

KBR, INC.
Form 10-Q
July 25, 2012
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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 June 30, 2012

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 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 | <input checked="" type="checkbox"/> | Accelerated filer | <input type="checkbox"/> |
| Non-accelerated filer | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/> |

(Do not check if a smaller reporting company)

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

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As of July 11, 2012, there were 147,323,837 shares of KBR, Inc. common stock, \$0.001 par value per share, outstanding.

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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 2011 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.

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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 June 30, | | Six Months Ended June 30, | |
|---|-----------------------------------|---------|---------------------------------|---------|
| | 2012 | 2011 | 2012 | 2011 |
| Revenue: | | | | |
| Services | \$2,029 | \$2,416 | \$3,993 | \$4,693 |
| Equity in earnings of unconsolidated affiliates, net | 33 | 41 | 70 | 85 |
| Total revenue | 2,062 | 2,457 | 4,063 | 4,778 |
| Operating costs and expenses: | | | | |
| Cost of services | 1,879 | 2,231 | 3,717 | 4,365 |
| General and administrative | 52 | 58 | 107 | 102 |
| Loss (gain) on disposition of assets, net | 2 | (1) | (2) | (2) |
| Total operating costs and expenses | 1,933 | 2,288 | 3,822 | 4,465 |
| Operating income | 129 | 169 | 241 | 313 |
| Interest expense, net | (2) | (5) | (4) | (10) |
| Foreign currency gains, net | 3 | 2 | 2 | 3 |
| Other non-operating income (expense) | 1 | — | (1) | (1) |
| Income before income taxes and noncontrolling interests | 131 | 166 | 238 | 305 |
| Less: Provision for income taxes | (19) | (39) | (28) | (61) |
| Net Income | 112 | 127 | 210 | 244 |
| Less: Net income attributable to noncontrolling interests | (8) | (27) | (15) | (39) |
| Net income attributable to KBR | \$104 | \$100 | \$195 | \$205 |
| Net income attributable to KBR per share: | | | | |
| Basic | \$0.70 | \$0.65 | \$1.31 | \$1.35 |
| Diluted | \$0.70 | \$0.65 | \$1.31 | \$1.34 |
| Basic weighted average common shares outstanding | 148 | 151 | 148 | 151 |
| Diluted weighted average common shares outstanding | 149 | 152 | 149 | 152 |
| Cash dividends declared per share | \$0.05 | \$0.05 | \$0.10 | \$0.10 |

See accompanying notes to condensed consolidated financial statements.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------------|-------|---------------------------------|-------|
| | 2012 | 2011 | 2012 | 2011 |
| Net income | \$112 | \$127 | \$210 | \$244 |
| Other comprehensive income (loss), net of tax: | | | | |
| Net cumulative translation adjustments (“CTA”): | | | | |
| Cumulative translation adjustments | (17) | (8) | (15) | (3) |
| Reclassification adjustment for CTA included in net income | 1 | — | (2) | (1) |
| Net cumulative translation adjustment, net of tax | (16) | (8) | (17) | (4) |
| Pension liability adjustments, net of tax provision of \$2, \$2, \$4 and \$3 | 6 | 3 | 11 | 8 |
| Unrealized gain (loss) on derivatives: | | | | |
| Unrealized holding gain (loss) on derivatives | 1 | 1 | 2 | (3) |
| Reclassification adjustments for losses included in net income | — | — | 2 | 1 |
| Net unrealized gain (loss) on derivatives, net of tax benefit of \$0, \$0, \$1 and \$2 | 1 | 1 | 4 | (2) |
| Other comprehensive (loss) income, net of tax | (9) | (4) | (2) | 2 |
| Comprehensive income | 103 | 123 | 208 | 246 |
| Less: Comprehensive income attributable to noncontrolling interests | (8) | (27) | (16) | (39) |
| Comprehensive income attributable to KBR | \$95 | \$96 | \$192 | \$207 |

See accompanying notes to condensed consolidated financial statements.

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KBR, Inc.

Condensed Consolidated Balance Sheets

(In millions, except share data)

| | June 30, 2012 (Unaudited) | December 31, 2011 |
|---|---------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and equivalents | \$824 | \$966 |
| Receivables: | | |
| Accounts receivable, net of allowance for bad debts of \$13 and \$24 | 1,155 | 1,227 |
| Unbilled receivables on uncompleted contracts | 710 | 435 |
| Total receivables | 1,865 | 1,662 |
| Deferred income taxes | 277 | 297 |
| Other current assets | 480 | 517 |
| Total current assets | 3,446 | 3,442 |
| Property, plant, and equipment, net of accumulated depreciation of \$329 and \$364 (including \$71 and \$75, net, owned by a variable interest entity – see Note 13) | 368 | 384 |
| Goodwill | 955 | 951 |
| Intangible assets, net | 105 | 113 |
| Equity in and advances to related companies | 222 | 190 |
| Noncurrent deferred income taxes | 123 | 128 |
| Noncurrent unbilled receivables on uncompleted contracts | 312 | 313 |
| Other noncurrent assets | 164 | 152 |
| Total assets | \$5,695 | \$5,673 |

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KBR, Inc.

Condensed Consolidated Balance Sheets, continued

(In millions, except share data)

| | June 30, 2012 (Unaudited) | December 31, 2011 |
|---|---------------------------------|----------------------|
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$806 | \$761 |
| Due to former parent, net | 52 | 53 |
| Advance billings on uncompleted contracts | 501 | 626 |
| Reserve for estimated losses on uncompleted contracts | 15 | 22 |
| Employee compensation and benefits | 196 | 226 |
| Current non-recourse project-finance debt of a variable interest entity (Note 13) | 10 | 10 |
| Other current liabilities | 598 | 586 |
| Total current liabilities | 2,178 | 2,284 |
| Noncurrent employee compensation and benefits | 440 | 470 |
| Noncurrent non-recourse project-finance debt of a variable interest entity (Note 13) | 83 | 88 |
| Other noncurrent liabilities | 158 | 177 |
| Noncurrent income tax payable | 123 | 141 |
| Noncurrent deferred tax liability | 92 | 71 |
| Total liabilities | 3,074 | 3,231 |
| 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, 172,863,492 and 172,367,045 shares issued, and 147,726,797 and 148,143,420 shares outstanding | — | — |
| Paid-in capital in excess of par | 2,021 | 2,005 |
| Accumulated other comprehensive loss | (550) | (548) |
| Retained earnings | 1,787 | 1,607 |
| Treasury stock, 25,136,695 shares and 24,223,625 shares, at cost | (593) | (569) |
| Total KBR shareholders' equity | 2,665 | 2,495 |
| Noncontrolling interests | (44) | (53) |
| Total shareholders' equity | 2,621 | 2,442 |
| Total liabilities and shareholders' equity | \$5,695 | \$5,673 |

See accompanying notes to condensed consolidated financial statements.

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KBR, Inc.

Condensed Consolidated Statements of Cash Flows

(In millions, Unaudited)

| | Six Months Ended June 30, | |
|---|------------------------------|-------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income | \$210 | \$244 |
| Adjustments to reconcile net income to net cash provided by (used in) operations: | | |
| Depreciation and amortization | 33 | 35 |
| Equity in earnings of unconsolidated affiliates | (70) | (85) |
| Deferred income tax expense (benefit) | 57 | (13) |
| Other adjustments | 14 | 5 |
| Changes in operating assets and liabilities: | | |
| Receivables | 55 | (25) |
| Unbilled receivables on uncompleted contracts | (292) | (8) |
| Accounts payable | 52 | (27) |
| Advanced billings on uncompleted contracts | (115) | (2) |
| Accrued employee compensation and benefits | (53) | 37 |
| Reserve for loss on uncompleted contracts | (7) | (4) |
| Collection (repayment) of advances from (to) unconsolidated affiliates, net | (3) | 22 |
| Distribution of earnings from unconsolidated affiliates | 47 | 61 |
| Other, net | 17 | (17) |
| Total cash flows provided by (used in) operating activities | (55) | 223 |
| Cash flows from investing activities: | | |
| Capital expenditures | (33) | (47) |
| Acquisition of business, net | (2) | — |
| (Investment in) / return of capital from equity method joint ventures | 4 | (11) |
| Total cash flows used in investing activities | (31) | (58) |
| Cash flows from financing activities: | | |
| Acquisition of noncontrolling interest | — | (164) |
| Payments to reacquire common stock | (25) | (37) |
| Distributions to noncontrolling interests, net | (7) | (46) |
| Payments of dividends to shareholders | (15) | (15) |
| Net proceeds from issuance of stock | 3 | 5 |
| Payments on long-term borrowings | (10) | (10) |
| Excess tax benefits from stock-based compensation | 4 | 3 |
| Return of cash collateral on letters of credit, net | — | 16 |
| Other financing activities | 1 | — |
| Total cash flows used in financing activities | (49) | (248) |
| Effect of exchange rate changes on cash | (7) | 9 |
| Decrease in cash and equivalents | (142) | (74) |
| Cash and equivalents at beginning of period | 966 | 786 |
| Cash and equivalents at end of period | \$824 | \$712 |
| Noncash financing activities | | |
| Dividends declared | \$8 | \$8 |

See accompanying notes to condensed consolidated financial statements.

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Note 1. Description of Business and Basis of Presentation

KBR, Inc., a Delaware corporation, was formed on March 21, 2006. KBR, Inc. and its subsidiaries (collectively, “KBR”) is a global engineering, construction and services company supporting the energy, hydrocarbons, government services, minerals, civil infrastructure, power, industrial and commercial markets. Headquartered in Houston, Texas, we offer a wide range of services through our Hydrocarbons, Infrastructure, Government and Power (“IGP”), Services and Other business segments. See Note 5 for additional financial information about our 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 (“U.S. GAAP”). 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, 2011 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 condensed 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 2012 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 operating and financial policies of the entity. The cost method is used when we do not have the ability to exert significant influence. Intercompany accounts and transactions are eliminated.

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:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------------|------|---------------------------------|------|
| Millions of shares | 2012 | 2011 | 2012 | 2011 |
| Basic weighted average common shares outstanding | 148 | 151 | 148 | 151 |
| Stock options and restricted shares | 1 | 1 | 1 | 1 |
| Diluted weighted average common shares outstanding | 149 | 152 | 149 | 152 |

For purposes of applying the two-class method in computing earnings per share, net earnings allocated to participating securities was approximately \$0.5 million for the three months ended June 30, 2012 and 2011, and approximately \$1

million for the six months ended June 30, 2012 and 2011. The diluted earnings per share calculation did not include 1.6 million and 1.1 million anti-dilutive weighted average shares for the three and six months ended June 30, 2012, respectively. The diluted earnings per share calculation did not include 0.7 million and 0.4 million anti-dilutive weighted average shares for the three and six months ended June 30, 2011, respectively.

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Note 3. Business Combinations and Other Transactions

Other Transactions

M.W. Kellogg Limited (“MWKL”). On December 31, 2010, we obtained control of the remaining 44.94% interest in our MWKL subsidiary located in the U.K for approximately £107 million subject to certain post-closing adjustments. The acquisition was recorded as an equity transaction that reduced noncontrolling interests, accumulated other comprehensive income (“AOCI”) and additional paid-in capital by \$180 million. We recognized direct transaction costs associated with the acquisition of approximately \$1 million as a charge to additional paid in capital. The initial purchase price of \$164 million was paid on January 5, 2011. During the third quarter of 2011, we settled various post-closing adjustments that resulted in a decrease to “Paid-in capital in excess of par” of approximately \$5 million. We also agreed to pay the former noncontrolling interest 44.94% of future proceeds collected on certain receivables owed to MWKL. Additionally, the former noncontrolling interest agreed to indemnify us for 44.94% of certain MWKL liabilities to be settled and paid in the future. As of June 30, 2012, we have liabilities of approximately \$8 million classified on our condensed consolidated balance sheet as “Other noncurrent liabilities” and \$1 million classified on our balance sheet as “Other current liabilities” reflecting our estimate of 44.94% of future proceeds from certain receivables owed to MWKL.

LNG Joint Venture. On January 5, 2011, we sold our 50% interest in a joint venture to our joint venture partner for approximately \$22 million. The joint venture was formed to execute an EPC contract for construction of an LNG plant in Indonesia. We recognized a gain on the sale of our interest of approximately \$8 million which is included in “Equity in earnings of unconsolidated affiliates, net” in our condensed consolidated income statement for the six months ended June 30, 2011.

Note 4. 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:

| Millions of dollars | June 30, 2012 | December 31, 2011 |
|---|------------------|----------------------|
| Probable unapproved claims | \$138 | \$ 31 |
| Probable unapproved change orders | \$51 | \$ 6 |
| KBR share of probable unapproved change orders of unconsolidated subsidiaries | \$25 | \$ — |

As of June 30, 2012, the probable unapproved claims and change orders related to several projects. Included in the table above are probable unapproved claims associated with the reimbursable portion of an EPC contract to construct an LNG facility for which we have recognized additional contract revenue totaling \$111 million. The contract claims on this project represent incremental subcontractor costs incurred and we believe we have legal entitlement to recover these costs from the customer under the terms of the EPC contract. Approximately \$43 million of the probable unapproved change orders at June 30, 2012 were subsequently approved by the customer in July 2012. Contracts with probable unapproved claims that will likely not be settled within one year totaled \$18 million at June 30, 2012 and \$19 million at December 31, 2011, and are reflected as a non-current asset in “Noncurrent unbilled receivables on uncompleted contracts” in our 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” in our condensed consolidated balance sheets. See Note 7 for a discussion of U.S. government contract claims, which are not included in the table above.

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. Based upon our evaluation of our performance and other legal analysis, we have not accrued for possible liquidated damages related to several projects totaling \$8 million at June 30, 2012 and \$11 million at December 31, 2011, that we could incur based upon completing the projects as currently forecasted.

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Note 5. 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.

Reportable 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. Reportable segment income excludes certain cost of services and general and administrative expenses directly attributable to the operating segment that is managed and reported at the corporate level, and corporate general and administrative expenses. Labor cost absorption in the following table represents income or expense generated by our central service labor and resource groups for amounts charged to the operating segments.

The table below presents information on our reportable business segments.

| Millions of dollars | Three Months | | Six Months | |
|--------------------------------------|---------------------------|---------|---------------------------|---------|
| | Ended June 30, 2012 | 2011 | Ended June 30, 2012 | 2011 |
| Revenue: | | | | |
| Hydrocarbons | \$1,122 | \$1,100 | \$2,238 | \$2,147 |
| Infrastructure, Government and Power | 491 | 890 | 1,009 | 1,745 |
| Services | 425 | 445 | 773 | 842 |
| Other | 24 | 22 | 43 | 44 |
| Total revenue | \$2,062 | \$2,457 | \$4,063 | \$4,778 |
| Operating segment income: | | | | |
| Hydrocarbons | 131 | 121 | 236 | 220 |
| Infrastructure, Government and Power | 28 | 72 | 67 | 133 |
| Services | 16 | 15 | 28 | 28 |
| Other | 12 | 13 | 22 | 25 |
| Operating segment income | 187 | 221 | 353 | 406 |
| Unallocated amounts: | | | | |
| Labor cost absorption | (6 |) 6 | (5 |) 9 |
| Corporate general and administrative | (52 |) (58 |) (107 |) (102 |
| Total operating income | \$129 | \$169 | \$241 | \$313 |

Note 6. Committed 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 general cash needs, use on other projects or distributions to us without proper approval by the respective joint venture. Cash held by our joint ventures that we consolidate for accounting purposes totaled approximately \$251 million at June 30, 2012 and \$244 million at December 31, 2011. We expect to use the cash on these projects to pay project costs.

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Note 7. United States Government Contract Work

We provide substantial work under our government contracts to the United States Department of Defense (“DoD”) and other governmental agencies. These contracts include our worldwide United States Army logistics contracts, known as LogCAP III and IV.

Given the demands of working in Iraq and elsewhere for the U.S. 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 termination, under any affected contract. If any contract were so terminated, 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 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 recognize revenue on our services rendered on a task order basis based on either a cost-plus-fixed-fee or cost-plus-base-fee and award fee arrangement. The fees are determined as a percentage rate applied to a negotiated estimate of the total costs for each task order. Commencing in the fourth quarter of 2009, we stopped accruing award fees and began recognizing them only upon receipt of the award fee letter due to the inability to reliably estimate the amount of fees to be awarded. During the first quarter of 2011, we were awarded and recognized revenue of \$16 million for award fees for the periods of performance from March 2010 through August 2010 on task orders in Iraq. No award fee pools are available for the periods of performance subsequent to February 2011.

In August of 2010, we executed a contract modification to the LogCAP III contract on the base life support task order in Iraq that resulted in an increase to our base fee on costs incurred and an increase in the maximum award fee on negotiated costs for the period of performance from September 2010 through February 2011. During the first quarter of 2011, we finalized negotiations with our customer and converted the task order from cost-plus-base-fee and award fee to cost-plus-fixed-fee for the period of performance beginning in March 2011. We recognize revenues for the fixed-fee component on the basis of proportionate performance as services are performed.

Government Compliance Matters

The negotiation, administration, and settlement of our contracts with the U.S. Government, consisting primarily of DoD 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 Standards (“CAS”), 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 (“ACO”). We attempt to resolve all issues identified in audit reports by working directly with the DCAA and the ACO. 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 ACO. KBR is permitted to respond to these documents and provide additional support. At June 30,

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2012, we have open Form 1's from the DCAA recommending suspension of payments totaling approximately \$349 million associated with our contract costs incurred in prior years, of which approximately \$144 million has been withheld from our current billings. As a consequence, for certain of these matters, we have withheld approximately \$58 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 do not believe we have a legal obligation to pay. We continue to work with our ACO's, 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 ("ASBCA") or the United States Court of Federal Claims ("U.S. COFC").

KBR excludes from billings to the U.S. Government costs that are potentially unallowable, 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 at the time we identify and estimate 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 and CAS, 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 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 such as the ASBCA or the U.S. COFC. 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 the collection of 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 2007, we received a Form 1 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 costs related to the private security. We subsequently received Form 1's 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 \$25 million in payments from us bringing the total payments withheld to approximately \$45 million as of June 30, 2012, out of the Form 1's 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 armed 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 do not agree with the Army's position that such costs are unallowable and that they are entitled to withhold amounts incurred for such costs.

We have provided at the Army's request information that addresses the use of armed security either directly or indirectly charged to LogCAP III. In 2007, we filed a complaint in the ASBCA to recover \$44 million of the amounts

withheld from us. In 2009, KBR and the Army agreed to stay the case pending further discussions with the DOJ as discussed further below. The ASBCA denied the Army's latest request to stay the proceedings. In April 2012, the ASBCA ruled, as requested by KBR, that our contract with the Army does not prohibit the use of private security contractors by either KBR or its subcontractors. However, our motion to dismiss was denied on grounds that potential fact issues remain related to the reasonableness of the private security costs charged to the contract. Discovery on the remaining issues is in process and the next hearing is scheduled to occur in October 2012. 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 DOJ for alleged violation of the False Claims Act as discussed further below under the heading "Investigations, Qui Tams and Litigation."

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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. During the first quarter of 2011, we received a Form 1 from the DCAA disapproving approximately \$25 million in costs related to containerized housing that had previously been deemed allowable. As of June 30, 2012, approximately \$51 million of costs have been suspended under Form 1's of which \$26 million have been withheld from us by our customer. We have withheld \$30 million from our subcontractor related to this matter. In April 2008, we filed a counterclaim in arbitration against our LogCAP III subcontractor, First Kuwaiti Trading Company, to recover the \$51 million we paid to the subcontractor for containerized housing as further described under the caption First Kuwaiti Trading Company arbitration below. During the first quarter of 2011, we filed a complaint before the ASBCA to contest the Form 1's and recover the amounts withheld from us by our customer. We believe that the costs incurred associated with providing containerized housing are reasonable, and we intend to vigorously defend ourselves in this matter. 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, we believe 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 June 30, 2012, we have outstanding Form 1's from the DCAA disapproving \$118 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. COFC or ASBCA to recover \$55 million of the \$63 million withheld from us by the customer. The U.S. COFC proceedings were held in the fourth quarter of 2011. In April 2012, the U.S. COFC ruled that KBR's negotiated price for certain DFAC services were not reasonable and that we are entitled to approximately \$12 million of the total \$41 million withheld from us by our customer related to one of our subcontractors, Tamimi. As a result of this ruling, we recognized a non-cash, pre-tax charge of approximately \$28 million as a reduction to revenue related to the disallowed portion of the questioned costs in the second quarter of 2012. We appealed the U.S. COFC ruling. Prior to the U.S. COFC ruling, Tamimi filed for arbitration against us in 2009 to recover the payments we withheld from Tamimi pending the resolution of Form 1's with our customer. In December 2010, the arbitration panel ruled that our subcontract terms were not sufficient to hold retention from Tamimi for price reasonableness matters and awarded the subcontractor \$38 million including interest and certain legal costs. We paid the award to Tamimi during the third quarter of 2011. We do not believe we have the ability to recover the disallowed portion of the questioned costs previously paid to Tamimi. With respect to the remaining questions raised regarding billing in accordance with contract terms, as of June 30, 2012, 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 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 June 30, 2012, we had withheld \$19 million in payments from several of our subcontractors pending the resolution of these remaining matters with our customer.

In March 2011, the DOJ filed a counterclaim in the U.S. COFC alleging KBR employees accepted bribes from Tamimi, in exchange for awarding a master agreement for DFAC services to Tamimi. The DOJ seeks disgorgement of all funds paid to KBR under the master agreement as well as all award fees paid to KBR under the related task orders. Trial in the U.S. COFC took place during the fourth quarter of 2011. In conjunction with the April 2012 ruling on the Tamimi matter discussed above, the U.S. COFC issued a judgment in favor of KBR on the common law fraud counterclaim ruling that the fraud allegations brought by the DOJ were without merit. We have been notified by the DOJ that it intends to appeal the U.S. COFC's fraud ruling and that it has filed a notice of appeal.

In August 2011, another DFAC subcontractor, Gulf Coast Catering (“GCC”), filed for arbitration in the London Court of International Arbitration to recover approximately \$9 million for payments we have withheld from them pending resolution of outstanding Form 1's with our customer. A hearing is scheduled for November 2012. As noted above, we have claims pending in the U.S. COFC to recover these amounts from the U.S. government.

Transportation costs. In 2007, the DCAA raised a question about our compliance with the provisions of the Fly America Act. During the first quarter of 2011, we received a Form 1 from the DCAA totaling \$6 million for alleged violations of the Fly America Act in 2004. 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. Included in our June 30, 2012 and December 31, 2011 accompanying condensed consolidated balance sheets, is an accrued estimate of the cost incurred for these potentially non-compliant flights. The DCAA may consider additional flights to be noncompliant resulting in potential larger

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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.

In the first quarter of 2011, we received a Form 1 from the DCAA disapproving certain transportation costs totaling approximately \$27 million associated with replacing employees who were deployed in Iraq and Afghanistan for less than 179 days. The DCAA claims these replacement costs violate the terms of the LogCAP III contract which expressly disallow certain costs associated with the contractor rotation of employees who have deployed less than 179 days including costs for transportation, lodging, meals, orientation and various forms of per diem allowances. We disagree with the DCAA's interpretation and application of the contract terms as it was applied to circumstances outside of our control including sickness, death, termination for cause or resignation and that such costs should be allowable. We do not believe we face a risk of significant loss from any disallowance of these costs in excess of the loss accruals we have recorded.

Construction services. From February 2009 through September 2010, we received Form 1's 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 February 2012, the Contracting Officer rendered a Contracting Officer Final Determination ("COFD") allowing approximately \$10 million and disallowing \$15 million of direct costs. We filed an appeal with the ASBCA in June 2012. As of June 30, 2012, 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 June 30, 2012, 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 in the U.S. District Court in the District of Columbia by a former employee alleging various wrongdoings in the form of overbillings to 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 pending a ruling on a discovery matter before further motions can be filed. The quantification of damages and theories that will remain has not yet been defined by the court. Trial for this matter has not been scheduled. We believe the relator's claim is without merit and that the likelihood that a loss has been incurred is remote. As of June 30, 2012, no amounts have been accrued.

First Kuwaiti Trading Company arbitration. In April 2008, First Kuwaiti Trading Company ("FKTC"), 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. The FKTC arbitration is being conducted under the rules of the London Court on International Arbitration and the venue is in the District of Columbia. First Kuwaiti alleged that we did not return or pay rent for many of the vehicles and seeks damages in the amount of \$134 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." To date arbitration hearings for four subcontracts have taken place primarily related to claims involving unpaid rents and damages on lost or unreturned vehicles. The arbitration panel has awarded approximately \$16 million to FKTC for claims involving unpaid rents and damages on lost or unreturned vehicles, repair costs on certain vehicles, damages suffered as a result of late vehicle returns, and interest thereon, net of maintenance, storage and security costs awarded to KBR. No payments are expected to occur until all claims are arbitrated and awards finalized. Arbitration hearings for the remaining subcontracts are expected to resume in September 2012. We believe any damages ultimately awarded to First Kuwaiti will be billable under the

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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.

Electrocution litigation. During 2008, a lawsuit was filed against KBR in Pittsburgh, Pennsylvania in the Allegheny County Common Pleas Court 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. KBR denies that its conduct was the cause of the event and denies legal responsibility. Plaintiffs are claiming unspecified damages for personal injury, death and loss of consortium by the parents. On July 13, 2012, the Court granted our motions to dismiss, concluding that the case is barred by the Political Question Doctrine and preempted by the Combatant Activities Exception to the Federal Tort Claims Act.

Burn Pit litigation. From November 2008 through February 2011, KBR was served with over 50 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 collectively representing approximately 250 individual plaintiffs. 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. The plaintiffs are claiming unspecified damages. All of the pending cases were removed to Federal Court and have been consolidated for multi-district litigation treatment before the U.S. Federal District Court in Baltimore, Maryland. In December 2010, the Court stayed virtually all discovery proceedings pending a decision from the Fourth Circuit Court of Appeals on three other cases involving the Political Question Doctrine and other jurisdictional issues. In May 2012, the Court denied plaintiff's request for jurisdictional discovery. In June 2012, KBR filed a renewed motion to dismiss which was heard in July 2012 and we expect a ruling during the second half of 2012. 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 reliably estimate a range of possible loss, if any, related to this matter at this time. Accordingly, as of June 30, 2012, no amounts have been accrued.

Sodium Dichromate litigation. From December 2008 through September 2009, five cases were filed in various federal district courts against KBR by national guardsman and other military personnel alleging exposure to potentially hazardous chemicals at the Qarmat Ali Water Treatment Plant in Iraq in 2003. The majority of the cases were re-filed and consolidated into two cases with one pending in Houston, Texas and one pending in the District of Oregon. Collectively, the suit represents approximately 170 individual plaintiffs all of which are current and former national guardsmen who claim they were exposed to sodium dichromate while escorting KBR employees who were working at the water treatment plant and that the defendants knew or should have known that the potentially toxic substance existed and negligently failed to protect the guardsmen from exposure. The plaintiffs are claiming unspecified damages. The U.S. Corps of Engineers ("USACE") was contractually obligated to provide a benign site free of war and environmental hazards before KBR's commencement of work on the site. KBR notified the USACE within two days after discovering the sodium dichromate and took effective measures to remediate the site. KBR services provided to the USACE were under the direction and control of the military and therefore, KBR believes it has adequate defenses to these claims. KBR will also assert Political Question Doctrine and Government Contractor defenses. Additionally, U.S. Government and other studies on the effects of exposure to the sodium dichromate contamination at the water treatment plant have found no long term harm to the soldiers. However, due to the inherent uncertainties of litigation and because the litigation is in the preliminary stages, we cannot accurately predict the ultimate outcome nor can we reliably estimate a range of possible loss, if any, related to this matter. Trials have been scheduled for September 2012 in Houston, Texas and October 2012 for the case in Oregon. As of June 30, 2012, no amounts have been accrued. During the period of time since the first litigation was filed against us, we have incurred legal defense costs that we believe are reimbursable under the related customer contract. We intend to bill for these costs, and if necessary, file claims with either the U.S. COFC or ASBCA to recover the associated revenues recognized to date.

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. The case was removed to U.S. Federal District Court in Houston, Texas. After numerous motions and rulings in the trial court and appeals to U.S. Fifth Circuit Court of Appeals, in January 2012, the appellate Court granted KBR's appeal on dispositive motions and dismissed the claims of all remaining plaintiffs on the grounds that their claims are banned by the exclusive remedy provisions of the Defense Base Act. Prior to the dismissal of the claims against KBR by the appellate Court, KBR settled the claims of one of the plaintiffs. The remaining plaintiffs sought a rehearing of the dismissal by the Fifth Circuit which was denied in April 2012. We believe the cost of settling with one of the plaintiffs is reimbursable under the related customer contract. We intend to bill for these costs, and if necessary, file claims with either the U.S. COFC or ASBCA

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to recover the associated revenues recognized to date. In July 2012, the plaintiffs filed a petition for a writ of certiorari in the U.S. Supreme Court.

DOJ False Claims Act complaint. In April 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 the LogCAP III contract. Discovery closed under the Court's scheduling order in the second quarter of 2012. The DOJ did not participate in discovery on the merits. We now have several discovery motions and potentially dispositive motions pending before the Court. As a result of these delays and pending motions, we believe trial is unlikely to occur in 2012. Additionally, we believe the ASBCA decision interpreting the LogCAP III contract discussed above under the heading "Private Security" is sufficient to dismiss the DOJ's False Claims Act case. We continue to believe this complaint is without merit. We have not adjusted our revenues or accrued any amounts related to this matter.

Other Matters

Claims. Included in receivables in our condensed consolidated balance sheets are unapproved claims for costs incurred under various government contracts totaling \$204 million at June 30, 2012, of which \$105 million is included in "Accounts receivable" and \$99 million is included in "Unbilled receivables on uncompleted contracts." Unapproved claims relate to contracts where our costs have exceeded the customer's funded value of the task order. The \$105 million of unapproved claims included in Accounts receivable results primarily from de-obligated funding on certain task orders that were also subject to Form 1's relating to certain DCAA audit issues discussed above. 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 \$99 million primarily represents 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 June 30, 2012, are considered to be probable of collection and have been previously recognized as revenue.

Note 8. Other Commitments and Contingencies

Barracuda-Caratinga Project Arbitration

In June 2000, we entered into a contract with Barracuda & Caratinga Leasing Company B.V., the project owner and claimant, 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 was conducted in New York under the guidelines of the United Nations Commission on International Trade Law ("UNCITRAL").

In September 2011, the arbitration panel awarded the claimant approximately \$193 million. The damages awarded were based on the panel's estimate to replace all subsea bolts, including those that did not manifest breaks, as well as legal and other costs incurred by the claimant in the arbitration and interest thereon since the date of the award. The panel rejected our argument, and the case law relied upon by us, that we were only liable for bolts that were discovered to be broken prior to the expiration of the warranty period that ended on June 30, 2006. As of June 30, 2012, we have a liability of \$205 million, including interest, to Petrobras for the failed bolts which is included in "Other current liabilities." The liability incurred by us in connection with the arbitration is covered by an indemnity from our former parent, Halliburton. Accordingly, we have recorded an indemnification receivable from Halliburton of \$205 million pursuant to the indemnification under the MSA which is included in "Other current assets" as of June 30, 2012. The arbitration award payable to Petrobras will be deductible for tax purposes when paid. The indemnification payment will be treated by KBR for tax purposes as a contribution to capital and accordingly is not taxable. Halliburton has directed us to challenge the arbitration award as being defective or outside the jurisdiction of the arbitration panel. This challenge was filed in the United States District Court for the Southern District of New York on December 16, 2011. The

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challenge has been fully briefed to the Court and oral argument has not been scheduled. We will continue to be responsible for all ongoing legal costs associated with this matter. If the challenge to the arbitration award is successful and the award payable to Petrobras is either reduced or reversed in a future period, we would reverse the related tax benefit previously recognized as a charge to income as tax expense in that period. As of June 30, 2012, we do not believe there are any legal limitations on our ability to recover the full amount of the cash arbitration award and we intend to assert our rights under the indemnity agreement with Halliburton.

PEMEX Arbitration

In 1997 and 1998 we entered into 3 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 the EPC 1 project. PEMEX subsequently filed counterclaims totaling \$157 million. 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. In connection with this award, we recognized a gain of \$117 million net of tax in 2009. The arbitration award is legally binding and on November 2, 2010, we received a judgment in our favor in the U.S. District Court for the Southern District of New York to recognize the award in the U.S. of approximately \$356 million plus Mexican value added tax and interest thereon until paid. PEMEX initiated an appeal to the U.S. Court of Appeals for the Second Circuit and asked for a stay of the enforcement of the judgment while on appeal. The stay was granted, but PEMEX was required to post collateral of \$395 million with the court registry. Appellate briefs have been filed by both parties and oral arguments were heard by the Second Circuit Court on February 2, 2012. On February 16, 2012, the Second Circuit issued an order remanding the case to the District Court to consider if the decision of the Collegiate Court in Mexico, described below, would have affected the trial court’s ruling. Both parties filed briefs and hearings were conducted in May and July 2012. Additional briefing has been requested by the Court and will be submitted in late August 2012 with a hearing to follow in September 2012. We believe the possibility of the trial court reversing its own ruling to be remote as U.S. courts have a strong record of recognizing and enforcing international arbitration awards. However, an unfavorable ruling by the trial court could have a material adverse impact to our results of operations.

PEMEX attempted to nullify the award in Mexico which was rejected by the Mexican trial court in June 2010. PEMEX then filed an “amparo” action on the basis that its constitutional rights had been violated which was denied by the Mexican court in October 2010. PEMEX subsequently appealed the adverse decision with the Collegiate Court in Mexico on the grounds that the arbitration tribunal did not have jurisdiction and that the award violated the public order of Mexico. Although these arguments were presented in the initial nullification and amparo actions and were rejected in both cases, in September 2011, the Collegiate Court in Mexico ruled in favor of PEMEX on the amparo action. The Collegiate Court ruled that PEMEX, by administratively rescinding the contract in 2004, deprived the arbitration panel of jurisdiction thereby nullifying the arbitration award. The Collegiate Court decision is contrary to the ruling received from the ICC as well as all other Mexican courts which have denied PEMEX’s repeated attempts to nullify the arbitration award. We also believe the Collegiate Court decision is contrary to Mexican law governing contract arbitration. However, we do not expect the Collegiate Court decision to affect the outcome of the U.S. appeal discussed above or our ability to ultimately collect the ICC arbitration award in the U.S. due to the significant assets of PEMEX in the U.S. as well as the collateral posted by PEMEX with the court registry. The circumstances of this matter are unique and in the unlikely event we are not able to collect the arbitration award in the U.S., we will pursue

other remedies including filing a North American Free Trade Agreement (“NAFTA”) arbitration to recover the award as an unlawful expropriation of assets by the government of Mexico.

We were successful in litigating and collecting on valid international arbitration awards against PEMEX on the EPC 22 and EPC 28 projects during 2008. Additionally, PEMEX has sufficient assets in the U.S. which we believe we will be able to attach as a result of the recognition of the ICC arbitration award in the U.S. Although it is possible we could resolve and collect the amounts due from PEMEX in the next 12 months, we believe the timing of the collection of the award is uncertain and therefore, we have continued to classify the amount due from PEMEX as a long term receivable included in “Noncurrent unbilled receivable on uncompleted contracts” as of June 30, 2012. No adjustments have been made to our receivable balance since recognition of the initial award in 2009. Depending on the timing and amount ultimately settled with PEMEX, including interest, we could recognize an additional gain upon collection of the award.

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In connection with the EPC 1 project, we have approximately \$80 million in outstanding performance bonds furnished to PEMEX when the project was awarded. The bonds were written by a Mexican bond company and backed by a U.S. insurance company which is indemnified by KBR. As a result of the ICC arbitration award in December 2009, the panel determined that KBR had performed on the project and recovery on the bonds by PEMEX was precluded. PEMEX filed an action in Mexico in June 2010 against the Mexican bond company to collect the bonds even though the arbitration award ruled that the bonds were to be returned to KBR. In May 2011, the Mexican trial court ruled PEMEX could collect the bonds even though PEMEX at the time was unsuccessful in its attempts to nullify the arbitration award. The decision was immediately appealed by the bonding company and PEMEX was not able to call the bonds while on appeal. In October 2011, we were officially notified that the appellate court ruled in favor of PEMEX, therefore allowing PEMEX to call the bonds. In December 2011, we and the Mexican bond company stayed payment of the bonds by filing direct amparos in the Mexican courts, and we filed a bond to cover interest accruing during the pendency of our amparo action. In the event our amparo is unsuccessful and the U.S. insurance company makes payment to the Mexican bonding company, we may be required to indemnify the U.S. insurance company. In this event, we will pursue other remedies including seeking relief in the U.S. District Court for the Southern District of New York or the filing of a NAFTA arbitration to recover the bonds as an unlawful expropriation of assets by the government of Mexico.

FAO Litigation

In April 2001, our subsidiary, MWKL, entered into lump-sum contracts with Fina Antwerp Olefins (FAO), a joint venture between ExxonMobil and Total, to perform EPC services for FAO's revamp and expansion of an existing olefins plant in Belgium. The contracts had an initial value of approximately €113 million. Upon execution of the contracts, MWKL was confronted with a multitude of changes and issues on the project resulting in significant cost overruns and schedule delays. The project was completed in October 2003. In 2005, after unsuccessful attempts to engage FAO in negotiations to settle MWKL's outstanding claims, MWKL filed suit against FAO in the Commercial Court of Antwerp, Belgium, seeking to recover amounts for rejected change requests, disruption, schedule delays and other items. MWKL sought the appointment of a court expert to determine the technical aspects of the disputes between the parties upon which the judge could rely for allocating liability and determining the final amount of MWKL's claim against FAO. FAO filed a counterclaim in 2006 claiming recovery of additional costs for various matters including, among others, project management, temporary offices, security, financing costs, deficient work items and disruption of activities some of which we believe is either barred by the language in the contract or has not been adequately supported. Although the court expert has issued several preliminary reports which support our claim receivable, a final report has yet to be issued that addresses the full value of KBR's claims. We currently expect the court expert to release a final report in October 2012. We do not believe we face a risk of significant loss associated with the value of the claim receivable recorded on our balance sheets or FAO's counterclaims. As of June 30, 2012, no amounts have been accrued related to the counterclaim.

Letters of credit

In connection with certain projects, we are required to provide letters of credit, surety bonds or guarantees to our customers. Letters of credit are provided to certain customers and counter-parties in the ordinary course of business as credit support for contractual performance guarantees, advanced payments received from customers and future funding commitments. We have approximately \$2 billion in committed and uncommitted lines of credit to support the issuance of letters of credit at June 30, 2012. We had utilized \$682 million of our line of credit capacity. Surety bonds are also posted under the terms of certain contracts to guarantee our performance. The letters of credit outstanding included \$219 million issued under our Credit Agreement and \$462 million issued under uncommitted bank lines at June 30, 2012. Of the total letters of credit outstanding, \$280 million relate to our joint venture operations and \$9 million of the letters of credit have terms that could entitle a bank to require additional cash collateralization on

demand. As the need arises, future projects will be supported by letters of credit issued under our Credit Agreement or other lines of credit arranged on a bilateral, syndicated or other basis. We believe we have adequate letter of credit capacity under our Credit Agreement and bilateral lines of credit to support our operations for the next twelve months.

Other

As of June 30, 2012, we had commitments to provide funds to our privately financed projects of \$8 million, primarily related to future equity funding on our Allenby and Connaught project coming due within one year. Our commitments to fund our privately financed projects are supported by letters of credit as described above.

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Note 9. Transactions with Former Parent

Pursuant to our master separation agreement, we agreed to indemnify Halliburton for, among other matters, all past, present and future liabilities related to our business and operations. We agreed to indemnify Halliburton for liabilities under various outstanding and certain additional credit support instruments relating to our businesses and for liabilities under litigation matters related to our business. Halliburton agreed to indemnify us for, among other things, liabilities unrelated to our business, for certain other agreed matters relating to the investigation of FCPA and related corruption allegations and the Barracuda-Caratinga project and for other litigation matters related to Halliburton's business. See Note 8. The tax sharing agreement provides for certain allocations of U.S. income tax liabilities and other agreements between us and Halliburton with respect to tax matters.

As of June 30, 2012, "Due to former parent, net" was approximately \$52 million and was comprised primarily of estimated amounts owed to Halliburton under the tax sharing agreement for income taxes. Our estimate of amounts due to Halliburton under the tax sharing agreement was approximately \$44 million at June 30, 2012 and relates to income tax adjustments paid by Halliburton subsequent to our separation that were directly attributable to us, primarily for the years from 2001 through 2006. The remaining balance of \$8 million included in "Due to former parent, net" as of June 30, 2012 is associated with various other amounts payable to Halliburton arising under the other separation agreements.

During the fourth quarter of 2011, Halliburton provided notice and demanded payment for amounts significantly greater than our accrued liability that it alleges are owed by us under the tax sharing agreement for various other tax-related transactions pertaining to periods prior to our separation from Halliburton. We believe that the amount in the demand is invalid based on our assessment of Halliburton's methodology for computing the claim. Based on advice from internal and external legal counsel, we do not believe that Halliburton has a legal entitlement to payment of the amount in the demand. However, although we believe we have appropriately accrued for amounts owed to Halliburton based on our interpretation of the tax sharing agreement, there may be changes to the amounts ultimately paid to or received from Halliburton under the tax sharing agreement upon final settlement. On July 3, 2012, KBR requested an arbitration panel be appointed to resolve certain intercompany issues arising under the master separation agreement in effect between the companies. We believe the intercompany issues were settled and released as a result of our separation from Halliburton in 2007. On July 10, 2012, Halliburton filed a complaint in Texas State Court seeking to compel resolution of all issues under the tax sharing agreement rather than the master separation agreement. We are evaluating our response to the complaint. The remaining tax-related issues in dispute will be resolved by a designated "accounting referee" as provided for under the terms of the tax sharing agreement.

As of June 30, 2012, included in "Other assets" is an income tax receivable of approximately \$18 million related to a foreign tax credit generated as a result of a final settlement we paid to a foreign taxing authority in 2011 for a disputed tax matter that arose prior to our separation from Halliburton. In order to claim the tax credit, we requested, and Halliburton agreed to and did file an amended U.S. Federal tax return for the period in which the disputed tax liability arose. However, Halliburton notified us that it does not intend to remit to us the refund received or to be received by Halliburton as a result of the amended return. KBR disputes Halliburton's position on this matter and believes it has legal entitlement to the \$18 million refund. We intend to vigorously pursue collection of this amount and certain other unrecorded counterclaims. The timing of ultimate resolution of these matters will depend in part on future discussion with Halliburton and arbitration under the terms of the separation agreements as discussed above.

As discussed above under "Barracuda-Caratinga Project Arbitration," we have recorded an indemnification receivable due from Halliburton of approximately \$205 million associated with our estimated liability in the bolts matter, including interest, which is included in "Other current assets" as of June 30, 2012.

Note 10. Income Taxes

Our effective tax rate was approximately 14% for the three months ended June 30, 2012 and 12% for the six months ended June 30, 2012. The U.S. statutory tax rate for all periods was 35%. Excluding discrete items, our effective tax rate was approximately 30% and 28% for the three and six months ended June 30, 2012, respectively. Our effective tax rate excluding discrete items increased during the second quarter of 2012 by approximately 3% as a result of incremental income taxes on certain undistributed foreign earnings in Australia that were previously deemed to be permanently reinvested. The effective tax rate excluding discrete items was lower than the U.S. statutory rate due to favorable tax rate differentials on foreign earnings and lower tax expense on foreign income from unincorporated joint ventures. In the first six months of 2012, we recognized discrete net tax benefits of approximately \$39 million including benefits primarily related to the recognition of previously unrecognized tax benefits related to tax positions taken in prior years due to progress in resolving transfer pricing matters with certain taxing jurisdictions, statute expirations on certain domestic tax matters and other reductions to foreign tax exposures as well as discrete tax benefits related to deductions arising from an unconsolidated joint venture in Australia.

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Our effective tax rate was approximately 24% for the three months ended June 30, 2011 and 20% for the six months ended June 30, 2011. Excluding discrete items, our effective tax rate was approximately 28% and 30% for the three and six months ended June 30, 2011 respectively. Our effective tax rate excluding discrete items for the three and six months ended June 30, 2011 was lower than the U.S. statutory rate of 35% due to favorable tax rate differentials on foreign earnings and lower tax expense on foreign income from unincorporated joint ventures. In the first six months of 2011, we recognized discrete tax benefits from the execution of tax planning strategies, the release of a tax reserve due to expiration of a statute and from the reduction of deferred tax liabilities as a result of changes in estimates of the tax liabilities related to the planned liquidation of an unconsolidated joint venture in Australia.

Note 11. Shareholders' Equity

The following table summarizes our shareholders' equity activities during the six months ended June 30, 2012 and 2011:

| Millions of dollars | Total | KBR Shareholders | | | | | Noncontrolling Interests |
|--|---------|----------------------------------|-------------------|----------------|--------------------------------------|---------|--------------------------|
| | | Paid-in Capital in Excess of par | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Loss | | |
| Balance at December 31, 2011 | \$2,442 | \$2,005 | \$1,607 | \$ (569) | \$ (548) | \$ (53) | |
| Share-based compensation | 9 | 9 | — | — | — | — | |
| Common stock issued upon exercise of stock options | 3 | 3 | — | — | — | — | |
| Tax benefit increase related to stock-based plans | 4 | 4 | — | — | — | — | |
| Dividends declared to shareholders | (15) | — | (15) | — | — | — | |
| Repurchases of common stock | (25) | — | — | (25) | — | — | |
| Issuance of ESPP shares | 1 | — | — | 1 | — | — | |
| Distributions to noncontrolling interests | (7) | — | — | — | — | (7) | |
| Net income | 210 | — | 195 | — | — | 15 | |
| Other comprehensive income, net of tax | (1) | — | — | — | (2) | 1 | |
| Balance at June 30, 2012 | \$2,621 | \$2,021 | \$1,787 | \$ (593) | \$ (550) | \$ (44) | |

| Millions of dollars | Total | KBR Shareholders | | | | | Noncontrolling Interests |
|--|-------|----------------------------------|-------------------|----------------|--------------------------------------|------|--------------------------|
| | | Paid-in Capital in Excess of par | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Loss | | |
| Balance at December 31, 2010 | 2,204 | 1,981 | 1,157 | (454) | (438) | (42) | |
| Share-based compensation | 9 | 9 | — | — | — | — | |
| Common stock issued upon exercise of stock options | 5 | 5 | — | — | — | — | |
| Tax benefit increase related to stock-based plans | 3 | 3 | — | — | — | — | |
| Dividends declared to shareholders | (15) | — | (15) | — | — | — | |
| Repurchases of common stock | (37) | — | — | (37) | — | — | |
| Issuance of ESPP shares | 2 | — | — | 2 | — | — | |

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| | | | | | | | | |
|---|---------|---|---------|---------|--------|---|--------|---|
| Distributions to noncontrolling interests | (46 |) | — | — | — | — | (46 |) |
| Net income | 244 | | — | 205 | — | — | 39 | |
| Other comprehensive income, net of tax | 2 | | — | — | — | 2 | — | |
| Balance at June 30, 2011 | \$2,371 | | \$1,998 | \$1,347 | \$(489 |) | \$(436 |) |
| | | | | | | | \$(49 |) |

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Accumulated other comprehensive loss consisted of the following balances:

| Millions of dollars | June 30, 2012 | December 31, 2011 |
|--|------------------|----------------------|
| Cumulative translation adjustments | \$(87) | \$(70) |
| Pension liability adjustments | (460) | (471) |
| Unrealized losses on derivatives | (3) | (7) |
| Total accumulated other comprehensive loss | \$(550) | \$(548) |

Note 12. Fair Value Measurements

The financial assets and liabilities measured at fair value on a recurring basis at June 30, 2012 are included below:

| Millions of dollars | Fair Value Measurements at Reporting Date Using | | | |
|------------------------|---|--|---|---|
| | Total Fair Value at Reporting Date | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Marketable securities | \$17 | \$11 | \$6 | \$— |
| Derivative assets | \$6 | \$— | \$6 | \$— |
| Derivative liabilities | \$2 | \$— | \$2 | \$— |

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.

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Note 13. 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 below.

Variable Interest Entities

The majority of our joint ventures are variable interest entities. We account for variable interest entities (“VIEs”) in accordance with FASB ASC 810 – Consolidation which 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 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 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. Thereafter, we continue to re-evaluate whether we are the primary beneficiary of the VIE in accordance with ASC 810-10. 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:

As of June 30, 2012

| Unconsolidated VIEs | Total assets | Total liabilities | Maximum exposure to loss |
|---------------------------------------|--------------|-------------------|--------------------------|
| (in millions, except for percentages) | | | |
| U.K. Road projects | \$1,350 | \$1,490 | \$31 |
| Fermoy Road project | \$217 | \$241 | \$2 |
| Allenby & Connaught project | \$2,889 | \$2,843 | \$28 |
| EBIC Ammonia project | \$751 | \$532 | \$44 |
| Inpex LNG project | \$1,163 | \$1,124 | \$42 |

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| Unconsolidated VIEs | As of December 31, 2011 | |
|---------------------------------------|-------------------------|-------------------|
| | Total assets | Total liabilities |
| (in millions, except for percentages) | | |
| U.K. Road projects | \$1,393 | \$1,520 |
| Fermoy Road project | \$228 | \$249 |
| Allenby & Connaught project | \$2,954 | \$2,916 |
| EBIC Ammonia project | \$693 | \$389 |

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. Our maximum exposure to loss represents our equity investments 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.

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 U.K. 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. As of June 30, 2012, our performance through the construction phase is supported by \$38 million in letters of credit. 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. 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 June 30, 2012, our assets and liabilities associated with our investment in this project, within our condensed consolidated balance sheet, were \$21 million and \$2 million, respectively. The \$26 million difference between our recorded liabilities and aggregate maximum exposure to loss was primarily related to our equity investments and \$8 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 performed the engineering, procurement and construction ("EPC") work for the project and continue to provide 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 June 30, 2012, our assets and liabilities associated with our investment in this project, within our condensed consolidated balance sheet, were \$68 million and \$3 million, respectively. The \$41 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 June 30, 2012.

Inpex LNG project. In January 2012, we signed an agreement to provide fixed-price and cost-reimbursable EPC services to construct the Inpex Ichthys Onshore LNG Export Facility in Darwin, Australia ("Inpex LNG project"). The project will be executed using two joint ventures in which we own a 30% equity interest. The investments are accounted for using the equity method of

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accounting. At June 30, 2012, our assets and liabilities associated with our investment in this project recorded in our condensed consolidated balance were \$32 million and \$2 million, respectively. The \$40 million difference between our recorded liabilities and aggregate maximum exposure to loss was related to our equity investment and other receivables due from the entity as of June 30, 2012.

Consolidated VIEs

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

| Consolidated VIEs (in millions, except for percentages) | As of June 30, 2012 | |
|--|-------------------------|-------------------|
| | Total assets | Total liabilities |
| Fasttrax Limited project | \$99 | \$104 |
| Escravos Gas-to-Liquids project | \$341 | \$396 |
| Pearl GTL project | \$135 | \$131 |
| Gorgon LNG project | \$449 | \$501 |
| | | |
| Consolidated VIEs (in millions, except for percentages) | As of December 31, 2011 | |
| | Total assets | Total liabilities |
| Fasttrax Limited project | \$103 | \$108 |
| Escravos Gas-to-Liquids project | \$326 | \$381 |
| Pearl GTL project | \$153 | \$146 |
| Gorgon LNG project | \$546 | \$607 |

Fasttrax Limited project. In December 2001, the Fasttrax Joint Venture (the "JV") was created to provide to the United Kingdom Ministry of Defense ("MOD") a fleet of new heavy equipment transporters ("HETs") capable of carrying a Challenger II tank. The JV owns, operates and maintains the HET fleet and provides heavy equipment transportation services to the British Army. The JV's entity structure includes a parent entity and its 100%-owned subsidiary, Fasttrax Ltd (the "SPV"). KBR and its partner each own 50% of the parent entity.

The JV's purchase of the assets was funded through the issuance of several series guaranteed secured bonds. The bonds are guaranteed by Ambac Assurance U.K. Ltd under a policy that guarantees the schedule of principal and interest payments to the bond trustee in the event of non-payment by Fasttrax. The total amount of non-recourse project-finance debt of a VIE consolidated by KBR at June 30, 2012, is summarized in the following table and are also reflected on the face of our condensed consolidated balance sheet as "Non-recourse project-finance 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. Assets collateralizing the JV's senior bonds include cash and equivalents of \$23 million and property, plant, and equipment of approximately \$71 million, net of accumulated depreciation of \$48 million as of June 30, 2012.

Consolidated amounts of non-recourse project-finance debt of a VIE

| Millions of Dollars | June 30, 2012 |
|--|------------------|
| Current non-recourse project-finance debt of a variable interest entity | \$10 |
| Noncurrent non-recourse project-finance debt of a variable interest entity | \$83 |

Total non-recourse project-finance debt of a variable interest entity \$93

Escravos 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 in the joint venture and determined that we are the primary beneficiary which is consolidated for financial reporting purposes. There are no consolidated assets that collateralize the joint venture’s obligations. However, at June 30, 2012 and December 31, 2011, the joint venture had approximately \$150 million and \$119 million of cash, respectively, which mainly relate to advanced billings in connection with the joint venture’s obligations under the EPC contract.

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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 was substantially complete as of December 31, 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.

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.

Note 14. Retirement Plans

The components of net periodic benefit cost related to pension benefits for the three and six months ended June 30, 2012 and 2011 were as follows:

| Millions of dollars | Three Months Ended June 30, | | | |
|--|-----------------------------|---------------|---------------|---------------|
| | 2012 | | 2011 | |
| | United States | International | United States | International |
| Components of net periodic benefit cost: | | | | |
| Service cost | \$— | \$— | \$— | \$ 1 |
| Interest cost | 1 | 20 | 1 | 20 |
| Expected return on plan assets | (1) | (23) | (1) | (23) |
| Recognized actuarial loss | — | 6 | 1 | 5 |
| Net periodic benefit cost | \$— | \$ 3 | \$ 1 | \$ 3 |

| Millions of dollars | Six Months Ended June 30, | | | |
|--|---------------------------|---------------|---------------|---------------|
| | 2012 | | 2011 | |
| | United States | International | United States | International |
| Components of net periodic benefit cost: | | | | |
| Service cost | \$— | \$ 1 | \$— | \$ 1 |
| Interest cost | 2 | 40 | 2 | 41 |
| Expected return on plan assets | (2) | (46) | (2) | (47) |
| Recognized actuarial loss | 1 | 12 | 1 | 10 |
| Net periodic benefit cost | \$ 1 | \$ 7 | \$ 1 | \$ 5 |

For the six months ended June 30, 2012, we contributed approximately \$13 million of the \$26 million we currently expect to contribute to our international plans in 2012, and approximately \$2 million of the \$4 million we currently expect to contribute to our domestic plans in 2012.

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 disclose 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 2011 Annual Report on Form 10-K.

Business Environment and Results of Operations

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, refining, biofuels 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.

Capital expenditures in our petroleum and petrochemical markets are driven by global and regional economic growth expectations reflected in a long global spending cycle. The spending cycle is moderated by fluctuations in crude oil prices and chemical feedstock costs including natural gas prices, and is also partially subject to financial shock. The hydrocarbons market in most international regions has improved from the downturn that occurred as a result of the worldwide economic recession. We now see long term growth in environmentally and economically driven energy projects including demand for related licensed process technologies, offshore oil and gas production, LNG, biofuels, motor fuels, chemicals and fertilizers. Upstream and downstream investment plans are advancing in such resource rich areas as the Middle East, Brazil, North Sea and East and West Africa. LNG prospects continue to develop in the Asia-Pacific region, as well as in East Africa and North America as a result of the recent gas discoveries. Each of these trends plays to our particular capability to deliver large projects in remote locations and harsh environments.

Abundant shale gas supplies and resulting low prices in North America are driving renewed interest in petrochemical project investments. Feasibility studies and front-end engineering and design projects continue to grow, reflecting clients' intentions to invest in capital intensive energy projects that utilize our process technologies and EPC project delivery skills.

Infrastructure, Government and Power Markets ("IGP")

A significant portion of our IGP business group's current activities supports the United States' and the United Kingdom's government operations in Iraq, Afghanistan and in other parts of the Middle East region. The logistics support services that we provide to the U.S. government are delivered under our LogCAP IV contract and other competitively bid contracts. As a result of withdrawal of U.S. combat troops in Iraq, we demobilized our operations under the LogCAP III contract effectively ended in December 2011, while continuing to support the US Department of State presence in Iraq under LogCAP IV. Although we have seen some U.S. troop deployments shift within the Middle East region to Afghanistan and other areas under LogCAP IV, we expect the volume of services we provide to the U.S. government in the Middle East to continue to decline over the next few years. As the overall U.S. and U.K. government spending for contingency operations declines, we see increased opportunities for logistics and infrastructure projects in Europe and other parts of the Middle East.

We operate in diverse civil infrastructure markets, including transportation, water and waste treatment and facilities. 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. There has been a general trend of historical under-investment in public infrastructure, particularly related to the quality of water, wastewater, roads and transit, rail, airports, and educational facilities where demand for expanded and improved infrastructure has historically outpaced funding. We have seen increased activity related to these types of projects particularly in the Middle East, however, the global economic recession has caused markets to remain flat in the U.S. and the U.K., which has resulted in delays or slow start-ups to major projects.

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In the industrial sector, we operate in a number of markets, including utility and non-utility power, forest products, advanced manufacturing, mining, minerals and metals and consumer products, both domestically and internationally. Forest products, advanced manufacturing and consumer products are experiencing modest market improvements while the mining, minerals and metals markets are growing driven by global demand for commodities. In the power sector, we serve regulated utilities, power cooperatives, municipalities and various non-regulated providers, primarily in the U.S. and U.K. markets. The power sector continues to be driven by long-term economic and demographic trends and changes in environmental regulations. Projects in the power sector are currently concentrated in emissions control, repowering, renewable power and new gas-fired power generation.

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 and institutional buildings, general industrial and manufacturing. Demand for industrial construction services is increasing markedly in Canada, while the commercial building market shows early signs of improvement.

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 four business groups including the related business units within Hydrocarbons and IGP. The business groups presented are consistent with our reportable segments discussed in Note 5 to our condensed consolidated financial statements. While certain of the business units and product service lines 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. In the first quarter of 2012, we began reporting the Infrastructure and Minerals as separate business units. Prior periods have been conformed to the current presentation.

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

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Three months ended June 30, 2012 compared to three months ended June 30, 2011

Revenue by Business Group

| Millions of dollars | Three Months Ended June 30, | | | |
|--|-----------------------------|---------|---------------|--------|
| | 2012 | 2011 | 2012 vs. 2011 | |
| | | | \$ | % |
| Revenue: (1) | | | | |
| Hydrocarbons: | | | | |
| Gas Monetization | \$809 | \$780 | \$29 | 4 % |
| Oil & Gas | 135 | 134 | 1 | 1 % |
| Downstream | 131 | 146 | (15) | (10)% |
| Technology | 47 | 40 | 7 | 18 % |
| Total Hydrocarbons | 1,122 | 1,100 | 22 | 2 % |
| Infrastructure, Government and Power: | | | | |
| North America Government and Logistics | 173 | 598 | (425) | (71)% |
| International Government, Defence and Support Services | 93 | 98 | (5) | (5)% |
| Infrastructure | 68 | 62 | 6 | 10 % |
| Minerals | 62 | 69 | (7) | (10)% |
| Power and Industrial | 95 | 63 | 32 | 51 % |
| Total IGP | 491 | 890 | (399) | (45)% |
| Services | 425 | 445 | (20) | (4)% |
| Ventures | 15 | 17 | (2) | (12)% |
| Other | 9 | 5 | 4 | 80 % |
| Total Revenue | \$2,062 | \$2,457 | \$(395) | (16)% |

We often participate on larger projects as a joint venture partner and also provide services to the joint venture as a (1) subcontractor. The amount included in our revenue represents our share of the earnings (loss) from unconsolidated joint ventures and revenue from services provided to joint ventures.

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Income (loss) by Business Group

| Millions of dollars | Three Months Ended June 30, | | | |
|--|-----------------------------|-------|---------------|---------|
| | 2012 | 2011 | 2012 vs. 2011 | |
| | | | \$ | % |
| Income (loss): | | | | |
| Hydrocarbons: | | | | |
| Gas Monetization | \$94 | \$76 | \$18 | 24 % |
| Oil & Gas | 38 | 30 | 8 | 27 % |
| Downstream | 13 | 21 | (8) | (38)% |
| Technology | 19 | 18 | 1 | 6 % |
| Total job income | 164 | 145 | 19 | 13 % |
| Divisional overhead | (33) | (24) | (9) | (38)% |
| Total Hydrocarbons | 131 | 121 | 10 | 8 % |
| Infrastructure, Government and Power: | | | | |
| North America Government and Logistics | 5 | 51 | (46) | (90)% |
| International Government, Defence and Support Services | 26 | 33 | (7) | (21)% |
| Infrastructure | 16 | 13 | 3 | 23 % |
| Minerals | 6 | 6 | — | — % |
| Power and Industrial | 10 | 8 | 2 | 25 % |
| Total job income | 63 | 111 | (48) | (43)% |
| Divisional overhead | (35) | (39) | 4 | 10 % |
| Total IGP | 28 | 72 | (44) | (61)% |
| Services: | | | | |
| Job income | 29 | 31 | (2) | (6)% |
| Divisional overhead | (13) | (16) | 3 | 19 % |
| Total Services | 16 | 15 | 1 | 7 % |
| Ventures: | | | | |
| Job income | 10 | 12 | (2) | (17)% |
| Gain on sales of assets | — | 1 | (1) | (100)% |
| Divisional overhead | — | (1) | 1 | 100 % |
| Total Ventures | 10 | 12 | (2) | (17)% |
| Other: | | | | |
| Job income | 5 | 3 | 2 | 67 % |
| Loss on sales of assets | (2) | — | (2) | — % |
| Divisional overhead | (1) | (2) | 1 | 50 % |
| Total Other | 2 | 1 | 1 | 100 % |
| Total business group income | 187 | 221 | (34) | (15)% |
| Unallocated amounts: | | | | |
| Labor costs absorption (expense) income | (6) | 6 | (12) | (200)% |
| Corporate general and administrative expense | (52) | (58) | 6 | 10 % |
| Total operating income | \$129 | \$169 | \$(40) | (24)% |

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Hydrocarbons

Gas Monetization. Revenue from Gas Monetization in the second quarter of 2012 increased \$29 million compared to the second quarter of 2011. Revenue increased due to incremental progress on the Gorgon and Ichthys LNG projects as well as higher subcontractor activity on the Skikda LNG project. Revenue from these projects increased approximately \$211 Million in the aggregate in the second quarter of 2012 compared to the second quarter of 2011. These increases were partially offset by reductions in revenue from GTL projects that were nearing completion.

Job income for the second quarter of 2012 increased \$18 million compared to the same period of the prior year primarily due to the Gorgon LNG, Skikda LNG, and Ichthys LNG projects, partially offset by lower progress on GTL and other projects that were nearing completion in the second quarter of 2012.

Oil & Gas. Oil & Gas revenue increased \$1 million and job income increased \$8 million in the second quarter of 2012 compared to the second quarter of 2011, primarily due to the start of a newly awarded technical service project and higher progress on other existing projects primarily located in the North Sea and Azerbaijan, as well as recognition of approximately \$8 million of license fee revenue for several semi-submersible hulls. These increases were partially offset by completion or near completion of other projects.

Downstream. Downstream revenue and job income decreased by \$15 million and \$8 million in the second quarter of 2012 compared to the same period of the prior year primarily due to the completion of engineering on a refinery project in Africa and lower volumes on projects in the Middle East that are completed or nearing completion in the second quarter of 2012. These decreases were partially offset by increases on recently awarded projects in North America and Saudi Arabia.

Technology. Technology revenue and job income increased by \$7 million and \$1 million in the second quarter of 2012 compared to the same period of the prior year, respectively, primarily due to the progress achieved on a proprietary equipment project in Indonesia, license and engineering projects in Russia, China and U.S. These projects collectively contributed approximately \$14 million to the increase in Technology revenue and approximately \$6 million to the increase in Technology job income. Partially offsetting these increases were decreases in revenue and job income associated with the completion of engineering services on an ammonia project located in Brazil.

Infrastructure, Government and Power (“IGP”)

North American Government and Logistics (“NAGL”). Revenue from our NAGL Operations decreased by \$425 million in the second quarter of 2012 compared to the second quarter of 2011, mainly as a result of the December 2011 completion of operations in Iraq under the LogCAP III contract. We have completed our closeout activities on the LogCAP III contract that were being executed from Kuwait and the U.S. during the second quarter of 2012. Our services in the region have been shifted to the LogCAP IV contract and primarily relate to supporting the U.S. Department of State in Iraq. Job income from NAGL decreased by approximately \$46 million in the second quarter of 2012 compared to the same period in the prior year primarily due to the unfavorable ruling from the U.S. COFC regarding the reasonableness of certain questioned costs associated with dining facility services which resulted in a non-cash, pre-tax charge of \$28 million recorded as a reduction to revenue as well as the completion of operations and closeout activities under the LogCAP III contract. Partially offsetting the decrease was higher job income related to the LogCAP IV contract.

International Government, Defence and Support Services (“IGDSS”). Revenue and job income from IGDSS decreased by approximately \$5 million and \$7 million in the second quarter of 2012 compared to the same period of the prior year. The decrease in revenue and job income was primarily related to reduced scope under a NATO contract in

Afghanistan and lower income from construction activities on the Allenby & Connaught project. These reductions are partially offset by increased activity related to a support services project in Africa, as well as other new project awards.

Infrastructure. Revenue from Infrastructure increased approximately \$6 million in the second quarter of 2012 over the same period of the prior year. Higher activity on various infrastructure projects primarily in Australia and the Middle East increased revenue by approximately \$6 million. Job income from Infrastructure increased \$3 million in the second quarter of 2012 over the same period of the prior year primarily due to higher activity on Australia and Middle East projects.

Minerals. Revenue from Minerals decreased approximately \$7 million and job income was flat in the second quarter of 2012 over the same period of the prior year primarily due to lower activity on existing mining projects.

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Power and Industrial (“P&I”). Revenue and job income from P&I increased \$32 million and \$2 million in the second quarter of 2012 over the same period in the prior year primarily due to increased volume and progress on projects including the coal gasification project in Mississippi and a waste-to-energy expansion project in Florida, that were awarded in late 2011 and early 2012. This growth was partially offset by a decline in volume and job income from projects which were completed or are approaching completion.

Services

Services revenue in the second quarter of 2012 decreased by \$20 million compared to the same period of the prior year. This decrease is primarily driven by lower revenue of \$62 million from our Building Group, primarily due to the completion of several large hospital projects. Also, revenue decreased \$32 million for our Industrial Services group, primarily due to the completion of a major turnaround project in 2011. These decreases were partially offset by increases in our U.S. Construction Group of \$64 million and \$10 million in our Canada operations, due to several new awards and increased activity on new projects.

Job income decreased by approximately \$2 million in the second quarter of 2012 compared to the same period of the prior year. This was due to the decline in Building Group and Industrial Services activity from the completion of several projects or projects being near completion. This decline was partially offset by increased activity in our U.S. Construction and other international operations.

Ventures

Our Ventures operations consist of investments in joint ventures accounted for under the equity method of accounting, net of tax. Ventures revenue was \$15 million and job income was \$10 million in the second quarter of 2012 compared to revenue of \$17 million and job income of \$12 million in the second quarter of 2011. The decrease in revenue and job income was attributable to lower ammonia prices as well as lower sales volume of ammonia related to the EBIC ammonia plant in Egypt.

Unallocated amounts

Labor cost absorption represents costs incurred by our central labor and resource groups net of the amounts charged to the operating business units. Labor cost absorption expense was \$6 million in the second quarter of 2012 compared to labor cost absorption income of \$6 million, a decrease of \$12 million over the same period of the prior year, primarily due to lower chargeability and utilization in several of our engineering offices compared to the second quarter of 2011.

General and administrative expense was \$52 million in the second quarter of 2012 compared to \$58 million in the second quarter of 2011. The decrease is primarily related to reduced incentive costs and payroll as well as lower costs associated with the implementation of an enterprise resource planning system.

Services Segment Revenues by Market Sector

The Services business segment provides construction management 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 the keys to our success in delivering construction and maintenance services. Accordingly, the Services business segment focuses on these key success factors. The analysis below is supplementally provided to present the revenue generated by the Services segment based on the markets served, some of which are the same sectors served by our other business segments. The perspective highlights the markets served by

our Services segment.

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| Millions of dollars | Three Months Ended June 30, 2012 | | |
|--|----------------------------------|------------------|---------------------------------|
| | Business Unit Revenue | Services Revenue | Total Revenue by Market Sectors |
| Hydrocarbons: | | | |
| Gas Monetization | \$809 | \$— | \$809 |
| Oil & Gas | 135 | 77 | 212 |
| Downstream | 131 | 98 | 229 |
| Technology | 47 | — | 47 |
| Total Hydrocarbons | 1,122 | 175 | 1,297 |
| Infrastructure, Government and Power: | | | |
| North America Government and Logistics | 173 | 15 | 188 |
| International Government, Defence and Support Services | 93 | — | 93 |
| Infrastructure | 68 | — | 68 |
| Minerals | 62 | — | 62 |
| Power and Industrial | 95 | 235 | 330 |
| Total IGP | 491 | 250 | 741 |
| Services | 425 | (425) | — |
| Other | 24 | — | 24 |
| Total KBR Revenue | \$2,062 | \$— | \$2,062 |

| Millions of dollars | Three Months Ended June, 2011 | | |
|--|-------------------------------|------------------|---------------------------------|
| | Business Unit Revenue | Services Revenue | Total Revenue by Market Sectors |
| Hydrocarbons: | | | |
| Gas Monetization | \$780 | \$— | \$780 |
| Oil & Gas | 134 | 54 | 188 |
| Downstream | 146 | 109 | 255 |
| Technology | 40 | — | 40 |
| Total Hydrocarbons | 1,100 | 163 | 1,263 |
| Infrastructure, Government and Power: | | | |
| North America Government and Logistics | 598 | 17 | 615 |
| International Government, Defence and Support Services | 98 | — | 98 |
| Infrastructure | 62 | — | 62 |
| Minerals | 69 | — | 69 |
| Power and Industrial | 63 | 265 | 328 |
| Total IGP | 890 | 282 | 1,172 |
| Services | 445 | (445) | — |
| Other | 22 | — | 22 |
| Total KBR Revenue | \$2,457 | \$— | \$2,457 |

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Non-operating items

Net interest expense was \$2 million in the second quarter of 2012 and \$5 million in the second quarter of 2011. The reduction in expense is primarily associated with favorable terms of our new Credit Agreement. Interest income was substantially the same in both periods.

Provision for income taxes was \$19 million in the second quarter of 2012 and \$39 million in the second quarter of 2011. Our effective tax rate was approximately 14% in the second quarter of 2012 and 24% in the second quarter of 2011. The U.S. statutory tax rate for all periods was 35%. Excluding discrete items, our effective tax rate was approximately 30% for the second quarter of 2012 and was lower than the U.S. statutory rate due to favorable tax rate differentials on foreign earnings and lower tax expense on foreign income from unincorporated joint ventures. Our effective tax rate excluding discrete items increased during the second quarter of 2012 by approximately 3% as a result of incremental income taxes on certain undistributed foreign earnings in Australia that were previously deemed to be permanently reinvested. In the second quarter of 2012, we recognized discrete net tax benefits of approximately \$19 million including benefits primarily related to the recognition of previously unrecognized tax benefits related to tax positions taken in prior years due to statute expirations on certain domestic tax matters and other reductions to foreign tax exposures.

Our effective tax rate for the three months ended June 30, 2011 was lower than the U.S. statutory rate of 35% due to favorable tax rate differentials on foreign earnings and lower tax expense on foreign income from unincorporated joint ventures. In addition, we recognized discrete tax benefits from the release of a tax reserve due to expiration of a statute in the second quarter of 2011.

Net income attributable to noncontrolling interests was \$8 million and \$27 million in the second quarter of 2012 and 2011, respectively. The decrease primarily resulted from higher costs on an LNG project executed by joint ventures. Additionally, in the second quarter of 2011, noncontrolling interests included cumulative contract-to-date impacts related to the effects of foreign currency and tax-related transfer pricing in our Gas Monetization business unit that did not recur in the second quarter of 2012.

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Six months ended June 30, 2012 compared to six months ended June 30, 2011

Revenue by Business Unit

| Millions of dollars | Six Months Ended June 30, | | | |
|--|---------------------------|---------|---------------|--------|
| | 2012 | 2011 | 2012 vs. 2011 | |
| | | | \$ | % |
| Revenue: (1) | | | | |
| Hydrocarbons: | | | | |
| Gas Monetization | \$1,614 | \$1,526 | \$88 | 6 % |
| Oil & Gas | 256 | 255 | 1 | — % |
| Downstream | 272 | 282 | (10) | (4)% |
| Technology | 96 | 84 | 12 | 14 % |
| Total Hydrocarbons | 2,238 | 2,147 | 91 | 4 % |
| Infrastructure, Government and Power: | | | | |
| North America Government and Logistics | 382 | 1,203 | (821) | (68)% |
| International Government, Defense and Support Services | 191 | 167 | 24 | 14 % |
| Infrastructure | 132 | 125 | 7 | 6 % |
| Minerals | 125 | 126 | (1) | (1)% |
| Power and Industrial | 179 | 124 | 55 | 44 % |
| Total IGP | 1,009 | 1,745 | (736) | (42)% |
| Services | 773 | 842 | (69) | (8)% |
| Ventures | 29 | 34 | (5) | (15)% |
| Other | 14 | 10 | 4 | 40 % |
| Total revenue | \$4,063 | \$4,778 | \$(715) | (15)% |

We often participate on larger projects as a joint venture partner and also provide services to the joint venture as a (1) subcontractor. The amount included in our revenue represents our share of the earnings (loss) from unconsolidated joint ventures and revenue from services provided to joint ventures.

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Income (loss) by Business Unit

| Millions of dollars | Six Months Ended June 30, | | | |
|--|---------------------------|--------|---------------|---------|
| | 2012 | 2011 | 2012 vs. 2011 | |
| | | | \$ | % |
| Income (loss): | | | | |
| Hydrocarbons: | | | | |
| Gas Monetization | \$173 | \$140 | \$33 | 24 % |
| Oil & Gas | 61 | 54 | 7 | 13 % |
| Downstream | 27 | 40 | (13) | (33)% |
| Technology | 39 | 36 | 3 | 8 % |
| Total job income | 300 | 270 | 30 | 11 % |
| Gain on sales of assets | — | 1 | (1) | (100)% |
| Divisional overhead | (64) | (51) | (13) | (25)% |
| Total Hydrocarbons | 236 | 220 | 16 | 7 % |
| Infrastructure, Government and Power: | | | | |
| North America Government and Logistics | 20 | 106 | (86) | (81)% |
| International Government, Defence and Support Services | 62 | 50 | 12 | 24 % |
| Infrastructure | 31 | 35 | (4) | (11)% |
| Minerals | 5 | 13 | (8) | (62)% |
| Power and Industrial | 20 | 14 | 6 | 43 % |
| Total job income | 138 | 218 | (80) | (37)% |
| Gain on sales of assets | 2 | — | 2 | — % |
| Divisional overhead | (73) | (85) | 12 | 14 % |
| Total IGP | 67 | 133 | (66) | (50)% |
| Services: | | | | |
| Job income | 57 | 63 | (6) | (10)% |
| Divisional overhead | (29) | (35) | 6 | 17 % |
| Total Services | 28 | 28 | — | — % |
| Ventures: | | | | |
| Job income (loss) | 18 | 23 | (5) | (22)% |
| Gain on sales of assets | — | 1 | (1) | (100)% |
| Divisional overhead | (1) | (2) | 1 | 50 % |
| Total Ventures | 17 | 22 | (5) | (23)% |
| Other: | | | | |
| Job income | 9 | 7 | 2 | 29 % |
| Divisional overhead | (4) | (4) | — | — % |
| Total Other | 5 | 3 | 2 | 67 % |
| Total business group income | \$353 | \$406 | \$(53) | (13)% |
| Unallocated amounts: | | | | |
| Labor costs absorption income (expense) | (5) | 9 | (14) | (156)% |
| Corporate general and administrative | (107) | (102) | (5) | (5)% |
| Total operating income | \$241 | \$313 | \$(72) | (23)% |

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Hydrocarbons Business Group

Gas Monetization. Revenues in the first six months of 2012 in Gas Monetization increased by \$88 million compared to 2011 which was primarily due to increased activity from the Gorgon LNG and Skikda LNG projects. Revenue from these projects increased approximately \$293 million in the aggregate compared to the first six months of 2011 primarily as a result of increased progress. Revenue further increased in the first six months of 2012 by approximately \$23 million as a result of increased activity on the newly awarded Ichthys LNG project. Partially offsetting the 2012 increases in Gas Monetization revenues are declines in revenues of approximately \$242 million in the aggregate due to lower activity and project completions on the Escravos GTL and Pearl LNG projects and the completion of the FEED phase of the Ichthys LNG project and other projects in 2011.

Gas Monetization job income increased approximately \$33 million in the first six months of 2012 compared to the same period of the prior year. Job income increased \$56 million as a combined result of increased activity from the Gorgon LNG and Skikda LNG projects. Partially offsetting these increases in job income were decreases of approximately \$21 million due to lower activity and project completions on the Escravos GTL and Pearl GTL projects and the completion of the FEED phase of the Ichthys LNG project and other projects in 2011. Included in 2011 was \$8 million from the sale of our interest in an unconsolidated joint venture that did not recur in 2012.

Oil & Gas. Revenues from Oil & Gas increased by approximately \$1 million and job income increased by \$7 million in the first six months of 2012 as compared to the first six months of 2011, primarily due to a newly awarded technical service project, higher progress on existing projects primarily located in the North Sea and Azerbaijan, as well as the recognition of approximately \$8 million in license fee revenue for several semi-submersible hulls. These increases were partially offset by completion or near completion of other projects.

Downstream. Downstream revenue and job income in the first six months of 2012 decreased by \$10 million and \$13 million, respectively over the same period of the prior year, primarily due to the completion of engineering on a refinery project in Africa and lower volumes on projects in the Middle East in the first six months of 2012, partially offset by increases on newly awarded projects in North America and Saudi Arabia.

Technology. Technology revenue and job income in the first six months of 2012 increased \$12 million and \$3 million over the same period of the prior year, respectively, primarily due to the progress achieved on a proprietary equipment projects in Brazil and Indonesia, and license and engineering projects in Egypt, China, U.S. and Russia which collectively contributed approximately \$37 million to the increase in Technology revenue and approximately \$15 million to the increase in Technology job income. Partially offsetting these increases were decreases in revenue and job income associated with the completion of engineering services on an ammonia project located in Brazil and the completion of engineering services on other projects.

Infrastructure, Government and Power Business Group

North America Government and Logistics (“NAGL”). Revenue from our NAGL Operations decreased approximately \$821 million in the first six months of 2012 over the same period in the prior year, mainly as a result of the December 2011 completion of operations in Iraq under the LogCAP III contract. We have completed our closeout activities on the LogCAP III contract that were being executed from Kuwait and the U.S. during the second quarter of 2012. Our services in the region have been shifted to the LogCAP IV contract and primarily relate to supporting the U.S. Department of State in Iraq. Job income from NAGL decreased by approximately \$86 million in the first six months of 2012 compared to the same period in the prior year primarily due to the unfavorable ruling from the U.S. COFC regarding the reasonableness of certain questioned costs associated with dining facility services which resulted in a non-cash, pre-tax charge of \$28 million recorded as a reduction to revenue as well as the completion of operations and

closeout activities under the LogCAP III contract. Partially offsetting the decrease was higher job income related to the LogCAP IV contract.

International Government, Defense and Support Services (“IGDSS”). Revenue and job income from IGDSS increased approximately \$24 million and \$12 million, respectively, in the first six months of 2012 compared to the same period of the prior year. These increases are primarily related to increased activity under a NATO contract in Afghanistan, increased activity related to a support services project in Africa, higher margins from construction activities on the Allenby & Connaught project, as well as project close-out activities and other new project awards.

Infrastructure. Revenue from Infrastructure increased approximately \$7 million in the first six months of 2012 over the same period of the prior year primarily due to increased activity on various projects primarily in Australia and the Middle East.

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Infrastructure projects primarily in Australia and the Middle East increased by approximately \$18 million and was partially offset by the absence of a project incentive earned on a transport project recognized in the first six months of 2011. Job income decreased \$4 million in the first six months of 2011 over the same period of the prior year primarily as a result of the absence of a project incentive recognized in the first six months of 2011 which did not recur in 2012, which was partially offset by an increase in job income due to higher activity on projects in Australia and the Middle East.

Minerals. Revenue and job income from Minerals decreased approximately \$1 million and \$8 million in the first six months of 2012 over the same period of the prior year primarily. Revenue decreased due to lower activity on mining projects. Job income declined primarily as a result of increased estimated costs to complete an EPC project in North America.

Power and Industrial (“P&I”). Revenue and job income from P&I increased approximately \$55 million and \$6 million in the first six months of 2012 over the same period in the prior year primarily due to increased volume and progress on projects including the coal gasification project in Mississippi and a waste-to-energy expansion project in Florida, that were awarded in late 2011 and early 2012. This growth was partially offset by a decline in volume and job income from projects which were completed or are approaching completion.

Services

Services revenue in the first six months of 2012 decreased by \$69 million as compared to the same period of the prior year. This decrease is primarily driven by lower revenue of \$100 million from our Building Group, primarily due to the completion of several large hospital projects. Also, revenue decreased \$43 million for our Industrial Services group, primarily due to the completion of a major turnaround project in 2011. These decreases were partially offset by increases in our U.S. Construction Group of \$56 million and \$23 million in our Canada operations, due to several new awards and increased activity on new projects.

Job income decreased by approximately \$6 million in the first six months of 2012 as compared to the same period of the prior year. This was due to the decline in Building Group and Industrial Services activity from the completion of several projects or projects being near completion. This decline was partially offset by increased activity in our U.S. Construction and international operations.

Ventures

Ventures revenue and job income both decreased \$5 million as compared to the same period of the prior year, and were primarily attributable to lower ammonia prices and noncash hedge accounting adjustments related to the EBIC ammonia plant in Egypt.

Unallocated amounts

Labor cost absorption. 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 was \$5 million for the first six months of 2012 as compared to income of \$9 million in the first six months of 2011 primarily due to lower chargeability and utilization in several of our engineering offices.

General and Administrative expense. General and administrative expense was \$107 million in the first six months of 2012 compared with \$102 million for the same period in the prior year. General and administrative expense increased \$5 million in the first six months of 2012 largely due to increased costs associated with enterprise resource planning implementation efforts.

Services Segment Revenues by Market Sector

The Services business segment provides construction and maintenance services to clients in a number of markets. We believe customer focus, attention to highly productive delivery, and a diverse market presence 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 of our reportable business segments by market. The revenues managed by the Services business segment have been allocated based on the markets served by the Services business segment. The perspective highlights the markets served by our Services segment.

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| Millions of dollars | Six Months Ended June 30, 2012 | | |
|---|--------------------------------|------------------|---------------------------------|
| | Business Unit Revenue | Services Revenue | Total Revenue by Market Sectors |
| Hydrocarbons: | | | |
| Gas Monetization | \$1,614 | \$— | \$1,614 |
| Oil & Gas | 256 | 118 | 374 |
| Downstream | 272 | 183 | 455 |
| Technology | 96 | — | 96 |
| Total Hydrocarbons | 2,238 | 301 | 2,539 |
| Infrastructure, Government and Power (“IGP”): | | | |
| North America Government and Logistics | 382 | 28 | 410 |
| International Government Defence and Support Services | 191 | — | 191 |
| Infrastructure | 132 | — | 132 |
| Minerals | 125 | — | 125 |
| Power and Industrial | 179 | 444 | 623 |
| Total IGP | 1,009 | 472 | 1,481 |
| Services | 773 | (773) | — |
| Other | 43 | — | 43 |
| Total KBR Revenue | \$4,063 | \$— | \$4,063 |

| Millions of dollars | Six Months Ended June 30, 2011 | | |
|---|--------------------------------|------------------------|-------------------------|
| | Business Unit Revenue | Allocation of Services | Total Allocated Revenue |
| Hydrocarbons: | | | |
| Gas Monetization | \$1,526 | \$— | \$1,526 |
| Oil & Gas | 255 | 89 | 344 |
| Downstream | 282 | 202 | 484 |
| Technology | 84 | — | 84 |
| Total Hydrocarbons | 2,147 | 291 | 2,438 |
| Infrastructure, Government and Power (“IGP”): | | | |
| North America Government and Logistics | 1,203 | 46 | 1,249 |
| International Government Defense and Support Services | 167 | — | 167 |
| Infrastructure | 125 | — | 125 |
| Minerals | 126 | — | 126 |
| Power and Industrial | 124 | 505 | 629 |
| Total IGP | 1,745 | 551 | 2,296 |
| Services | 842 | (842) | — |
| Other | 44 | — | 44 |
| Total KBR Revenue | \$4,778 | \$— | \$4,778 |

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Non-operating items

Net interest expense was \$4 million in the first six months of 2012 and \$10 million in the first six months of 2011. The reduction in expense is primarily associated with favorable terms of our new Credit Agreement. Interest income was substantially the same in both periods.

Provision for income taxes was \$28 million in the first six months of 2012 and \$61 million in the first six months of 2011. Our effective tax rate was approximately 12% for the six months ended of 2012 and 20% for the six months of 2011. Our effective tax rate excluding discrete items for the first six months of 2012 was lower than our statutory rate of 35% primarily due to due to favorable tax rate differentials on foreign earnings and lower tax expense on foreign income from unincorporated joint ventures. In the first six months of 2012, we also recognized discrete net tax benefits of approximately \$39 million including benefits primarily related to the recognition of previously unrecognized tax benefits related to tax positions taken in prior years due to progress in resolving transfer pricing matters with certain taxing jurisdictions, statute expirations on certain domestic tax matters and other reductions to foreign tax exposures as well as discrete tax benefits related to deductions arising from an unconsolidated joint venture in Australia.

Our effective tax rate excluding discrete items for the first six months of 2011 was lower than our statutory rate of 35% primarily due to favorable tax rate differentials on foreign earnings and lower tax expense on foreign income from unincorporated joint ventures. In addition, we recognized discrete tax benefits in the first quarter of 2011 from the execution of tax planning strategies, the release of a tax reserve due to expiration of a statute and from the reduction of deferred tax liabilities as a result of changes in estimates of the tax liabilities related to the planned liquidation of an Australian unconsolidated joint venture.

Net income attributable to noncontrolling interests was \$15 million in the first six months of 2012 and \$39 million in the first six months of 2011. The decrease primarily resulted from higher costs on an LNG project executed by joint ventures. Additionally, in the first six months of 2011, noncontrolling interests included cumulative contract-to-date impacts related to the effects of foreign currency and tax-related transfer pricing in our Gas Monetization business unit that did not recur in the first six months of 2012.

Backlog

Backlog represents the dollar amount of revenue we expect to realize in the future as a result of performing work on contracts awarded to us. We generally include total expected revenue in backlog when a contract is awarded and/or the scope is definitized. In many instances, arrangements included in backlog are complex, nonrepetitive in nature, and may fluctuate depending on estimated revenue and contract duration. 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 certain long-term service contracts with a defined contract term, such as those associated with privately financed projects, the amount included in backlog is limited to five years.

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 \$5.6 billion as of June 30, 2012 and \$1.7 billion as of December 31, 2011. We 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 \$2.9 billion as of June 30, 2012 and \$3.4 billion as of December 31, 2011. All backlog is attributable to firm orders as of June 30, 2012 and December 31, 2011. Backlog attributable to unfunded government orders was \$124 million at June 30, 2012 and \$395 million as of December 31, 2011.

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Backlog

| Millions of dollars | June 30, 2012 | December 31, 2011 |
|--|------------------|----------------------|
| Hydrocarbons: | | |
| Gas Monetization | \$8,282 | \$3,880 |
| Oil & Gas | 219 | 289 |
| Downstream | 704 | 546 |
| Technology | 236 | 258 |
| Total Hydrocarbons | 9,441 | 4,973 |
| Infrastructure, Government and Power (“IGP”): | | |
| North America Government and Logistics | 552 | 899 |
| International Government, Defence and Support Services | 941 | 1,086 |
| Infrastructure | 233 | 265 |
| Minerals | 142 | 237 |
| Power and Industrial | 710 | 777 |
| Total IGP | 2,578 | 3,264 |
| Services | 2,296 | 1,766 |
| Ventures | 923 | 928 |
| Total backlog | \$15,238 | \$10,931 |

We estimate that as of June 30, 2012, 42% of our backlog will be executed within one year. As of June 30, 2012, 40% of our backlog was attributable to fixed-price contracts and 60% 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 backlog increased approximately \$4.5 billion due to the award of the Ichthys LNG project in Gas Monetization of approximately \$5.6 billion and was partially offset by \$1.3 billion of work performed on existing projects in Hydrocarbons. IGP backlog decreased by \$686 million primarily as a result of work performed on existing projects across all IGP business units. Services backlog increased \$530 million as new awards of \$1.3 billion primarily in our Building Group and Canada product lines were offset by work performed of approximately \$756 million on various construction projects in the U.S. and Canada.

Liquidity and Capital Resources

Cash and equivalents totaled \$824 million at June 30, 2012 and \$966 million at December 31, 2011, which included \$251 million and \$244 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. We expect to use joint venture cash for project costs and distribution of profits.

Cash generated from operations is our primary source of operating liquidity. Our cash balances are held in numerous locations throughout the world, the majority of which are outside of the U.S. Of the \$824 million in cash and equivalents held at June 30, 2012, approximately \$492 million is held in foreign subsidiaries. Demands on our domestic cash have increased as a result of our strategic initiatives including business acquisitions and share repurchases. We fund these initiatives through our existing cash and investment balances and internally generated cash. When appropriate, we may access offshore cash and equivalents. Where local regulations limit an efficient intercompany transfer of amounts held outside of the U.S., we will continue to utilize these funds for foreign activities

primarily associated with project execution. We believe that internally generated cash flows are sufficient to support our day-to-day business operations, both domestically and internationally, for at least the next 12 months.

With the exception of earnings from operations in Australia, we generally do not provide for U.S. federal and state income taxes on the accumulated but undistributed earnings of non-United States subsidiaries. Taxes are provided as necessary with respect

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to earnings that are considered not permanently reinvested. During the second quarter of 2012 we provided for U.S. federal and state income taxes on 50% of the earnings of our Australian operations during six month period ending June 30, 2012. We will continue to provide for U.S. federal and state taxes on this portion of the earnings of our Australian operations as we no longer intend to permanently reinvest these amounts. For all other non-U.S. subsidiaries, no U.S. taxes are provided because such earnings are intended to be reinvested indefinitely to finance foreign activities. These accumulated but undistributed foreign earnings could be subject to additional tax if remitted, or deemed remitted, as a dividend. Determination of the amount of unrecognized deferred U.S. income tax liability is not practicable; however, the potential foreign tax credits associated with the deferred income would be available to reduce the resulting U.S. tax liabilities. As of June 30, 2012, foreign cash and equivalents that could be subject to additional U.S. income taxes and withholding taxes payable to the various foreign jurisdictions if remitted, or deemed remitted, as a dividend, excluding cash held by consolidated joint ventures, is estimated to be approximately \$398 million.

Cash Flow Activities

| Millions of dollars | Six Months Ended June 30, | |
|---|---------------------------|----------|
| | 2012 | 2011 |
| Cash flows provided by (used in) operating activities | \$ (55) |) \$ 223 |
| Cash flows used in investing activities | (31) |) (58) |
| Cash flows used in financing activities | (49) |) (248) |
| Effect of exchange rate changes on cash | (7) |) 9 |
| Decrease in cash and equivalents | \$(142) |) \$(74) |

Operating activities. Cash used in operations totaled \$55 million in the first six months of 2012 and was driven primarily by the timing of working capital requirements on several large projects. In addition, we contributed approximately \$15 million to our pension funds during the first six months of 2012.

Cash provided by operations totaled \$223 million in the first six months of 2011 and was driven primarily by strong performance and collections of advances and distributions of earnings from unconsolidated affiliates. Cash paid for income taxes, net of refunds, was approximately \$92 million for the first six months of 2011. Additionally, we contributed approximately \$53 million to our pension funds during the first six months of 2011 including a one-time contribution of approximately \$39 million which we had previously agreed with the trustees of one of our international plans.

Investing activities. Cash used in investing activities in the first six months of 2012 totaled \$31 million which was primarily due to capital expenditures of \$33 million associated with information technology projects and leasehold improvements.

Cash used in investing activities in the first six months of 2011 totaled \$58 million which was primarily due to capital expenditures of \$47 million primarily related to information technology projects and leasehold improvements. Additionally, we made investments totaling \$11 million in an equity method joint venture associated with the lease extension of our corporate headquarters.

Financing activities. Cash used in financing activities in the first six months of 2012 totaled \$49 million and included \$25 million for the repurchase of common stock, \$15 million for dividend payments to common shareholders, \$10 million for principal payments on other long-term borrowings consisting primarily of non-recourse debt of the Fasttrax VIE and computer software purchases financed in 2010.

Cash used in financing activities in the first six months of 2011 totaled \$248 million and included \$164 million of payments to acquire the noncontrolling interest in MWKL, \$46 million related to distributions to owners of noncontrolling interests in several of our consolidated joint ventures, \$37 million for the repurchase of approximately 1 million shares of our common stock, \$15 million for dividend payments to common shareholders, and \$10 million for principal payments on other long-term borrowings consisting primarily of non-recourse debt of the Fasttrax VIE and computer software purchases financed in 2010. These payments were partially offset by a return of cash of approximately \$16 million used to collateralize standby letters of credit.

Future sources of cash. Future sources of cash include cash flows from operations, including cash advances from our clients, cash derived from working capital management and advances under our Credit Agreement.

Future uses of cash. Future uses of cash will primarily relate to working capital requirements, capital expenditures and acquisitions. In addition, we will use cash to fund pension obligations, payments under operating leases, cash dividends, share

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repurchases and various other obligations as they arise. Our capital expenditures will be focused primarily on information technology, real estate, facilities and equipment.

Credit Agreement

On December 2, 2011, we entered into a \$1 billion, five-year unsecured revolving credit agreement (the "Credit Agreement") with a syndicate of international banks, replacing the three-year unsecured revolving credit agreement, dated November 3, 2009 (the "Prior Credit Agreement") which terminated upon closing of the Credit Agreement. The Credit Agreement expires in December 2016 and may be used for working capital, the issuance of letters of credit, and other general corporate purposes. Amounts drawn under the Credit Agreement will bear interest at variable rates, per annum, based either on (i) the London interbank offered rate ("LIBOR") plus an applicable margin of 1.50% to 1.75%, or (ii) a base rate plus an applicable margin of 0.50% to 0.75%, with the base rate being equal to the highest of (a) reference bank's publicly announced base rate, (b) the Federal Funds Rate plus 0.5%, or (c) LIBOR plus 1%. The amount of the applicable margin to be applied will be determined by the Company's ratio of consolidated debt to consolidated EBITDA for the prior four fiscal quarters, as defined in the Credit Agreement. The Credit Agreement provides for fees on letters of credit issued under the Credit Agreement at a rate equal to the applicable margin for LIBOR-based loans, except for performance letters of credit, which are priced at 50% of such applicable margin. KBR pays a 0.15% issuance fee on the face amount of a letter of credit at issuance. KBR also pays a commitment fee of 0.25%, per annum, on any unused portion of the commitment under the Credit Agreement. As of June 30, 2012, there were \$219 million in letters of credit and no advances outstanding.

The Credit Agreement contains customary covenants similar to the Prior Credit Agreement which include financial covenants requiring maintenance of a ratio of consolidated debt to consolidated EBITDA not greater than 3.5 to 1 and a minimum consolidated net worth of \$2 billion plus 50% of consolidated net income for each quarter beginning December 31, 2011, and 100% of any increase in shareholders' equity attributable to the sale of equity interests.

The Credit Agreement contains a number of other covenants restricting, among other things, our ability to incur additional liens and indebtedness, enter into asset sales, repurchase our equity shares and make certain types of investments. Our subsidiaries are restricted from incurring indebtedness, however, they are permitted to incur indebtedness as it relates to purchase money obligations, capitalized leases, 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 any time outstanding. Additionally, our subsidiaries may incur unsecured indebtedness not to exceed \$200 million in aggregate outstanding principal amount at any time. We are also permitted to repurchase our equity shares, provided that no such repurchases shall be made from proceeds borrowed under the Credit Agreement, and that the aggregate purchase price and dividends paid after December 2, 2011, does not to exceed the Distribution Cap (equal to the sum of \$750 million plus the lesser of (i) \$400 million and (ii) the amount received by us in connection with the arbitration and subsequent litigation of the PEMEX contracts as discussed in Note 8 to our condensed consolidated financial statements). At June 30, 2012, the remaining availability under the Distribution Cap was approximately \$695 million.

Currently, we do not believe we have any significant exposure to the ongoing European debt crisis through our banking relationships. Although we maintain banking relationships with several U.K. and continental European banks, very few banks are located in the more economically distressed nations within the European Union, such as Greece, Ireland, Italy, Portugal or Spain.

Nonrecourse Project Finance Debt

Fasttrax Limited, a joint venture in which we indirectly own a 50% equity interest with an unrelated partner, was awarded a contract in 2001 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 of bonds secured by the assets of Fasttrax Limited totaling approximately £84.9 million and are non-recourse to KBR and its partner including £12.2 million which was replaced when the shareholders funded combined equity and subordinated debt of approximately £12.2 million. The bonds are guaranteed by Ambac Assurance UK Ltd under a policy that guarantees the schedule of the principal and interest payments to the bond trustee in the event of non-payment by Fasttrax Limited.

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

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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, 2012 through 2016 totals £6 million in each year and £33 million thereafter. In accordance with FASB ASC 810 our condensed consolidated financial statements for three months ended June 30, 2012, 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. For additional information see Note 13 of our condensed consolidated financial statements.

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, surety bonds or guarantees to our customers. Letters of credit are provided to certain customers and counter-parties in the ordinary course of business as credit support for contractual performance guarantees, advanced payments received from customers and future funding commitments. We have approximately \$2 billion in committed and uncommitted lines of credit to support the issuance of letters of credit at June 30, 2012. We had utilized \$682 million of our line of credit capacity. Surety bonds are also posted under the terms of certain contracts to guarantee our performance. The letters of credit outstanding included \$219 million issued under our Credit Agreement and \$462 million issued under uncommitted bank lines at June 30, 2012. Of the total letters of credit outstanding, \$280 million relate to our joint venture operations and \$9 million of the letters of credit have terms that could entitle a bank to require additional cash collateralization on demand. As the need arises, future projects will be supported by letters of credit issued under our Credit Agreement or other lines of credit arranged on a bilateral, syndicated or other basis. We believe we have adequate letter of credit capacity under our Credit Agreement and bilateral lines of credit to support our operations for the next twelve months.

Other obligations. As of June 30, 2012, we had commitments to provide funds to our privately financed projects of \$8 million, primarily related to future equity funding on our Allenby and Connaught project coming due within one year. Our commitments to fund our privately financed projects are supported by letters of credit as described above.

Other factors affecting liquidity

Percentage-of-completion contracts. As of June 30, 2012, probable unapproved claims were approximately \$138 million and included claims associated with the reimbursable portion of an EPC contract to construct an LNG facility for which we have recognized additional contract revenue totaling \$111 million. The contract claims on this project represent incremental subcontractor costs incurred and we believe we have legal entitlement to recover these costs from the customer under the terms of the EPC contract. If we are unable to settle the claim(s) with the customer, we intend to pursue recovery through other dispute resolution procedures. The claims related to this EPC contract have been recorded as a current asset in "Unbilled receivables on uncompleted contracts" in our condensed consolidated balance sheet as of June 30, 2012.

Government claims. Included in receivables in our condensed consolidated balance sheets are unapproved claims for costs incurred under various government contracts totaling \$204 million at June 30, 2012, of which \$105 million is included in "Accounts receivable" and \$99 million is included in "Unbilled receivables on uncompleted contracts." Unapproved claims relate to contracts where our costs have exceeded the customer's funded value of the task order. The \$105 million of unapproved claims included in Accounts receivable results primarily from de-obligated funding on certain task orders that were also subject to Form 1's relating to certain DCAA audit issues discussed above. 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 \$99 million primarily represents 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 June 30, 2012, are considered to be probable of collection and have been previously 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

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negotiating claims and closing out the contract. Based upon our evaluation of our performance and other legal analysis, we have not accrued for possible liquidated damages related to several projects totaling \$8 million at June 30, 2012 and \$11 million at December 31, 2011 (including amounts related to our share of unconsolidated subsidiaries), that we could incur based upon completing the projects as currently forecasted.

Transactions with Former Parent

Information related to transactions with our former parent is described in Note 9 to the condensed consolidated financial statements and in Managements' Discussion and Analysis of Financial Condition and Results of Operations – Transactions with Former Parent and the information discussed therein is incorporated herein.

Legal Proceedings

Information related to various commitments and contingencies is described in Notes 7 and 8 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 June 30, 2012 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.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Information related to various commitments and contingencies is described in Notes 7 and 8 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

We have updated certain risk factors affecting our business since those presented in our Annual Report on Form 10-K, Part I, Item 1A, for the fiscal year ended December 31, 2011. Except for the risk factors updated, there have been no material changes in our assessment of our risk factors from those set forth in our Annual Report on Form 10-K, which is incorporated herein by reference, for the year ended December 31, 2011. Our updated risk factors are included below.

We rely on information technology systems to conduct our business, and disruption, failure or security breaches of these systems could adversely affect our business and results of operations.

We rely heavily on information technology (IT) systems in order to achieve our business objectives. We also rely upon industry accepted security measures and technology to securely maintain confidential and proprietary information maintained on our IT systems. However, our portfolio of hardware and software products, solutions and services and our enterprise IT systems may be vulnerable to damage or disruption caused by circumstances beyond our control such as catastrophic events, power outages, natural disasters, computer system or network failures, computer viruses, cyber attacks or other malicious software programs. The failure or disruption of our IT systems to perform as anticipated for any reason could disrupt our business and result in decreased performance, significant remediation costs, transaction errors, loss of data, processing inefficiencies, downtime, litigation, and the loss of suppliers or customers. A significant disruption or failure could have a material adverse effect on our business operations, financial performance and financial condition. We have experienced limited and infrequent security threats, none of which we considered to be significant to our business or results of operations.

A portion of our revenues is generated by large, recurring business from certain significant customers. A loss, cancellation or delay in projects by our customers in the future could negatively affect our revenues.

We provide services to a diverse customer base, including international and national oil and gas companies, independent refiners, petrochemical producers, fertilizer producers and domestic and foreign governments. Revenue from the United States government, which was derived almost entirely from our IGP business group, totaled \$2.2 billion, or 24% of consolidated revenue, in 2011, \$3.3 billion, or 32% of consolidated revenue, in 2010, and \$5.2 billion, or 43% of consolidated revenue, in 2009. Revenue from the Chevron Corporation, which was derived almost entirely from our Hydrocarbons business group, totaled \$1.1 billion, or 27% of consolidated revenue for the six months ended June 30, 2012, \$2.0 billion, or 22% of consolidated revenue, in 2011, \$1.8 billion, or 18% of consolidated revenue, in 2010, and \$1.4 billion or 11%, of consolidated revenue, in 2009. For the six months ended June 30, 2012, revenue from Sonatrach totaled \$432 million, or 11% of consolidated revenue. No other customers represented 10% or more of consolidated revenues in any of the periods presented.

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

(a) None.

(b) None.

On August 26, 2011, KBR announced that its Board of Directors authorized a new share repurchase program to repurchase up to 10 million of our outstanding common shares. The authorization does not specify an expiration (c) date. The following is a summary of share repurchases of our common stock settled during the three months ended June 30, 2012. We also maintain a share maintenance program to repurchase shares issued based on vesting and other activity under our equity compensation plans.

| Purchase Period | Total Number of Shares Purchased (c) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (c) | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (a) |
|---------------------------|--------------------------------------|------------------------------|--|--|
| April 2 - 23, 2012 | | | | |
| Repurchase Program | — | \$— | — | 8,143,420 |
| Employee Transactions (b) | 22,315 | \$34.97 | — | — |
| May 4 - 30, 2012 | | | | |
| Repurchase Program | — | \$— | — | 8,143,420 |
| Employee Transactions (b) | 1,786 | \$28.02 | — | — |
| June 4 - 29, 2012 | | | | |
| Repurchase Program | 695,505 | \$24.29 | 416,623 | 7,726,797 |
| Employee Transactions (b) | 714 | \$24.45 | — | — |
| Total | | | | |
| Repurchase Program | 695,505 | \$24.29 | 416,623 | 7,726,797 |
| Employee Transactions (b) | 24,815 | \$34.17 | — | — |

(a) Represents remaining common shares that may be repurchased pursuant to the August 26, 2011 announced share repurchase program.

(b) 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.

(c) The difference between total number of shares purchased and total number of shares purchased as part of publicly announced plans or programs pertains to repurchases under our share maintenance program.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

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Item 6. Exhibits

| Exhibit Number | Description |
|----------------|---|
| 3.1 | KBR Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to KBR's current report on Form 8-K filed June 7, 2012; File No. 1-33146) |
| 3.2 | Amended and Restated Bylaws of KBR, Inc. (incorporated by reference to Exhibit 99.1 Charter to KBR's current report on Form 8-K filed January 23, 2012; 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 | KBR, Inc. 2006 Stock and Incentive Plan (As Amended and Restated March 7, 2012) (incorporated by reference to KBR's definitive Proxy Statement dated April 5, 2012) |
| 10.2 | Severance and Change of Control Agreement, between KBR Technical Services, Inc., a Delaware corporation, KBR, Inc., and Ivor Harrington (incorporated by reference to Exhibit 10.1 to KBR's current report on Form 8-K dated July 12, 2012; File No. 1-33146) |
| * 31.1 | Certification by Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| * 31.2 | Certification by Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| ** 32.1 | Certification by the Chief Executive Officer Furnished Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| ** 32.2 | Certification by the Chief Financial Officer Furnished Pursuant to 18 U.S.C. Section 1350 as Adopted 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.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| *** 101.LAB | XBRL Taxonomy Extension Labels Linkbase Document |
| *** 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

* Filed with this Form 10-Q
** Furnished with this Form 10-Q
*** Submitted pursuant to Rule 405 and 406T of Regulation S-T.

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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
Executive Vice President and Chief Financial Officer

/s/ Dennis S. Baldwin
Dennis S. Baldwin
Senior Vice President and Chief Accounting
Officer

Date: July 25, 2012

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