enable that business to expand its capabilities worldwide as well as support FEED and detailed design projects.

Note 14. Transactions with Former Parent and Other Related Party Transactions

Our balance payable to Halliburton of \$49 million at September 30, 2010 and \$53 million at December 31, 2009, was comprised of amounts owed to Halliburton primarily for estimated outstanding income taxes under the tax sharing agreement. Until we are able to resolve certain outstanding matters with Halliburton, the ultimate amount of payment is subject to change.

We perform many of our projects through incorporated and unincorporated joint ventures. In addition to participating as a joint venture partner, we often provide engineering, procurement, construction, operations or maintenance services to the joint venture as a subcontractor. Where we provide services to a joint venture that we control and therefore consolidate for financial reporting purposes, we eliminate intercompany revenues and expenses on such transactions. In situations where we account for our interest in the joint venture under the equity method of accounting, we do not eliminate any portion of our revenues or expenses. We recognize the profit on our services provided to joint ventures that we consolidate and joint ventures that we record under the equity method of accounting primarily using the percentage-of-completion method. Total revenues from services provided to our unconsolidated joint ventures recorded in our consolidated statements of income were \$30 million and \$46 million for the three months ended September 30, 2010 and 2009, respectively and revenues of \$107 million and \$126 million for the nine months ended September 30, 2010 and 2009, respectively. Income or loss from services provided to our unconsolidated joint ventures was income of \$4 million and income of \$3 million for the three months ended September 30, 2010 and 2009, respectively and income of \$11 million and loss of \$4 million for the nine months ended September 30, 2010, and 2009, respectively.

Note 15. Recent Accounting Pronouncements

In October 2009, the FASB issued Accounting Standards Update (“ASU”) 2009-13, Revenue Recognition (Topic 605) – Multiple-Deliverable Revenue Arrangements. ASU 2009-13 addresses the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. Specifically, this guidance amends the criteria in Subtopic 605-25, Revenue Recognition-Multiple-Element Arrangements, for separating consideration in multiple-deliverable arrangements. This guidance establishes a selling price hierarchy for determining the selling price of a deliverable, which is based on: (a) vendor-specific objective evidence; (b) third-party evidence; or (c) estimates. This guidance also eliminates the residual method of allocation and requires that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. In addition, this guidance significantly expands required disclosures related to a vendor’s multiple-deliverable revenue arrangements. ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We are evaluating the impact that the adoption of ASU 2009-13 will have on our financial position, results of operations, cash flows and disclosures.

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements. This ASU requires some new disclosures and clarifies some existing disclosure requirements about fair value measurement as set forth in Codification Subtopic 820-10. The FASB’s objective is to improve these disclosures and, thus, increase the transparency in financial reporting. Specifically, ASU 2010-06 amends Codification Subtopic 820-10 to now require:

- A reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; and
- In the reconciliation for fair value measurements using significant unobservable inputs, a reporting entity should present separately information about purchases, sales, issuances, and settlements.

In addition, ASU 2010-06 clarifies the requirements of the following existing disclosures:

- For purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and
- A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements.

The ASU is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Early application is permitted. The adoption of this accounting standard update did not have a material impact on our financial position, results of operations, cash flows and disclosures.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The purpose of management’s discussion and analysis (“MD&A”) is to increase the understanding of the reasons for material changes in our financial condition since the most recent fiscal year-end and results of operations during the current fiscal period as compared to the corresponding period of the preceding fiscal year. The MD&A should be read in conjunction with the condensed consolidated financial statements and accompanying notes and our 2009 Annual Report on Form 10-K.

Business Environment and Results of Operations

Business Reorganization

During the first quarter of 2010, we reorganized our business into discrete engineering and construction business units, each focused on a specific segment of the market with identifiable customers, business strategies, and sales and marketing capabilities. The reorganization includes the realignment of certain underlying projects among our existing business units as well as the transfer of certain projects to several newly formed business units. Certain realigned business units are reported under the newly formed Infrastructure, Government & Power (“IGP”) and Hydrocarbons business groups. Each business group is led by a business group president who reports directly to our chief operating decision maker. Our Services and Ventures business units will continue to operate as stand-alone business units reporting directly to our chief operating decision maker.

Business Environment

Hydrocarbon Markets

We provide a full range of engineering, procurement and construction services for large and complex upstream and downstream projects, including LNG and GTL facilities, onshore and offshore oil and gas production facilities, industrial and other projects. We serve customers in the gas monetization, oil and gas, petrochemical, refining and chemical markets throughout the world. Our projects are generally long term in nature and are impacted by factors including market conditions, financing arrangements, governmental approvals and environmental matters. Demand for our services depends primarily on our customers’ capital expenditures in our construction market sectors.

We have benefited in recent years from increased capital expenditures from our petroleum and petrochemical customers driven by historically high crude oil and natural gas prices and general global economic expansion that occurred prior to mid-2008. We have indications that the hydrocarbons market in most international regions has partially recovered from the worldwide economic recession and financial market condition. We continue to see long term growth in environmentally and economically driven energy projects and for related licensed process technologies for offshore gas productions, LNG, biofuels, motor fuels, chemicals and fertilizers. Feasibility studies and front-end engineering and design projects remain steady reflecting clients’ intentions to invest in capital intensive energy projects, albeit releasing and proceeding with projects in phases and conducting increased levels of economic analysis. Specifically relating to construction and maintenance in the United States, we continue to see projects proceeding predominately with smaller brownfield and maintenance projects driven by environmental regulation, clean fuels, biofuels, aging facilities, process technology enhancements and efficiency upgrades. The timing of new Gulf of Mexico offshore gas production projects has slowed due to the six-month Federal government drilling moratorium.

Infrastructure, Government and Power Markets (“IGP”)

A significant portion of our IGP business group’s current activities supports the United States’ and the United Kingdoms’ government operations in Iraq, Afghanistan and in other parts of the Middle East region. These operations have resulted in one of the largest military deployments since World War II, which has caused a parallel increase in government spending. The logistics support services that KBR provides the U.S. military are delivered under our LogCAP III and LogCAP IV contracts, which are competitively bid contracts. KBR is the only company providing services under the LogCAP III contract. Currently, the U.S. government is transitioning work from LogCAP III to LogCAP IV, which is a multiple award contract with three contractors, including KBR, who can each bid and potentially win specific task orders. As troop deployments shift within the Middle East region, and as

[Table of Contents](#)

additional work is awarded under LogCAP IV, we have seen a decline in work under LogCAP III and we expect this decline will continue. We expect the U.K. military will remain engaged in the region, although their presence has shifted from Iraq to Afghanistan.

We operate in diverse civil infrastructure markets, including transportation, waste and water treatment and facilities maintenance. In addition to U.S. state, local and federal agencies, we provide these services to governments around the world including the U.K., Australia and the Middle East. In Australia, we also provide related services to the global mining industry. There has been a general trend of historic under-investment in infrastructure, particularly related to the quality of water, wastewater, roads and transit, airports, and educational facilities which has historically declined while demand for expanded and improved infrastructure has historically outpaced funding. We have seen increased activity related to these types of projects, however, the global economic recession has caused a slow down in some projects. Stimulus spending and a general economic recovery should result in increased opportunities in the future across all sectors.

In the industrial sector, we operate in a number of markets, including forest products, minerals and metals and consumer products, with a heavy domestic focus, but with our international opportunities increasing. Forest products and consumer products are seeing some market improvements with minerals and metals markets sensitive to potential stimulus spending. In the power sector, we serve both utility and independent power producers, also with a heavy domestic focus. This market continues to be driven by air quality related projects and new generation projects.

We provide a wide range of construction and maintenance services to a variety of industries in the U.S. and Canada, including forest products, power, commercial buildings, general industrial and manufacturing. Similar to the hydrocarbon markets, we see projects moving forward that are focused on meeting statutory requirements and efficiency improvements rather than capacity expansion. Despite the volatility in economic conditions throughout 2009, we continued to see an increase in prequalification requests from our clients and expect a number of our markets to strengthen in 2010 and 2011.

For a more detailed discussion of the results of operations for each of our business groups and business units, corporate general and administrative expense, income taxes and other items, see “Results of Operations” below.

Results of Operations

We analyze the financial results for each of our business groups and business units. The business groups presented are consistent with our reportable operating segments discussed in Note 4 (Business Segment Information) to our condensed consolidated financial statements. While certain of the business groups and business units presented below do not meet the criteria for reportable segments in accordance with FASB ASC 280 – Segment Reporting, we believe this supplemental information is relevant and meaningful to our investors for various reasons including monitoring our progress and growth in certain markets and product lines.

[Table of Contents](#)

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

Three months ended September 30, 2010 compared to three months ended September 30, 2009

Revenue by Business Unit

<i>Millions of dollars</i>	Three Months Ended September 30,			
	2010	2009	Increase (Decrease)	Percentage Change
Revenue: (1)				
Hydrocarbons:				
Gas Monetization	\$ 698	\$ 641	\$ 57	9%
Oil & Gas	107	95	12	13%
Downstream	139	121	18	15%
Technology	30	27	3	11%
Total Hydrocarbons business group revenue	<u>974</u>	<u>884</u>	<u>90</u>	<u>10%</u>
Infrastructure, Government and Power (“IGP”):				
North America Government and Defense	753	1,193	(440)	(37)%
International Government and Defense	87	71	16	23%
Infrastructure and Minerals	64	86	(22)	(26)%
Power and Industrial	79	129	(50)	(39)%
Total IGP business group revenue	<u>983</u>	<u>1,479</u>	<u>(496)</u>	<u>(34)%</u>
Services	480	464	16	3%
Ventures	13	5	8	160%
Other	5	8	(3)	(38)%
Total revenue	<u>\$2,455</u>	<u>\$ 2,840</u>	<u>\$ (385)</u>	<u>(14)%</u>

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

[Table of Contents](#)

Income (loss) by Business Unit

<i>Millions of dollars</i>	Three Months Ended September 30.			
	2010	2009	Increase (Decrease)	Percentage Change
Business Unit Income (loss):				
Hydrocarbons:				
Gas Monetization	\$ 59	\$ 40	\$ 19	48%
Oil & Gas	24	20	4	20%
Downstream	23	16	7	44%
Technology	14	14	—	—
Total job income	120	90	30	33%
Divisional overhead	(27)	(25)	(2)	(8)%
Total Hydrocarbons business group income	93	65	28	43%
Infrastructure, Government and Power (“IGP”):				
North America Government and Defense	73	82	(9)	(11)%
International Government and Defense	22	17	5	29%
Infrastructure and Minerals	14	24	(10)	(42)%
Power and Industrial	6	22	(16)	(73)%
Total job income	115	145	(30)	(21)%
Divisional overhead	(32)	(41)	9	22%
Total IGP business group income	83	104	(21)	(20)%
Services:				
Job income	45	39	6	15%
Divisional overhead	(19)	(18)	(1)	(6)%
Total Services business unit income	26	21	5	24%
Ventures:				
Job income	7	5	2	40%
Divisional overhead	(1)	(1)	—	—
Total Ventures business unit income	6	4	2	50%
Other:				
Job income	6	2	4	200%
Impairment of goodwill	—	(6)	6	100%
Divisional overhead	(1)	(1)	—	—
Total Other business unit income (loss)	5	(5)	10	200%
Total business unit income	\$ 213	\$ 189	\$ 24	13%
Unallocated amounts:				
Loss on disposition of assets - corporate	(1)	(1)	—	—
Labor costs absorption (1)	4	(3)	7	233%
Corporate general and administrative	(53)	(54)	1	2%
Total operating income	\$ 163	\$ 131	\$ 32	24%

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

Hydrocarbons Business Group

Gas Monetization. Revenues in the third quarter of 2010 in our Gas Monetization Operations increased by \$57 million primarily due to increased activity from the Gorgon LNG, Escravos GTL and several other LNG projects. Revenue from these projects increased \$151 million in the aggregate in the third quarter of 2010 primarily as a result of the transition from the FEED to the EPCM portion of the Gorgon project and extended estimated completion date on the Escravos GTL project. Partially offsetting these increases in revenues was a decline in revenues of approximately \$94 million due to lower procurement and subcontractor activity on the Skikda LNG project and the lower progress on the Pearl GTL project.

Gas Monetization job income increased approximately \$19 million in the third quarter of 2010 compared to the same period of the prior year. Job income increased \$22 million as a result of the increased work on the EPCM portion of the Gorgon LNG project. Additionally, job income increased due to the absence of a charge of \$30 million recognized in the third quarter of 2009 from two other nearly completed LNG projects resulting from schedule delays, subcontractor claims and equipment failures. These increases were partially offset by decreases in job income of approximately \$24 million in the aggregate on the Escravos and Pearl GTL projects primarily due to overall lower progress. Additionally, primarily due to actions and inactions on the part of the customer, we identified increases in the estimated cost to complete an LNG project due to a schedule delay which resulted in a non-cash charge of approximately \$42 million to job income in the third quarter. We are evaluating our legal entitlement under the contract with our customer and will vigorously pursue all other available remedies which may reduce our exposure to the estimated project cost increases in future periods.

During the third quarter, we negotiated a final settlement agreement with one of our commercial agents who provided services to various Gas Monetization projects which resulted in a non-cash increase to Gas Monetization job income of approximately \$42 million. Prior to the settlement, the agent was reviewed and approved under our policies on business conduct.

Oil & Gas. Revenues from our Oil & Gas Operations increased by approximately \$12 million and job income increased by \$4 million in the third quarter of 2010 as compared to the third quarter of 2009. These increases in revenue and job income were primarily related to new projects and higher progress on existing projects including the CLOV, Jack St. Malo, COP Define and other projects. Partially offsetting these increases in revenues and job income were decreases due to the completion of several technical service projects as well as the EOS North Rankin project in Australia which is nearing completion.

Downstream. Downstream revenue in the third quarter of 2010 increased by \$18 million primarily due to increases on the Sonangol refining job in Africa and petrochemical projects in the Middle East including Shaybah and Yanbu, which increased approximately \$49 million in the aggregate as a result of increased activity over the prior year. These increases in revenues were partially offset by lower revenues on the Saudi Kayan project and other projects as they near completion. Downstream job income in the third quarter of 2010 increased by approximately \$7 million as compared to the same period of the prior year. The increase was primarily driven by increased activity on the Sonangol and several projects in the Middle East including the Shaybah and Yanbu projects which contributed \$11 million to job income in the aggregate, partially offset by lower job income related to projects that were either completed or nearing completion in the third quarter of 2010.

Technology. Technology revenues in the third quarter of 2010 increased \$3 million, primarily due to the progress achieved on a number of new projects including a grassroots ammonia and urea project in Brazil and Turkmenistan, two ammonia projects in India and a petrochemical plant in China. These increases were partially offset by the completion of engineering services on several ammonia projects located in Venezuela, Trinidad and India.

Infrastructure, Government and Power (“IGP”) Business Group

North America Government and Defense (“NAGD”). Revenue from our NAGD Operations decreased approximately \$440 million in the third quarter of 2010 over the same period in the prior year. The decrease in NAGD revenue includes a \$523 million decline resulting from an overall reduction in volume for U.S. military support activities primarily in Iraq under our LogCAP III contract. The lower volume is primarily due to the continued reductions in staff and personnel on the project as military bases have closed and combat troop levels declined. We expect to continue providing services on certain task orders through 2011. Although the decreases in revenue on the LogCAP III project have been partially offset by an increase in revenue of \$98 million on a task order under the LogCAP IV contract, we expect our overall volume of work to continue to decrease in Iraq throughout the remainder of 2010.

Job income from our NAGD Operations decreased by approximately \$9 million primarily as a result of the overall reduction in volume of U.S. military support activities primarily in Iraq partially offset by an increase in award fees recognized as compared to the same period of the prior year. The overall reduction in volume on the LogCAP III contract resulted in a decrease to job income of \$20 million. Additionally, job income decreased due to the absence of a gain of \$17 million in the third quarter of 2009 when we determined the costs incurred in previous periods related to the litigation with one our LogCAP III subcontractors was billable to our customer. These decreases were partially offset by award fees on the LogCAP III project in the third quarter of 2010 of approximately \$19 million higher as compared to the same period of the prior year as well as increases to job income from activities on the LogCAP IV contract which started in early 2010.

International Government and Defense (“IGD”). Revenue from our IGD Operations increased approximately \$16 million and job income increased \$5 million in the third quarter of 2010 compared the same period in the prior year. The increase in revenue was primarily related to the ongoing presence of troops in Afghanistan where we provide contingency logistics, operations and maintenance and other services to the U.K. MoD and NATO under the TDA and NAMS projects. Job income in the third quarter of 2010 increased due to contingency releases related to warranty expirations on the Tier 3 Basra project which was completed in 2009 as well as higher construction margins on the Allenby & Connaught project.

Infrastructure and Minerals (“I&M”). Revenue from our I&M Operations decreased approximately \$22 million in the third quarter of 2010 over the same period in the prior year due to lower overall activity on several projects including Southern Regional Water Pipeline and Hope Downs South Minerals projects in Australia, the Scottish Water project in the U.K. and the Yas Island Development project in Abu Dhabi. The projects have either been completed prior to the first quarter of 2010 or scaled down as a result of the global economic conditions. Additionally, new project awards have been either delayed or canceled further contributing to the decrease. Job income from our I&M Operations decreased in the third quarter of 2010 by approximately \$10 million primarily as a result of the overall decrease in project activity and new project awards.

Power and Industrial (“P&I”). Revenue from our P&I Operations decreased approximately \$50 million in the third quarter of 2010 over the same period in the prior year largely as a result of the completion of fieldwork on the Georgia Power plant and Procter & Gamble projects in early 2010 and lower progress on the Red River project in Louisiana as the project is substantially complete. These decreases were partially offset by increased volume on a new waste-to-energy project in Florida and new work for other projects. Job income from our P&I Operations decreased by \$16 million in the third quarter of 2010 primarily as a result of completion of the Georgia Power plant and Procter & Gamble projects, lower profits on the Red River project that is nearing completion, as well as the absence of a gain in the third quarter of 2009 from final collection of a fully-reserved project receivable.

Services

Services revenue in the third quarter of 2010 increased by \$16 million as compared to the third quarter of 2009. Revenue from our Industrial Services group increased \$31 million primarily as a result of increased construction maintenance and services under a new multi-site contract for DuPont throughout the Eastern and Gulf Coast regions of the U.S., the Atlanta Public Schools project, as well as the increased levels of turnaround work based in Canada. Additionally, revenues in our Building Group increased \$20 million primarily driven by the recent awards of significant hospital projects. Partially offsetting these increases in revenues were decreases of approximately \$32 million in our Canadian operations largely attributable to the completion of the Shell Scotford Upgrader project.

[Table of Contents](#)

Job income increased by approximately \$6 million in the third quarter of 2010 over the third quarter of 2009. The increase in job income resulted from the increased activity on the multi-site DuPont project, the Atlanta Public Schools and the Hunt Refining projects as well as favorable change orders on the Progress Energy Power contract. These increases were partially offset by the lower profits on projects in our Canadian and US Construction operations that are nearing completion.

Ventures

Ventures revenue was \$13 million and job income was \$7 million in the third quarter of 2010 as compared to both revenue and job income of \$5 million in the third quarter of 2009. The increase in revenue is primarily attributable to the consolidation of Fasttrax Limited, in the first quarter of 2010 which is the primary contracting entity with the MoD in a project that owns and operates heavy equipment transport vehicles for the U.K. military. This variable interest entity, in which we have a 50% ownership interest, was previously accounted for using the equity method of accounting. Ventures job income increased during the third quarter of 2010 primarily due to the consolidation of Fasttrax Ltd. as well as improved performance of the EBIC ammonia plant project which became operational in 2009. The EBIC ammonia plant performance benefitted from increased sales volume and higher ammonia prices than in the same quarter of the prior year.

Unallocated amounts

Labor cost absorption. Labor cost absorption income was \$4 million in the third quarter of 2010 and labor cost absorption expense was \$3 million in the third quarter of 2009. Labor cost absorption represents costs incurred by our central labor and resource groups (above) or under the amounts charged to the operating business units. Labor cost absorption income increased in the third quarter of 2010 primarily due to higher chargeability and utilization in several of our engineering offices as well as higher incentive compensation which was partially offset by lower headcount. Partially offsetting these increases were lower costs due to closure of one of our offices in Lagos as well as lower costs under our 2009 incentive compensation plan.

Services Business Unit Revenues by Market Sector

The Services business segment provides construction and maintenance services to clients in a number of markets that are also served by our other business units. Customer focus, attention to highly productive delivery, and a diverse market presence we believe are keys to our success in delivering construction and maintenance services. Accordingly, the Services business segment focuses on these key success factors. The analysis shown below is supplementally provided to present the revenues managed by the Services business segment based on the markets served by the Services business segment. The perspective highlights the markets served by our Services segment.

	Three Months Ended September 30, 2010		
	Business Unit Revenue	Services Market Sectors	Total Revenue by Market Sectors
Hydrocarbons business group:			
Gas Monetization	\$ 698	\$ —	\$ 698
Oil & Gas	107	69	176
Downstream	139	142	281
Technology	30	—	30
Total Hydrocarbons business group revenue	<u>974</u>	<u>211</u>	<u>1,185</u>
Infrastructure, Government and Power (“IGP”):			
North America Government and Defense	753	38	791
International Government and Defense	87	—	87
Infrastructure and Minerals	64	—	64
Power and Industrial	79	231	310
Total IGP business group revenue	<u>983</u>	<u>269</u>	<u>1,252</u>
Services	480	(480)	—
Other	18	—	18
Total KBR Revenue	<u>\$ 2,455</u>	<u>\$ —</u>	<u>\$ 2,455</u>

	Three Months Ended September 30, 2009		
	Business Unit Revenue	Services Market Sectors	Total Revenue by Market Sectors
Hydrocarbons business group:			
Gas Monetization	\$ 641	\$ —	\$ 641
Oil & Gas	95	104	199
Downstream	121	129	250
Technology	27	—	27
Total Hydrocarbons business group revenue	<u>884</u>	<u>233</u>	<u>1,117</u>
Infrastructure, Government and Power (“IGP”):			
North America Government and Defense	1,193	24	1,217
International Government and Defense	71	—	71
Infrastructure and Minerals	86	—	86
Power and Industrial	129	207	336
Total IGP business group revenue	<u>1,479</u>	<u>231</u>	<u>1,710</u>
Services	464	(464)	—
Other	13	—	13
Total KBR Revenue	<u>\$ 2,840</u>	<u>\$ —</u>	<u>\$ 2,840</u>

[Table of Contents](#)

Non-operating items

Net interest expense was \$3 million in the third quarter of 2010 and net interest income was zero in the third quarter of 2009. Interest expense increased in the third quarter of 2010 primarily as a result of increased commitment fees paid under the terms of our new credit facility, increased rates associated with outstanding performance-related and financial-related issued letters of credit, and fees paid to Halliburton for guarantees provided to us for various financial commitments. Additionally, interest expense recognized in the third quarter of 2010 on non-recourse project-finance debt was \$2 million higher due to the consolidation of Fastrax Limited effective January 1, 2010.

Provision for income taxes was \$43 million in the third quarter of 2010 and \$33 million in the third quarter of 2009. Our effective tax rate was approximately 27% for the three months ended September 30, 2010 and 25% for the three months ended September 30, 2009. Our effective tax rate for the three months ended September 30, 2010 was lower than our statutory rate of 35% primarily due to favorable rate differentials on foreign earnings, benefits associated with income from unincorporated joint ventures and several favorable discrete tax items including the true-up of prior year U.S. income taxes and utilization of additional U.S. foreign tax credits during the third quarter of 2010. Our effective tax rate in the third quarter of 2009 was lower than our statutory rate of 35% primarily due to the final determination of previously estimated 2008 domestic and foreign taxable income, made in connection with the preparation and filing of our 2008 consolidated tax returns as well as benefits associated with income on unincorporated joint ventures.

Nine months ended September 30, 2010 compared to nine months ended September 30, 2009

Revenue by Business Unit

<i>Millions of dollars</i>	Nine Months Ended September 30.			
	2010	2009	Increase (Decrease)	Percentage Change
Revenue: (1)				
Hydrocarbons:				
Gas Monetization	\$ 2,081	\$ 1,976	\$ 105	5%
Oil & Gas	295	297	(2)	(1)%
Downstream	429	358	71	20%
Technology	95	70	25	36%
Total Hydrocarbons business group revenue	<u>2,900</u>	<u>2,701</u>	<u>199</u>	<u>7%</u>
Infrastructure, Government and Power ("IGP"):				
North America Government and Defense	2,689	4,150	(1,461)	(35)%
International Government and Defense	284	208	76	37%
Infrastructure and Minerals	201	258	(57)	(22)%
Power and Industrial	280	344	(64)	(19)%
Total IGP business group revenue	<u>3,454</u>	<u>4,960</u>	<u>(1,506)</u>	<u>(30)%</u>
Services	1,347	1,437	(90)	(6)%
Ventures	41	16	25	156%
Other	15	27	(12)	(44)%
Total revenue	<u>\$ 7,757</u>	<u>\$ 9,141</u>	<u>\$ (1,384)</u>	<u>(15)%</u>

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

[Table of Contents](#)

Income (loss) by Business Unit

<i>Millions of dollars</i>	Nine Months Ended September 30,			
	2010	2009	Increase (Decrease)	Percentage Change
Business Unit Income (loss):				
Hydrocarbons:				
Gas Monetization	\$ 195	\$ 155	\$ 40	26%
Oil & Gas	53	64	(11)	(17)%
Downstream	73	42	31	74%
Technology	43	34	9	26%
Total job income	<u>364</u>	<u>295</u>	<u>69</u>	<u>23%</u>
Gain on disposition of assets	1	—	1	—
Divisional overhead	<u>(80)</u>	<u>(70)</u>	<u>(10)</u>	<u>(14)%</u>
Total Hydrocarbons business group income	<u>285</u>	<u>225</u>	<u>60</u>	<u>27%</u>
Infrastructure, Government and Power (“IGP”):				
North America Government and Defense	201	225	(24)	(11)%
International Government and Defense	62	52	10	19%
Infrastructure and Minerals	47	68	(21)	(31)%
Power and Industrial	<u>35</u>	<u>42</u>	<u>(7)</u>	<u>(17)%</u>
Total job income	345	387	(42)	(11)%
Divisional overhead	<u>(111)</u>	<u>(112)</u>	<u>1</u>	<u>1%</u>
Total IGP business group income	<u>234</u>	<u>275</u>	<u>(41)</u>	<u>(15)%</u>
Services:				
Job income	125	116	9	8%
Loss on disposition of assets	(1)	—	(1)	—
Divisional overhead	<u>(52)</u>	<u>(52)</u>	<u>—</u>	<u>—</u>
Total Services business unit income	<u>72</u>	<u>64</u>	<u>8</u>	<u>13%</u>
Ventures:				
Job income (loss)	24	15	9	60%
Gain on disposition of assets	—	2	(2)	(100)%
Divisional overhead	<u>(3)</u>	<u>(2)</u>	<u>(1)</u>	<u>(50)%</u>
Total Ventures business unit income	<u>21</u>	<u>15</u>	<u>6</u>	<u>40%</u>
Other:				
Job income	10	7	3	43%
Impairment of goodwill	—	(6)	6	100%
Divisional overhead	<u>(5)</u>	<u>(5)</u>	<u>—</u>	<u>—</u>
Total Other business unit income	<u>5</u>	<u>(4)</u>	<u>9</u>	<u>225%</u>
Total business unit income	\$ 617	\$ 575	\$ 42	7%
Unallocated amounts:				
Loss on disposition of assets - corporate	(3)	(1)	(2)	(200)%
Labor costs absorption (1)	4	(5)	9	180%
Corporate general and administrative	<u>(157)</u>	<u>(157)</u>	<u>—</u>	<u>—</u>
Total operating income	\$ 461	\$ 412	\$ 49	12%

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

Hydrocarbons Business Group

Gas Monetization. Revenues in the first nine months of 2010 in our Gas Monetization Operations increased by \$105 million primarily due to increased activity from the Gorgon LNG and another LNG project. Revenue from these projects increased \$306 million in the aggregate compared to the first nine months of 2009 primarily as a result of the transition from the FEED to the EPCM portion of the Gorgon project as well as change orders on another LNG project that is nearing completion. Partially offsetting these increases in revenues was a decline in revenues of approximately \$199 million due to lower procurement and subcontractor activity on the Skikda LNG projects and the lower progress on the Pearl GTL project.

Gas Monetization job income increased approximately \$40 million in the first nine months of 2010 compared to the same period of the prior year. Job income increased \$92 million in the aggregate as a result of change orders on an LNG project executed through a joint venture that is now completed and increased activity on the EPCM portion of the Gorgon LNG project. Additionally, job income increased due to the absence of a charge of \$15 million in the first nine months of 2009 on two LNG projects resulting from schedule delays, subcontractor claims and equipment failures. Partially offsetting the increases in job income were decreases of approximately \$54 million in the aggregate on the Escravos and Pearl GTL projects, and another LNG project due to overall lower progress or completion of project. Additionally, primarily due to actions and inactions on the part of the customer, we identified increases in the estimated cost to complete an LNG project due to a schedule delay which resulted in a non-cash charge of approximately \$42 million to job income in the third quarter. We are evaluating our legal entitlement under the contract with our customer and will vigorously pursue all other available remedies which may reduce our exposure to the estimated project cost increases in future periods.

During the third quarter, we negotiated a final settlement agreement with one of our commercial agents who provided services to various Gas Monetization projects which resulted in a non-cash increase to Gas Monetization job income of approximately \$42 million. Prior to the settlement, the agent was reviewed and approved under our policies on business conduct.

Oil & Gas. Revenue in our Oil & Gas Operations decreased by \$2 million and job income decreased by \$11 million in the first nine months of 2010 over the same quarter of the prior year. The decrease in revenue and job income is related to the completion of various technical services projects as well as the EOS North Rankin project in Australia which is nearing completion. These decreases in revenue were partially offset by new project awards and higher progress on existing projects including the COP Define, Bigfoot, Jack St. Malo and other projects. Job income was negatively impacted by increased legal fees and the unfavorable settlement of several issues related to various completed projects.

Downstream. Downstream revenue for the first nine months of 2010 increased by \$71 million primarily due to increases on the Sonangol refining job in Africa and petrochemical projects in the Middle East including the Ras Tanura, Shaybah and Yanbu projects which increased approximately \$159 million in the aggregate as a result of increased activity over the prior year. These increases in revenues were partially offset by lower revenues due to the Saudi Kayan project in the Middle East and several projects in the Americas that were either completed or were nearing completion.

Downstream job income in the first nine months of 2010 increased by approximately \$31 million as compared to the same period of the prior year. The increase was primarily driven by increased activity on the Sonangol and Ras Tanura projects which contributed \$32 million to the increase. Additionally, Downstream job income in the first nine months of 2009 included \$16 million in charges on our EBIC ammonia project due to

[Table of Contents](#)

additional costs related to the commissioning and start up of the plant which further contributed to the improvement in job income during the first nine months of 2010. Partially offsetting these increases in job income was a charge of approximately \$9 million related to an account receivable reserve adjustment recorded in the second quarter of 2010 as well as decreases on several Americas projects that were completed or nearing completion.

Technology. Technology revenues and job income in the first nine months of 2010 increased \$25 and \$9 million, respectively, primarily due to the progress achieved on a number of new projects including several grassroots ammonia and urea projects in Brazil and Turkmenistan, two ammonia equipment projects in India, petrochemical plants in Korea and China, and a refining project in Angola. These new projects contributed approximately \$51 million to the increase in Technology revenues and approximately \$30 million to the increase in Technology job income in the first nine months of 2010. Partially offsetting these increases were decreases in revenue and job income associated with the completion of engineering services on several ammonia projects located in Venezuela, Trinidad, and India, and other refining projects in Spain and Russia.

Infrastructure, Government and Power (“IGP”) Business Group

North America Government and Defense (“NAGD”). Revenue from our NAGD Operations decreased approximately \$1.5 billion in the third quarter of 2010 over the same period in the prior year. The decrease in NAGD revenue includes a \$1.5 billion decline resulting from an overall reduction in volume for U.S. military support activities primarily in Iraq under our LogCAP III contract. The lower volume is primarily due to the continued reductions in staff and personnel on the project as military bases have closed and combat troop levels declined. We expect to continue providing services on certain task orders through 2011. Although the decreases in revenue on the LogCAP III project have been partially offset by an increase in revenue of \$123 million on a task order under the LogCAP IV contract, we expect our overall volume of work to continue to decrease in Iraq throughout the remainder of 2010. Also contributing to the decrease in NAGD revenue is \$93 million less revenue as a result of lower volumes of work under the CENTCOM project.

Job income from our NAGD Operations decreased by approximately \$24 million primarily as a result of the overall reduction in volume of U.S. military support activities primarily in Iraq partially offset by a net increase in award fees recognized as compared to the same period of the prior year. The overall reduction in volume and higher charges for potentially unallowable costs on the LogCAP III contract resulted in a decrease to job income of \$48 million. Additionally, job income decreased due to the absence of a gain of \$17 million in the third quarter of 2009 when we determined the costs related to the litigation with the LogCAP III subcontractor was billable to our customer. These decreases were partially offset by award fees on the LogCAP III project of 2010 which were approximately \$41 million higher as compared to the same period of the prior year.

International Government and Defense (“IGD”). Revenue from our IGD Operations increased approximately \$76 million and job income increased approximately \$10 in the first nine months of 2010 compared the same period in the prior year. The increase in revenue was primarily related to the ongoing presence of troops in Afghanistan where we provide contingency logistics, operations and maintenance and other services to the U.K. MoD and NATO under the TDA, CONLOG and NAMSA projects. Job income in the first nine months of 2010 increased due to higher construction margins on the Allenby & Connaught project as well as higher volume of services for the TDA, CONLOG and other U.K. MoD projects. These increases were partially offset due to decreases in job income on the Tier 3 Basra project which was completed in 2009.

Infrastructure and Minerals (“I&M”). Revenue from our I&M Operations decreased approximately \$57 million in the first nine months of 2010 over the same period in the prior year due to lower overall activity on several projects including Southern Regional Water Pipeline and Hope Downs South Minerals projects in Australia, the Scottish Water project in the U.K. and the Yas Island Development project in Abu Dhabi. These projects have either been completed prior to the third quarter of 2010 or scaled down as a result of the global economic conditions. Additionally, new project awards have been either delayed or canceled, further contributing to the decrease. Job income from our I&M Operations decreased in the first nine months of 2010 by approximately \$21 million primarily as a result of the overall decrease in project activity and new project awards.

Power and Industrial (“P&I”). Revenue from our P&I Operations decreased approximately \$64 million and job income decreased \$7 million in the third quarter of 2010 over the same period in the prior year largely as a result of the completion of fieldwork on the Georgia Power plant and Procter & Gamble projects in early 2010 and lower progress on the Red River project in Louisiana as the project substantially complete. These decreases were partially offset by increased volume on a new waste-to-energy project in Florida and new work for other projects.

[Table of Contents](#)

Services

Services revenue in the first nine months of 2010 decreased by \$90 million as compared to the first nine months of 2009. Approximately \$130 million of the decrease occurred in our Building Group due to lower volume. Although the building group was awarded several new projects in 2009 including the Boeing 787 Assembly Facility, these projects did not significantly contribute to revenues in the first nine months of 2010 as they are executed through joint ventures that we do not control and are thus accounted for under the equity method of accounting. Partially offsetting these decreases in revenues were increases of approximately \$43 million in our Industrial Services primarily as a result of increased construction maintenance and services under a new multi-site contract for DuPont throughout the Eastern and Gulf Coast regions of the U.S., the Atlanta Public Schools project, as well as the increased levels of turnaround work based in Canada.

Job income increased by approximately \$9 million in the first nine months of 2010 compared to the first nine months of 2009. Increases in job income primarily result from the increased activity on the Shell AOSP and various U.S. Construction projects.

Ventures

Ventures revenue was \$41 million and job income was \$24 million in the first nine months of 2010 as compared to revenue of \$16 million and job income of \$15 million in the first nine months of 2009. The increase in revenue is primarily attributable to the consolidation of Fasttrax Limited, in the first quarter of 2010 which is the primary contracting entity with the MoD in a project that owns and operates heavy equipment transport vehicles for the U.K. military. This variable interest entity, in which we have a 50% ownership interest, was previously accounted for using the equity method of accounting. Ventures job income increased during the third quarter of 2010 primarily due to the consolidation of Fasttrax Ltd. as well as improved performance of the EBIC ammonia plant project which became operational in 2009. The EBIC ammonia plant performance benefitted from increased sales volume and higher ammonia prices than in the period of the prior year. These improvements were offset by reduced income from the UK road projects which benefitted from tax credits in 2009 resulting from a change in UK tax treatment.

Unallocated amounts

Labor cost absorption. Labor cost absorption income was \$4 million in the first nine months of 2010 and labor cost absorption expense was \$5 million in the first nine months of 2009. Labor cost absorption represents costs incurred by our central labor and resource groups (above) or under the amounts charged to the operating business units. Labor cost absorption expense decreased in the first nine months of 2010 primarily due to higher chargeability and utilization in several of our engineering offices as well as higher incentive compensation which was partially offset by lower headcount. Partially offsetting these increases were lower costs due to closure of one of our offices in Lagos as well as lower costs under our 2009 incentive compensation plan.

Services Business Unit Revenues by Market Sector

The Services business segment provides construction and maintenance services to clients in a number of markets that are also served by our other business units. Customer focus, attention to highly productive delivery, and a diverse market presence we believe are keys to our success in delivering construction and maintenance services. Accordingly, the Services business segment focuses on these key success factors. The analysis shown below is supplementally provided to present the revenues managed by the Services business segment based on the markets served by the Services business segment. The perspective highlights the markets served by our Services segment.

	<u>Nine Months Ended September 30, 2010</u>		
	<u>Business Unit Revenue</u>	<u>Services Market Sectors</u>	<u>Total Revenue by Market Sectors</u>
Hydrocarbons business group:			
Gas Monetization	\$ 2,081	\$ —	\$ 2,081
Oil & Gas	295	248	543
Downstream	429	428	857
Technology	95	—	95
Total Hydrocarbons business group revenue	<u>2,900</u>	<u>676</u>	<u>3,576</u>
Infrastructure, Government and Power (“IGP”):			
North America Government and Defense	2,689	71	2,760
International Government and Defense	284	—	284
Infrastructure and Minerals	201	—	201
Power and Industrial	280	600	880
Total IGP business group revenue	<u>3,454</u>	<u>671</u>	<u>4,125</u>
Services	1,347	(1,347)	—
Other	56	—	56
Total KBR Revenue	<u>\$ 7,757</u>	<u>\$ —</u>	<u>\$ 7,757</u>

	<u>Nine Months Ended September 30, 2009</u>		
	<u>Business Unit Revenue</u>	<u>Services Market Sectors</u>	<u>Total Revenue by Market Sectors</u>
Hydrocarbons business group:			
Gas Monetization	\$ 1,976	\$ —	\$ 1,976
Oil & Gas	297	224	521
Downstream	358	413	771
Technology	70	—	70
Total Hydrocarbons business group revenue	<u>2,701</u>	<u>637</u>	<u>3,338</u>
Infrastructure, Government and Power (“IGP”):			
North America Government and Defense	4,150	51	4,201
International Government and Defense	208	—	208
Infrastructure and Minerals	258	—	258
Power and Industrial	344	749	1,093
Total IGP business group revenue	<u>4,960</u>	<u>800</u>	<u>5,760</u>
Services	1,437	(1,437)	—
Other	43	—	43
Total KBR Revenue	<u>\$ 9,141</u>	<u>\$ —</u>	<u>\$ 9,141</u>

[Table of Contents](#)

Non-operating items

Net interest expense was \$12 million in the first nine months of 2010 and net interest income was \$1 million in the first nine months of 2009. Interest expense increased in the first nine months of 2010 primarily as a result of increased commitment fees paid under the terms of our new credit facility, increased rates associated with outstanding performance-related and financial-related issued letters of credit, and fees paid to Halliburton for guarantees provided to us for various financial commitments. Additionally, interest expense recognized in the second and third quarter of 2010 on non-recourse project-finance debt was \$5 million higher as a result of the consolidation of Fasttrax Limited effective January 1, 2010.

Provision for income taxes was \$146 million in the first nine months of 2010 and \$137 million in the first nine months of 2009. Our effective tax rate was approximately 33% for the nine months ended September 30, 2010 and 2009. Our effective tax rate in the first nine months of 2010 was lower than our statutory rate of 35% primarily due to favorable rate differentials on foreign earnings and benefits associated with income from unincorporated joint ventures. Our effective tax rate for the nine months ended September 30, 2009 was lower than our statutory rate of 35% primarily due to the final determination of previously estimated 2008 domestic and foreign taxable income, made in connection with the preparation and filing of our 2008 consolidated tax returns as well as benefits associated with income on unincorporated joint ventures.

Backlog

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

For our projects related to unconsolidated joint ventures, we have included in the table below our percentage ownership of the joint venture's revenue in backlog. However, because these projects are accounted for under the equity method, only our share of future earnings from these projects will be recorded in our revenue. Our backlog for projects related to unconsolidated joint ventures totaled \$1.9 billion at September 30, 2010 and \$2.1 billion at December 31, 2009. We also consolidate joint ventures which are majority-owned and controlled or are variable interest entities in which we are the primary beneficiary. Our backlog included in the table below for projects related to consolidated joint ventures with noncontrolling interests includes 100% of the backlog associated with those joint ventures and totaled \$4.3 billion at September 30, 2010 and \$4.6 billion at December 31, 2009.

Backlog⁽¹⁾
(in millions)

	September 30, 2010	December 31, 2009
Hydrocarbons:		
Gas Monetization	\$ 5,858	\$ 6,976
Oil & Gas	246	109
Downstream	470	535
Technology	185	154
Total Hydrocarbons backlog	<u>6,759</u>	<u>7,774</u>
Infrastructure, Government and Power (“IGP”):		
North America Government and Defense	1,115	1,341
International Government and Defense	1,229	1,427
Infrastructure and Minerals	139	167
Power and Industrial	215	338
Total IGP backlog	<u>2,698</u>	<u>3,273</u>
Services	2,051	2,302
Ventures	820	749
Total backlog for continuing operations	<u>\$ 12,328</u>	<u>\$ 14,098</u>

(1) All backlog is attributable to firm orders as of September 30, 2010 and December 31, 2009. Backlog attributable to unfunded government orders was \$136 million at September 30, 2010 and \$326 million as of December 31, 2009.

We estimate that as of September 30, 2010, 53% of our backlog will be complete within one year. As of September 30, 2010, approximately 21% of our backlog was attributable to fixed-price contracts and 79% was attributable to cost-reimbursable contracts. For contracts that contain both fixed-price and cost-reimbursable components, we classify the components as either fixed-price or cost-reimbursable according to the composition of the contract except for smaller contracts where we characterize the entire contract based on the predominant component.

Hydrocarbons business group backlog declined approximately \$1.0 billion primarily because of a decline in Gas Monetization business unit backlog of approximately \$1.1 billion due to work performed on the Gorgon LNG, Skikda LNG, Escravos GTL, Pearl GTL and other projects and with no new significant awards in the first nine months of 2010. Also contributing to the decline in Hydrocarbons business group backlog was a decline in the Downstream business unit backlog primarily related to work performed on our Ras Tanura, Sonangol, Yanbu and Saudi Kayan projects. These declines were partially offset by new awards of \$258 million in our Oil & Gas and Technology business.

Backlog in our IGP business group decreased by \$575 million primarily as a result of work performed on existing projects of approximately \$707 million which were partially offset by new awards of \$283 million primarily in our International and North America Government and Defense operations. Work performed in our North America Government and Defense operations was approximately \$401 million in the first nine months of 2010, primarily related to our LogCAP III and IV, DOCCC, Alaska JOC and other support projects partially offset by new awards of \$100 million on our LogCAP IV project. In our International Government and Defense operations work performed totaled \$307 million primarily related to the Allenby and Connaught project, Conlog Afghanistan ISP and TDA, which was partially offset by new awards in 2010, primarily from the U.K. MoD.

Backlog in Services declined \$251 million primarily due to work performed of approximately \$708 on various construction projects in the U.S. and Canada. These declines were partially offset by new awards of approximately \$457 million which include major awards in our Building Group product line and in our Industrial Services product line.

Liquidity and Capital Resources

Cash and equivalents totaled \$1.2 billion at September 30, 2010 and \$941 million at December 31, 2009, which included \$253 million and \$236 million, respectively, of cash held by our joint ventures that we consolidate for accounting purposes. Joint venture cash balances are limited to joint venture activities and are not available for use on other projects, general cash needs or distributions to us without approval of the board of directors of the respective joint ventures and we expect to use the cash to pay project costs.

As of September 30, 2010, we had restricted cash of \$21 million related to the amounts held in deposit with certain banks to collateralize standby letters of credit, of which \$11 million is included in "Other current assets" and \$10 million is included in "Other assets" in the accompanying condensed consolidated financial statements.

Revolving Credit Facility

On November 3, 2009, we entered into a new syndicated, unsecured \$1.1 billion three-year revolving credit agreement (the "Revolving Credit Facility"), with Citibank, N.A., as agent, and a group of banks and institutional lenders replacing the Prior Revolving Credit Facility, which was terminated at the same time as the closing of the Revolving Credit Facility. The Revolving Credit Facility may be used for working capital and letters of credit for general corporate purposes, which expires in November 2012. While there is no sublimit for letters of credit under this facility, letters of credit fronting commitments that totaled \$830 million at December 31, 2009 have been expanded to \$880 million in January 2010. Amounts drawn under the Revolving Credit Facility will bear interest at variable rates based either on the London interbank offered rate plus 3%, or a base rate plus 2%, with the base rate being equal to the highest of reference bank's publicly announced base rate, the Federal Funds Rate plus 0.5%, or the London interbank offered rate plus 1%. Fees on letters of credit issued under the Revolving Credit Facility are 1.5% for performance and commercial letters of credit and 3% for all others. We are also charged an issuance fee of 0.05% for the issuance of a letter of credit, a per annum commitment fee of 0.625% for any unused portion of the Revolving Credit Facility, and a per annum fronting commitment fee of 0.25%. As of September 30, 2010, there were no borrowings and \$308 million in letters of credit issued and outstanding under the Revolving Credit Facility.

The Revolving Credit Facility includes financial covenants requiring maintenance of a ratio of consolidated debt to consolidated EBITDA of less than 3.5 to 1 and a minimum consolidated net worth of \$2 billion plus 50% of consolidated net income for each quarter ending after September 30, 2009 plus 100% of any increase in shareholders equity attributable to the sale of equity securities. At September 30, 2010, we were in compliance with these ratios and other covenants mentioned above.

The Revolving Credit Facility also contains a number of covenants restricting, among other things, our ability to incur additional liens and sales of our assets, as well as limiting the amount of investments we can make. The Revolving Credit Facility also permits us, among other things, to declare and pay shareholder dividends and/or engage in equity repurchases not to exceed \$400 million in the aggregate during the term of the facility and to incur indebtedness in respect of purchase money obligations, capitalized leases and refinancing or renewals secured by liens upon or in property acquired, constructed or improved in an aggregate principal amount not to exceed \$200 million. At September 30, 2010, the remaining limit of the above mentioned covenant that we can use to re-acquire KBR common stock or to pay dividends is approximately \$159 million. Our subsidiaries may incur unsecured indebtedness not to exceed \$100 million in aggregate outstanding principal amount at any time.

Nonrecourse Project Finance Debt

In 2001, Fasttrax Limited, a joint venture in which we indirectly own a 50% equity interest with an unrelated partner, was awarded a contract with the U.K. MoD to provide a fleet of 92 heavy equipment transporters ("HETs") to the British Army. Under the terms of the arrangement, Fasttrax Limited operates and maintains the HET fleet for a term of 22 years. The purchase of the HETs by the joint venture was financed through a series bonds secured by the assets of Fasttrax Limited totaling approximately £84.9 million and are non-recourse to KBR and its partner of which £12.2 million provided equity bridge financing. The bridge financing was replaced in 2005 with combined equity capital contributions and subordinated loans from the joint venture partners. The bonds are guaranteed by Ambac Assurance UK Ltd under a policy that guarantees the schedule of the principle and interest payments to the bond trustee in the event of non-payment by Fasttrax Limited.

[Table of Contents](#)

The guaranteed secured bonds were issued in two classes consisting of Class A 3.5% Index Linked Bonds in the amount of £56 million and Class B 5.9% Fixed Rate Bonds in the amount of £16.7 million. Payments on both classes of bonds commenced in March 2005 and are due in semi-annual installments over the term of the bonds which end in 2021. Subordinated notes payable to our 50% partner initially bear interest at 11.25% increasing to 16% over the term of the note through 2025. Payments on the subordinated debt commenced in March 2006 and are due in semi-annual installments over the term of the note.

The combined principal installments for both classes of bonds and subordinated notes, including inflation adjusted bond indexation, due for the years ended December 31, 2010, 2011 and 2012 and thereafter total approximately £3 million, £6 million, £6 million and £67 million, respectively.

Since the inception of the project, we accounted for our investment in the project entity using the equity method of accounting. As a result of the adoption of Accounting Standards Update No. 2009-17 – Consolidation (Topic 810) “Improvements to Financial Reporting by Enterprises with Variable Interest Entities”, effective January 1, 2010 we concluded that we are the primary beneficiary of Fasttrax Limited because we control the activities that most significantly impact the economic performance of the entity. We have applied the requirements of FASB ASC 810 on a prospective basis from the date of adoption. As such, our condensed consolidated financial statements for the first nine months of 2010 include the accounts of Fasttrax Limited and accordingly, the cash and equivalents, property, plant and equipment, and the non-recourse project financing debt. The secured bonds are an obligation of Fasttrax Limited and will never be a debt obligation of KBR because they are non-recourse to the joint venture partners. Accordingly, in the event of a default on the term loan, the lenders may only look to the resources of Fasttrax Limited for repayment.

Cashflow Activities

	For the Nine Months Ended	
	2010	2009
Cash flows provided by (used in) operating activities	\$ 541	\$ (27)
Cash flows used in investing activities	(83)	(20)
Cash flows used in financing activities	(258)	(92)
Effect of exchange rate changes on cash	12	14
Increase (decrease) in cash and equivalents	\$ 212	\$ (125)
Cash increase due to consolidation of a variable interest entity	22	—
Net increase (decrease) in cash and equivalents	\$ 234	\$ (125)

Operating activities. Cash provided by operations was \$541 million in the first nine months of 2010, compared to cash used by operations of \$27 million in the first nine months of 2009. Cash provided by operations during the first nine months of 2010 was primarily driven by overall earnings as well as improvements in cash receipts on certain projects in our Gas Monetization business unit. Also contributing to the increase in cash provided by operations was the decline of approximately \$108 million in working capital requirements for our LogCAP project including the receipt of \$94 million of award fees during the first nine months of 2010. Additionally, cash held by joint ventures that we consolidate for accounting purposes increased approximately \$17 million during the first nine months of 2010.

Cash used in operations was \$27 million in the first nine months of 2009. Cash held by our joint venture projects that we consolidate for accounting purposes increased from \$175 million at December 31, 2008 to \$185 million at September 30, 2009. Offsetting these cash decreases were increases of \$34 million in distributions and repayments of advances we received from our unconsolidated joint ventures, which are accounted for using the equity method of accounting.

Investing activities. Cash used in investing activities for the first nine months of 2010 totaled \$83 million compared to \$20 million during the first nine months of 2009. Cash used for capital expenditures were \$39 million and \$22 million for the first nine months of 2010 and 2009, respectively. The increase in capital expenditures was primarily related to increased corporate infrastructure spending and leasehold improvements. During the first nine months of 2010, we paid \$20 million for the exclusive right to certain technology under a 25-year licensing arrangement. In the second quarter of 2010 we acquired Energo Engineering for approximately \$16 million in cash, subject to an escrowed holdback amount of \$6 million to secure working capital adjustments. In the first nine months of 2010, we also made investments totaling \$14 million in several equity method joint ventures. Additionally, we financed approximately \$19 million for the purchase of computer software for internal use during the third quarter of 2010 which was a non-cash investing activity.

[Table of Contents](#)

Financing activities. Cash used in financing activities for the first nine months of 2010 totaled \$258 million and included \$217 million of payments to repurchase approximately 9.5 million shares of our common stock, \$37 million related to distributions to noncontrolling shareholders of several of our consolidated joint ventures, \$24 million related to dividend payments to shareholders. These payments were partially offset by return of cash used to collateralize standby letters of credit of approximately \$26 million. Cash used in financing activities was \$92 million for the first nine months of 2009 and included \$27 million of payments to reacquire 1.7 million shares of our common stock and \$54 million related to dividend payments to our shareholders and to noncontrolling shareholders of several of our consolidated joint ventures. Included in other financing activities of \$11 million was net cash collateralization of our standby letters of credit in accordance with certain agreements.

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

Future uses of cash. Future uses of cash will primarily relate to working capital requirements for our operations and acquisitions. In addition, we will use cash to fund capital expenditures, pension obligations, operating leases, cash dividends, share repurchases and various other obligations as they arise. Our capital expenditures will be focused primarily on information technology, real estate and equipment/facilities. From October 1, 2010 through October 13, 2010, we repurchased approximately 0.6 million shares of KBR stock for approximately \$14 million under our share repurchase program which completes purchases under our share repurchase plan authorized by our current Board of Directors.

On October 6, 2010, our Board of Directors declared a quarterly cash dividend of \$0.05 per share of common stock payable on January 17, 2011 to shareholders of record on December 15, 2010. The dividend payment is approximately \$8 million. Any future dividend declarations will be at the discretion of our Board of Directors.

Off balance sheet arrangements

Letters of credit, surety bonds and bank guarantees. In connection with certain projects, we are required to provide letters of credit or surety bonds to our customers. Letters of credit are provided to customers in the ordinary course of business to guarantee advance payments from certain customers, support future joint venture funding commitments and to provide performance and completion guarantees on engineering and construction contracts. We have \$1.7 billion in committed and uncommitted lines of credit to support letters of credit and as of September 30, 2010, we had utilized \$496 million of our credit capacity. We have an additional \$200 million in letters of credit issued and outstanding under various other facilities that are unconditionally and irrevocably guaranteed by Halliburton. Surety bonds are also posted under the terms of certain contracts primarily related to state and local government projects to guarantee our performance.

The \$496 million in letters of credit outstanding on KBR lines of credit was comprised of \$308 million issued under our Revolving Credit Facility and \$188 million issued under uncommitted bank lines at September 30, 2010. Of the total letters of credit outstanding, \$37 million of the letters of credit have terms that could entitle a bank to require additional cash collateralization on demand. Approximately \$196 million of the \$308 million letters of credit issued under our Revolving Credit Facility have expiry dates close to or beyond the maturity date of the facility. Under the terms of the Revolving Credit Facility, if the original maturity date of November 2, 2012 is not extended then the issuing banks may require that we provide cash collateral for these extended letters of credit no later than 95 days prior to the original maturity date. As the need arises, future projects will be supported by letters of credit issued under our Revolving Credit Facility or arranged on a bilateral basis. We believe we have adequate letter of credit capacity under our existing Revolving Credit Facility and bilateral lines of credit to support our operations for the next twelve months.

[Table of Contents](#)

Other obligations. We had commitments to provide funds to our privately financed and other projects of \$43 million as of September 30, 2010 primarily related to future equity funding on our Allenby and Connaught project. Commitments to fund these projects are supported by letters of credit as described above. At September 30, 2010, approximately \$17 million of the \$43 million in commitments will become due within one year.

We have an obligation to fund estimated losses on our uncompleted contracts which totaled \$29 million at September 30, 2010. Approximately \$26 million of this amount relates to our Escravos project, the majority of which is expected to be funded in 2010.

We executed two lease amendments for office space in two separate high-rise office buildings in Houston, Texas for the purpose of significantly expanding our current leased office space and to extend the original term of these leases to June 30, 2030. In the third quarter of 2010, we executed an additional lease agreement for office space located in one high-rise office building in Houston, Texas for the purpose of expanding our leased office space. The non-cancelable lease term expires on December 31, 2018. As a result we expect our estimated total rentals on all noncancelable operating leases to be as follows: \$56 million in 2010; \$50 million in 2011, \$47 million in 2012; \$42 million in 2013; \$39 million in 2014 and \$327 thereafter.

Other factors affecting liquidity

Government claims. Included in unbilled receivables in the accompanying balance sheets are unapproved claims for costs incurred under various government contracts totaling \$160 million at September 30, 2010 and \$113 million at December 31, 2009. Unapproved claims relate to contracts where our costs have exceeded the customer's funded value of the task order. The unapproved claims at September 30, 2010 include approximately \$122 million resulting from the de-obligation of 2004 and 2005 funding on certain task orders that were also subject to Form 1 notices relating to certain DCAA audit issues discussed above. This balance includes \$71 million that was de-obligated in the third quarter of 2010 which consists of funds nearing the 5-year expiration date. We believe such disputed costs will be resolved in our favor at which time the customer will be required to obligate funds from appropriations for the year in which resolution occurs. The remaining unapproved claims balance of approximately \$38 million represents primarily costs for which incremental funding is pending in the normal course of business. The majority of costs in this category are normally funded within several months after the costs are incurred. The unapproved claims outstanding at September 30, 2010 are considered to be probable of collection and have been recognized as revenue.

Liquidated damages. Many of our engineering and construction contracts have milestone due dates that must be met or we may be subject to penalties for liquidated damages if claims are asserted and we were responsible for the delays. These generally relate to specified activities that must be met within a project by a set contractual date or achievement of a specified level of output or throughput of a plant we construct. Each contract defines the conditions under which a customer may make a claim for liquidated damages. However, in some instances, liquidated damages are not asserted by the customer, but the potential to do so is used in negotiating claims and closing out the contract.

We had not accrued for liquidated damages related to several projects, including the exposure described in the above paragraph, totaling \$28 million at September 30, 2010 (including amounts related to our share of unconsolidated subsidiaries), that we could incur based upon completing the projects as forecasted.

Halliburton indemnities. Halliburton has agreed to indemnify us and certain of our greater than 50%-owned subsidiaries for fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of certain claims made or assessed against us by U.S. and certain foreign governmental authorities or a settlement thereof, relating to investigations under the FCPA or analogous applicable foreign statutes related investigations with respect to the construction and subsequent expansion by TSKJ of a natural gas liquefaction complex in Nigeria. Halliburton has also agreed to indemnify us for out-of-pocket cash costs and expenses, or cash settlement or cash arbitration awards in lieu thereof, we may incur as a result of the replacement of certain subsea flow-line bolts installed in connection with the Barracuda-Caratinga project. See Note 7 to our condensed consolidated financial statements for further discussion.

In February 2009, one of our subsidiaries plead guilty to violating and conspiring to violate the FCPA. In accordance with the terms of the settlement and under the terms of the Halliburton indemnity, Halliburton paid \$142 million in the first nine months of 2010 and \$369 million in the first nine months of 2009 on our behalf for penalties resulting from the FCPA violations, which have been reflected in the accompanying statement of cash flows as noncash operating activities.

[Table of Contents](#)

Legal Proceedings

Information related to various commitments and contingencies is described in Notes 6 and 7 to the condensed consolidated financial statements.

Environmental Regulation

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

In addition to federal and state laws and regulations, other countries where we do business often have numerous environmental regulatory requirements by which we must abide in the normal course of our operations. The portions of our business to which these requirements apply primarily relates to our Gas Monetization, Oil & Gas, Downstream and Services business units where we perform construction and industrial maintenance services or operate and maintain facilities. For certain locations, including our property at Clinton Drive, we have not completed our analysis of the site conditions and until further information is available, we are only able to estimate a possible range of remediation costs. These locations were primarily utilized for manufacturing or fabrication work and are no longer in operation. The use of these facilities created various environmental issues including deposits of metals, volatile and semi-volatile compounds, and hydrocarbons impacting surface and subsurface soils and groundwater. The range of remediation costs could change depending on our ongoing site analysis and the timing and techniques used to implement remediation activities. We do not expect costs related to environmental matters will have a material adverse effect on our condensed consolidated financial position or results of operations. Based on the information presently available to us, we have accrued approximately \$7 million for the assessment and remediation costs associated with all environmental matters, which represents the low end of the range of possible costs that could be as much as \$14 million.

New Accounting Standards

Information related to new accounting standards is described in Note 15 to the condensed consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to financial instrument market risk from changes in foreign currency exchange rates and interest rates. We selectively manage these exposures through the use of derivative instruments to mitigate our market risk from these exposures. The objective of our risk management is to protect our cash flows related to sales or purchases of goods or services from market fluctuations in currency rates. Our use of derivative instruments includes the following types of market risk:

- volatility of the currency rates;
- time horizon of the derivative instruments;
- market cycles; and
- the type of derivative instruments used.

We do not use derivative instruments for trading purposes. We do not consider any of these risk management activities to be material.

Item 4. Controls and Procedures

In accordance with Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2010 to provide reasonable assurance that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms. Our disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

During the most recent fiscal quarter, there have been no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Information related to various commitments and contingencies is described in Notes 6 and 7 to the condensed consolidated financial statements and in Managements’ Discussion and Analysis of Financial Condition and Results of Operations – Legal Proceedings and the information discussed therein is incorporated herein.

Item 1A. Risk Factors

There are no material changes from the risk factors previously disclosed in Part I, Item 1A in our Annual Report on Form 10-K, which is incorporated herein by reference, for the year ended December 31, 2009.

[Table of Contents](#)

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

- (a) None.
- (b) None.
- (c) On June 8, 2010, we initiated a Board of Directors authorized share repurchase program to repurchase up to 10 million of our outstanding common shares in the open market or privately negotiated transactions to reduce and maintain, over time, our outstanding shares at approximately 150 million shares. We entered into an agreement with an agent to conduct a designated portion of the repurchase program in accordance with Rules 10b-18 and 10b5-1 under the Securities Exchange Act of 1934. The following is a summary of share repurchases of our common stock settled during the three months ended September 30, 2010.

<u>Purchase Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</u>
July 1 – 30, 2010				
Repurchase Program	2,054,331	\$ 21.30	2,054,331	5,445,469
Employee Transactions ^(a)	32,305	\$21.71	—	—
August 3 – 31, 2010				
Repurchase Program	2,732,900	\$ 23.23	2,732,900	2,712,569
Employee Transactions ^(a)	1,775	\$ 23.12	—	—
September 1 – 30, 2010				
Repurchase Program	2,135,300	\$ 23.94	2,135,300	577,269
Employee Transactions ^(a)	1,369	\$ 24.17	—	—
Total				
Repurchase Program ^(b)	6,922,531	\$22.88	6,922,531	577,269
Employee Transactions ^(a)	35,449	\$21.88	—	—

- (a) Reflects shares acquired from employees in connection with the settlement of income tax and related benefit withholding obligations arising from vesting in restricted stock units.
- (b) In October 2010, we repurchased approximately 0.6 million of our outstanding common shares which completed our repurchase of 10 million shares under the share repurchase program initiated on June 8, 2010.

Item 3. Defaults Upon Senior Securities

None.

Item 4. (Removed and Reserved)

Item 5. Other Information

None.

[Table of Contents](#)

Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description</u>
3.1	KBR Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to KBR's registration statement on Form S-1; Registration No. 333-133302)
3.2	Amended and Restated Bylaws of KBR, Inc. (incorporated by reference to Exhibit 3.1 to KBR's Form 10-Q for the period ended June 30, 2008; File No. 1-33146)
4.1	Form of specimen KBR common stock certificate (incorporated by reference to Exhibit 4.1 to KBR's registration statement on Form S-1; Registration No. 333-133302)
10.1	Severance and Change of Control Agreement (incorporated by reference to Exhibit 10.1 to KBR's Form 8-K filed on August 16, 2010, by and between KBR and Dennis S. Baldwin)
* 31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
* 31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
** 32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
** 32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
***101.INS	XBRL Instance Document
***101.SCH	XBRL Taxonomy Extension Schema Document
***101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
***101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
***101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
***101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
*	Filed with this Form 10-Q
**	Furnished with this Form 10-Q
***	In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

[Table of Contents](#)

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.

KBR, INC.

/s/ Susan K. Carter

Susan K. Carter

Senior Vice President and Chief Financial Officer

/s/ Dennis S. Baldwin

Dennis S. Baldwin

Vice President and Chief Accounting Officer

Date: October 28, 2010

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF THE
SARBANES-OXLEY ACT OF 2002**

I, William P. Utt, certify that:

1. I have reviewed this quarterly report on Form 10-Q of KBR, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 28, 2010

/s/ William P. Utt

William P. Utt
Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 302 OF THE
SARBANES-OXLEY ACT OF 2002**

I, Susan K. Carter, certify that:

1. I have reviewed this quarterly report on Form 10-Q of KBR, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 28, 2010

/s/ Susan K. Carter

Susan K. Carter
Chief Financial Officer

**WRITTEN STATEMENT OF CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 906 OF THE
SARBANES-OXLEY ACT OF 2002**

The undersigned, the Chief Executive Officer of KBR, Inc. (the "Company"), hereby certifies that to his knowledge, on the date hereof:

(a) the Form 10-Q of the Company for the quarter ended September 30, 2010, filed on the date hereof with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(b) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ William P. Utt

William P. Utt
Chief Executive Officer

Date: October 28, 2010

**WRITTEN STATEMENT OF
CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 906 OF THE
SARBANES-OXLEY ACT OF 2002**

The undersigned, the Chief Financial Officer of KBR, Inc. (the "Company"), hereby certifies that to his knowledge, on the date hereof:

(a) the Form 10-Q of the Company for the quarter ended September 30, 2010, filed on the date hereof with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(b) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Susan K. Carter

Susan K. Carter
Chief Financial Officer

Date: October 28, 2010

