KBR, INC.
Form 10-Q
April 27, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2011

OR

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from ______ to ______

Commission File Number 1-33146

KBR, Inc.

(a Delaware Corporation)

20-4536774

601 Jefferson Street

Suite 3400

Houston, Texas 77002

(Address of Principal Executive Offices)

Telephone Number Area Code (713) 753-3011

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days. Yes x 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 x 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	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

As of April 15, 2011, there were 151,552,430 shares of KBR, Inc. common stock, $0.001 par value per share, outstanding.

KBR, Inc.

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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 2010 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 March 31, 2011	Three Months Ended March 31, 2010
Revenue:		
Services	$ 2,277	$ 2,616
Equity in earnings of unconsolidated affiliates, net	44	15
Total revenue	2,321	2,631
Operating costs and expenses:		
Cost of services	2,134	2,483
General and administrative	44	49
Gain on disposition of assets, net	(1)	
Total operating costs and expenses	2,177	2,532
Operating income	144	99
Interest expense, net	(5)	(4)
Foreign currency gains (losses), net	1	(2)
Other non-operating expense	(1)	
Income before income taxes and noncontrolling interests	139	93
Less: Provision for income taxes	22	34
Net income	117	59
Less: Net income attributable to noncontrolling interests	12	13
Net income attributable to KBR	$ 105	$ 46
Net income attributable to KBR per share:		
Basic	$ 0.69	$ 0.29
Diluted	$ 0.69	$ 0.29
Basic weighted average common shares outstanding	151	160
Diluted weighted average common shares outstanding	152	161
Cash dividends declared per share	$ 0.05	$

See accompanying notes to condensed consolidated financial statements.

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KBR, Inc.

Condensed Consolidated Balance Sheets

(In millions except share data)

	March 31, 2011 (Unaudited)	December 31, 2010
Assets		
Current assets:		
Cash and equivalents	$ 788	$ 786
Receivables:		
Accounts receivable, net of allowance for bad debts of $26 and $27	1,398	1,455
Unbilled receivables on uncompleted contracts	468	428
Total receivables	1,866	1,883
Deferred income taxes	190	199
Other current assets	385	394
Total current assets	3,229	3,262
Property, plant, and equipment, net of accumulated depreciation of $343 and $334 (including $81 and $80, net, owned by a variable interest entity see Note 12)	374	355
Goodwill	951	947
Intangible assets, net	125	127
Equity in and advances to related companies	241	219
Noncurrent deferred income taxes	101	103
Noncurrent unbilled receivables on uncompleted contracts	322	320
Other assets	124	84
Total assets	$ 5,467	$ 5,417
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 905	$ 921
Due to former parent, net	43	43
Obligation to former noncontrolling interest (Note 3)	20	180
Advance billings on uncompleted contracts	593	498
Reserve for estimated losses on uncompleted contracts	26	26
Employee compensation and benefits	237	200
Current non-recourse project-finance debt of a variable interest entity (Note 12)	9	9
Other current liabilities	513	470
Total current liabilities	2,346	2,347
Noncurrent employee compensation and benefits	360	397
Noncurrent non-recourse project-finance debt of a variable interest entity (Note 12)	97	92
Other noncurrent liabilities	148	132
Noncurrent income tax payable	108	128
Noncurrent deferred tax liability	119	117
Total liabilities	3,178	3,213
KBR Shareholders equity:		
Preferred stock, $0.001 par value, 50,000,000 shares authorized, 0 shares issued and outstanding		

Common stock, $0.001 par value, 300,000,000 shares authorized, 171,812,229 and 171,448,067 shares issued, and 151,493,710 and 151,132,049 shares outstanding				
Paid-in capital in excess of par		1,989		1,981
Accumulated other comprehensive loss		(432)		(438)
Retained earnings		1,254		1,157
Treasury stock, 20,318,519 shares and 20,316,018 shares, at cost		(455)		(454)
Total KBR shareholders equity		2,356		2,246
Noncontrolling interests		(67)		(42)
Total shareholders equity		2,289		2,204
Total liabilities and shareholders equity	$	5,467	$	5,417

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 March 31, 2011	Three Months Ended March 31, 2010
Net income	$ 117	$ 59
Other comprehensive income (loss), net of tax benefit (provision):		
Net cumulative translation adjustments	4	2
Pension liability adjustments	5	3
Net unrealized gains (losses) on derivatives	(3)	3
Total other comprehensive income, net of tax	6	8
Comprehensive income	123	67
Less: Comprehensive income attributable to noncontrolling interests	(12)	(13)
Comprehensive income attributable to KBR	$ 111	$ 54

See accompanying notes to condensed consolidated financial statements.

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KBR, Inc.

Condensed Consolidated Statements of Cash Flows

(In millions)

(Unaudited)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Cash flows from operating activities:		
Net income	$ 117	$ 59
Adjustments to reconcile net income to net cash provided by (used in) operations:		
Depreciation and amortization	17	15
Equity in earnings of unconsolidated affiliates	(44)	(15)
Deferred income taxes	9	(17)
Other	1	8
Changes in operating assets and liabilities:		
Receivables	82	(438)
Unbilled receivables on uncompleted contracts	(27)	155
Accounts payable	(29)	(28)
Advanced billings on uncompleted contracts	80	169
Accrued employee compensation and benefits	38	74
Reserve for loss on uncompleted contracts		(4)
Collection (repayment) of advances from (to) unconsolidated affiliates, net	23	(1)
Distribution of earnings from unconsolidated affiliates	9	9
Other assets	(17)	(3)
Other liabilities	(34)	12
Total cash flows provided by (used in) operating activities	225	(5)
Cash flows from investing activities:		
Capital expenditures	(26)	(14)
Investment in equity method joint ventures	(8)	(4)
Investment in licensing arrangement		(20)
Total cash flows used in investing activities	(34)	(38)
Cash flows from financing activities:		
Acquisition of noncontrolling interest	(164)	
Payments to reacquire common stock	(2)	(1)
Distributions to noncontrolling interests, net	(37)	(7)
Payments of dividends to shareholders	(8)	(8)
Net proceeds from issuance of stock	3	
Excess tax benefits from stock-based compensation	1	
Return of cash collateral on letters of credit, net	5	17
Total cash flows provided by (used in) financing activities	(202)	1
Effect of exchange rate changes on cash	13	(13)
Increase (decrease) in cash and equivalents	2	(55)
Cash increase due to consolidation of a variable interest entity		22

Cash and equivalents at beginning of period	786	941
Cash and equivalents at end of period	$ 788	$ 908

See accompanying notes to condensed consolidated financial statements.

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KBR, Inc.

Condensed Consolidated Statements of Cash Flows (continued)

(In millions)

(Unaudited)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Noncash activities:		
Noncash operating activities		
Other assets (Note 8)	$	$ 47
Other liabilities (Note 8)	$	$ (47)
Noncash financing activities		
Dividends declared	$ 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, petrochemicals, government services, industrial and civil infrastructure sectors. 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 reportable business segments.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules of the United States Securities and Exchange Commission (SEC) for interim financial statements and do not include all annual disclosures required by accounting principles generally accepted in the United States (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, 2010 filed with the SEC. We believe that the presentation and disclosures herein are adequate to make the information not misleading, and the condensed consolidated financial statements reflect all normal adjustments that management considers necessary for a fair presentation of our consolidated results of operations, financial position and cash flows. Operating results for interim periods are not necessarily indicative of results to be expected for the full fiscal year 2011 or any other future periods.

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

Our condensed consolidated financial statements include the accounts of majority-owned, controlled subsidiaries and variable interest entities where we are the primary beneficiary. The equity method is used to account for investments in affiliates in which we have the ability to exert significant influence over the affiliates operating and financial policies. The cost method is used when we do not have the ability to exert significant influence. 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 March 31,	
Millions of shares	**2011**	**2010**
Basic weighted average common shares outstanding	151	160
Stock options and restricted shares	1	1
Diluted weighted average common shares outstanding	152	161

The amount of antidilutive weighted average shares was immaterial for the three months ended March 31, 2011. The diluted earnings per share calculation did not include 1.4 million antidilutive weighted average shares for the three months ended March 31, 2010.

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Note 3. Business Combinations and Other Transactions

Business Combinations

ENI Holdings, Inc. (the Roberts & Schaefer Company). On December 21, 2010, we completed the acquisition of 100% of the outstanding common shares of ENI Holdings, Inc. (ENI). ENI is the parent to the Roberts & Schaefer Company (R&S), a privately held, EPC services company for material handling and processing systems. Headquartered in Chicago, Illinois, R&S provides services and associated processing infrastructure to customers in the mining and minerals, power, industrial, refining, aggregates, precious and base metals industries.

The purchase price was $280 million plus preliminary net working capital of $17 million which included cash acquired of $8 million. The total net cash paid at closing of $289 million is subject to post-closing adjustments. The purchase price is subject to an escrowed holdback amount of $43 million to secure post-closing working capital adjustments, indemnifications obligations of the sellers and other contingent obligations related to the operations of the business. During the first quarter of 2011, we recorded an increase to goodwill of approximately $3 million primarily associated with additional purchase consideration payable to the seller based upon our estimates of post-closing working capital adjustments and final valuation of acquired intangible assets. R&S operating results are reported in our IGP segment.

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 initial purchase price of $164 million was paid on January 5, 2011. In addition, we agreed to pay the former noncontrolling interest 44.94% of future proceeds collected on certain receivables owed to MWKL. Furthermore, 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 March 31, 2011, we had recorded a net liability of approximately $20 million recorded as Obligation to former noncontrolling interest reflecting our estimate 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 which is nearing completion. 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 consolidated income statement for the three months ended March 31, 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	**March 31, 2011**	**December 31, 2010**
Probable unapproved claims	$ 26	$ 19
Probable unapproved change orders	3	10
Probable unapproved change orders related to unconsolidated subsidiaries		3

As of March 31, 2011, the probable unapproved claims related to several completed projects. Contracts with probable unapproved claims that will likely not be settled within one year totaled $20 million at March 31, 2011, and $19 million at December 31, 2010, 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.

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

We filed for arbitration with the International Chamber of Commerce (ICC) in 2004 claiming recovery of damages of $323 million for 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 U.S. Federal Court to recognize the award in the U.S. of approximately $356 million plus interest thereon until paid. PEMEX initiated an appeal and a stay related to the enforcement of the judgment which was granted by the Lower District Court and PEMEX was required to post collateral of $395 million with the court registry.

PEMEX attempted to nullify the award in Mexican court which was rejected by the Mexican trial court. PEMEX has filed additional appeals in the Mexican Courts. We will respond to further efforts by PEMEX to nullify our award as may be required. 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 March 31, 2011. 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.

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.

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

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The table below presents information on our reportable business segments.

Millions of dollars	Three Months Ended March 31, 2011	2010
Revenue:		
Hydrocarbons	$ 1,047	$ 922
Infrastructure, Government and Power	855	1,274
Services	397	415
Other	22	20
Total revenue	$ 2,321	$ 2,631
Operating segment income:		
Hydrocarbons	$ 99	$ 76
Infrastructure, Government and Power	61	46
Services	13	21
Other	12	9
Operating segment income	185	152
Unallocated amounts:		
Labor cost absorption	3	(4)
Corporate general and administrative	(44)	(49)
Total operating income	$ 144	$ 99

Note 6. Committed and Restricted Cash

Cash and equivalents include cash related to contracts in progress as well as cash held by our joint ventures that we consolidate for accounting purposes. Joint venture cash balances are limited to joint venture activities and are not available for other projects, general cash needs, or distribution to us without approval of the board of directors of the respective joint ventures. Cash held by our joint ventures that we consolidate for accounting purposes totaled approximately $207 million at March 31, 2011 and $136 million at December 31, 2010. We expect to use the cash on these projects to pay project costs.

Restricted cash consists of amounts held in deposit with certain banks to collateralize standby letters of credit. Our current restricted cash is included in Other current assets and our non-current restricted cash is included in Other assets on our condensed consolidated financial statements. Our restricted cash balances are presented in the table below:

Millions of dollars	March 31, 2011	December 31, 2010
Current restricted cash	$ 7	$ 11
Non-current restricted cash	8	10
Total restricted cash	$ 15	$ 21

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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 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, we may not receive award fees under the affected contract, and our ability to secure future contracts could be adversely affected, although we would receive payment for amounts owed for our allowable costs under cost-reimbursable contracts. Other remedies that could be sought by our government customers for any improper activities or performance issues include sanctions such as forfeiture of profits, suspension of payments, fines, and suspensions or debarment from doing business with the government. Further, the negative publicity that could arise from disagreements with our customers or sanctions as a result thereof could have an adverse effect on our reputation in the industry, reduce our ability to compete for new contracts, and may also have a material adverse effect on our business, financial condition, results of operations, and cash flow.

We have experienced and expect to be a party to various claims against us by employees, third parties, soldiers, subcontractors and others that have arisen out of our work in Iraq such as claims for wrongful termination, assaults against employees, personal injury claims by third parties and army personnel, and subcontractor claims. While we believe we conduct our operations safely, the environments in which we operate often lead to these types 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. Both fees are determined as a percentage rate applied to a negotiated estimate of the total costs for each task order. For task orders under an award fee arrangement, our customer is contractually obligated to periodically convene Award-Fee Boards, which are comprised of individuals who have been designated to assist the Award Fee Determining Official (AFDO) in making award fee determinations. The amounts of award fees are determined at the sole discretion of the AFDO.

During the first quarter of 2010, we determined that we could no longer reliably estimate fees to be awarded by the AFDO and, accordingly, adjusted our accrual rate to 0%. Until such time as we are able to resume making reliable fee estimates on the LogCAP III contract, we will recognize award fees only when awarded. No award fees were awarded to us in the first quarter of 2010. During the first quarter of 2011, we were awarded and recognized revenue for award fees of $16 million representing approximately 53% of the available award fee pool for the periods of performance from March 2010 through August 2010 on task orders in Iraq. We were awarded ratings of very good on these task orders.

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. We expect to receive award fees for this period of performance during the third quarter of 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 Department of Defense contracts, are subject to audit by the Defense Contract Audit Agency (DCAA), which serves in an advisory role to the Defense Contract Management Agency (DCMA) which is responsible for the administration of our contracts. The scope of these audits include, among other things, the allowability, allocability, and reasonableness of incurred costs, approval of annual overhead rates, compliance with the Federal Acquisition Regulation (FAR) and Cost Accounting 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 March 31, 2011, open Form 1 s from the DCAA recommending suspension of payments totaling approximately $377 million associated with our contract costs incurred in prior years, of which approximately $162 million has been withheld from our current billings. As a consequence, for certain of these matters, we have withheld approximately $78 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 $84 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 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. The Army previously indicated that not all task orders and subcontracts had been reviewed and that they may make additional adjustments. 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 $24 million in payments from us bringing the total payments withheld to approximately $44 million as of March 31, 2011 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 acquired security. We believe that, while the LogCAP III contract anticipates that the Army will provide force protection to KBR employees, it does not prohibit us or any of our subcontractors from using private security services to provide force protection to KBR or subcontractor personnel. In addition, a significant portion of our subcontracts are competitively bid fixed price subcontracts. As a result, we do not receive details of the subcontractors cost estimate nor are we legally entitled to it. Further, we have not paid our subcontractors any additional compensation for security services. Accordingly, we believe that we are entitled to reimbursement by the Army for the cost of services provided by us or our subcontractors, even if they incurred costs for private force protection services. Therefore, we 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.

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We have provided at the Army s request information that addresses the use of armed security either directly or indirectly charged to LogCAP III. To date, we have filed appeals to the ASBCA to recover $44 million of the amounts withheld from us. We believe these sums were properly billed under our contract with the Army. At this time, we believe the likelihood that a loss related to this matter has been incurred is remote. We have not adjusted our revenues or accrued any amounts related to this matter. This matter is also the subject of a separate claim filed by the Department of Justice (DOJ) for alleged violation of the False Claims Act as discussed further below under the heading Investigations, Qui Tams and Litigation.

Containers. In June 2005, the DCAA recommended withholding certain costs associated with providing containerized housing for soldiers and supporting civilian personnel in Iraq. The DCMA agreed that the costs be withheld pending receipt of additional explanation or documentation to support the subcontract costs. We have not received a final determination by the DCMA and, as requested, we continue to provide information to the DCMA. 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 March 31, 2011, 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 claim to the ASBCA to recover the $51 million of 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 March 31, 2011, we have outstanding Form 1 s from the DCAA disapproving $164 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 to recover $55 million of the $82 million withheld from us by the customer. The claims proceedings are in the discovery process and no trial date has been set but is expected to occur in 2011. With respect to questions raised regarding billing in accordance with contract terms, as of March 31, 2011, we believe it is reasonably possible that we could incur losses in excess of the amount accrued for possible subcontractor costs billed to the customer that were possibly not in accordance with contract terms. However, we are unable to estimate an amount of possible loss or range of possible loss in excess of the amount accrued related to any costs billed to the customer that were not in accordance with the contract terms. We believe the prices obtained for these services were reasonable, we intend to vigorously defend ourselves in this matter and we do not believe we face a risk of significant loss from any disallowance of these costs in excess of amounts withheld from subcontractors. As of March 31, 2011, we had withheld $38 million in payments from our subcontractors pending the resolution of these matters with our customer.

In 2009, one of our subcontractors, Tamimi, filed for arbitration to recover approximately $35 million for payments we have withheld from them pending the resolution of the Form 1 s with our customer. In December 2010, the arbitration panel ruled that the subcontract terms were not sufficient to hold retention from Tamimi for price reasonableness matters and awarded the subcontractor $38 million including interest thereon and certain legal costs. As noted above, we have claims pending in the U.S. COFC to recover these amounts from the U.S. government and we believe it is probable that we will recover such amounts. Additionally, in March 2011, the U.S. government filed a counterclaim alleging KBR employees accepted bribes from Tamimi in exchange for awarding a master agreement for DFAC services to Tamimi. The government 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. We have evaluated the government s counterclaim and believe it to be without merit. Trial for the claims in the U.S. COFC is scheduled to begin in June 2011.

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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 March 31, 2011 and December 31, 2010 accompanying 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 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 form the DCAA disapproving certain personnel replacement 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 believe the risk of loss associated with the disallowance of these costs is remote. As of March 31, 2011, we had not accrued any amounts related to this matter.

Construction services. As of March 31, 2011, we have outstanding 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 April 2010, we met with the U.S. Navy in an attempt to settle the potentially unallowable costs. As a result of the meeting, approximately $7 million of the potentially unallowable costs was agreed to be allowable and approximately $1 million unallowable. Settlement of the remaining disputed amounts is pending further discussions with the customer regarding the applicable provisions of the FAR and interpretations thereof, as well as providing additional supporting documentation to the customer. As of March 31, 2011, 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 March 31, 2011, we have accrued our estimate of probable loss related to this matter; however, it is reasonably possible we could incur additional losses.

Investigations and Litigation

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

First Kuwaiti Trading Company arbitration. In April 2008, First Kuwaiti Trading Company, one of our LogCAP III subcontractors, filed for arbitration of a subcontract under which KBR had leased vehicles related to work performed on our LogCAP III contract. First Kuwaiti alleged that we did not return or pay rent for many of the vehicles and 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. Three arbitration hearings took place in 2010 in Washington, D.C. primarily related to claims involving unpaid rents and damages on lost or unreturned vehicles totaling approximately $77 million for which the arbitration panel awarded $7 million to FKTC plus an unquantified amount for repair costs on certain vehicles, damages suffered as a result of late vehicle returns, and interest thereon, to be determined at a later date. No payments are expected to occur until all claims are arbitrated and awards finalized. The next arbitration hearing is scheduled to occur in May 2011 and we believe any damages ultimately awarded to First Kuwaiti will be billable under the LogCAP III contract. Accordingly, we have accrued amounts payable and a related unbilled receivable for the amounts awarded to First Kuwaiti pursuant to the terms of the contract.

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Electrocution litigation. During 2008, a lawsuit was filed against KBR alleging that the Company was responsible for an electrical incident which resulted in the death of a soldier. This incident occurred at the Radwaniyah Palace Complex. It is alleged in the suit that the electrocution incident was caused by improper electrical maintenance or other electrical work. We intend to vigorously defend this matter. KBR denies that its conduct was the cause of the event and denies legal responsibility. The case was removed to Federal Court where motion to dismiss was filed. The court issued a stay in the discovery of the case, pending an appeal of certain pre-trial motions to dismiss that were previously denied. In August 2010, the Court of Appeal dismissed our appeal concluding it did not have jurisdiction. The case is currently proceeding with the discovery process. We are unable to determine the likely outcome nor can we estimate a range of potential loss, if any, related to this matter at this time. As of March 31, 2011, no amounts have been accrued.

Burn Pit litigation. KBR has been 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 who purport to represent a large class of unnamed persons. The lawsuits primarily allege negligence, willful and wanton conduct, battery, intentional infliction of emotional harm, personal injury and failure to warn of dangerous and toxic exposures which has resulted in alleged illnesses for contractors and soldiers living and working in the bases where the pits are operated. All of the pending cases have been removed to Federal Court, the majority of which have been consolidated for multi-district litigation treatment. We filed a motion to strike an amended consolidated petition filed by the plaintiffs which was granted by the Court. The Court directed the parties to propose a plan for limited jurisdictional discovery. In December 2010, the Court stayed virtually all proceedings pending a decision from the Fourth Circuit Court of Appeals on three other cases involving the Political Question Doctrine and other jurisdictional issues. We intend to vigorously defend these matters. Due to the inherent uncertainties of litigation and because the litigation is at a preliminary stage, we cannot at this time accurately predict the ultimate outcome nor can we reliably estimate a range of possible loss, if any, related to this matter at this time. Accordingly, as of March 31, 2011, no amounts have been accrued.

Convoy Ambush litigation. In April 2004, a fuel convoy in route from Camp Anaconda to Baghdad International Airport for the U.S. Army under our LogCAP III contract was ambushed resulting in deaths and severe injuries to truck drivers hired by KBR. In 2005, survivors of the drivers killed and those that were injured in the convoy, filed suit in state court in Houston, Texas against KBR and several of its affiliates, claiming KBR deliberately intended that the drivers in the convoy would be attacked and wounded or killed. The suit also alleges KBR committed fraud in its hiring practices by failing to disclose the dangers associated with working in the Iraq combat zone. In September 2006, the case was dismissed based upon the court s ruling that it lacked jurisdiction because the case presented a non-justiciable political question. Subsequently, three additional suits were filed, arising out of insurgent attacks on other convoys that occurred in 2004 and were likewise dismissed as non-justiciable under the Political Question Doctrine. Currently, the cases are stayed pending our appeal in the Fifth Circuit Courts of Appeals on various grounds and we anticipated the appeal will be assigned to a three judge panel to be heard later in 2011. We are unable to determine the likely outcome of these cases at this time nor can we reliably estimate a range of possible loss, if any. Accordingly, as of March 31, 2011, no amounts have been accrued.

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 LogCAP III. We have filed motions to dismiss the complaint which are currently pending. We have not adjusted our revenues or accrued any amounts related to this matter.

Other Matters

Claims. Included in receivables in our consolidated balance sheets are unapproved claims for costs incurred under various government contracts totaling $147 million at March 31, 2011 of which $120 million is included in Accounts receivable and $27 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 $120 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 $27 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 March 31, 2011 are considered to be probable of collection and have been previously recognized as revenue.

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Note 8. Other Commitments and Contingencies

Foreign Corrupt Practices Act (FCPA) investigations

In February 2009, KBR LLC entered a guilty plea to violations of the FCPA in the United States District Court, Southern District of Texas, Houston Division (the Court), related to the Bonny Island investigation. KBR LLC pled guilty to one count of conspiring to violate the FCPA and four counts of violating the FCPA, all arising from the intent to bribe various Nigerian government officials through commissions paid to agents working on behalf of TSKJ on the Bonny Island project. The plea agreement reached with the DOJ resolved all criminal charges in the DOJ s investigation and called for the payment of a criminal penalty of $402 million, of which Halliburton was obligated to pay $382 million under the terms of the master separation agreement, while we were obligated to pay $20 million. We also agreed to a period of organizational probation of three years, during which we retain a monitor who assesses our compliance with the plea agreement and evaluates our FCPA compliance program over the three year period, with periodic reports to the DOJ. In addition, we settled a civil enforcement action by the SEC which called for Halliburton and KBR, jointly and severally, to make payments totaling $177 million, all of which was payable by Halliburton pursuant to the indemnification under the master separation agreement. As of December 31, 2010, all criminal and civil penalties to the DOJ and SEC were paid.

In addition to the DOJ and SEC investigations, the U.K. Serious Fraud Office (SFO) conducted an investigation of activities by current and former employees of M. W. Kellogg Limited (MWKL) regarding the Bonny Island project. During the investigation, MWKL self-reported to the SFO its corporate liability for corruption-related offenses arising out of the Bonny Island project and entered into a plea negotiation process under the Attorney General s Guidelines on Plea Discussions in Cases of Serious and Complex Fraud issued by the Attorney General for England and Wales. In February 2011, MWKL reached a settlement with the SFO in which the SFO accepted that MWKL was not party to any unlawful conduct and assessed a civil penalty of approximately $11 million including interest and reimbursement of certain costs of the investigation. The settlement terms included a full release of all claims against MWKL, its current and former parent companies, subsidiaries and other related parties including their respective current or former officers, directors and employees with respect to the Bonny Island project. As of December 31, 2010, we recorded a liability to the SFO of $11 million included in Other current liabilities in our consolidated balance sheet. Due to the indemnity from Halliburton under the master separation agreement, we recognized a receivable from Halliburton of approximately $6 million in Due to former parent, net in our consolidated balance sheet. As of March 31, 2011, we are not aware of any uncertainties related to the indemnity from Halliburton or any material limitations on our ability to recover amounts due to us for matters covered by the indemnity from Halliburton. All amounts due to the SFO were paid during the first quarter of 2011.

In addition, Halliburton settled corruption allegation claims asserted by the Federal Government of Nigeria in late 2010. The settlement provided a complete release to KBR and all of its affiliates and related companies in connection with any liability for matters related to the Bonny Island project in Nigeria.

Under the terms of the master separation agreement, Halliburton has agreed to indemnify us, and any of our greater than 50%-owned subsidiaries, for our share of fines or other monetary penalties or direct monetary damages, including disgorgement, as a result of claims made or assessed by a governmental authority of the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria or a settlement thereof relating to FCPA and related corruption allegations, which could involve Halliburton and us through The M. W. Kellogg Company, MWKL, or their or our joint ventures in projects both in and outside of Nigeria, including the Bonny Island, Nigeria project. Halliburton s indemnity will not apply to any other losses, claims, liabilities or damages assessed against us as a result of or relating to FCPA matters and related corruption allegations or to any fines or other monetary penalties or direct monetary damages, including disgorgement, assessed by governmental authorities in jurisdictions other than the United States, the United Kingdom, France, Nigeria, Switzerland or Algeria, or a settlement thereof, or assessed against entities such as TSKJ, in which we do not have an interest greater than 50%.

With the settlement of the DOJ, SEC, SFO and Nigerian investigations, all known investigations in the Bonny Island project have been concluded. We are not aware of any other corruption allegations against us by governmental authorities in foreign jurisdictions.

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Commercial Agent Fees

We have, both before and after the separation from our former parent, used commercial agents on some of our large-scale international projects to assist in understanding customer needs, local content requirements, vendor selection criteria and processes and in communicating information from us regarding our services and pricing. Prior to separation, it was identified by our former parent in performing its investigation of anti-corruption activities that certain of these agents may have engaged in activities that were in violation of anti-corruption laws at that time and the terms of their agent agreements with us. Accordingly, we ceased the receipt of services from and payment of fees to these agents. Fees for these agents are included in the total estimated cost for these projects at their completion. In connection with actions taken by U.S. Government authorities, we have removed certain unpaid agent fees from the total estimated costs in the period that we obtained sufficient evidence to conclude such agents violated the terms of their contracts with us. In the first quarter of 2011, we reduced project cost estimates for the remaining unpaid agent fees on the Bonny Island project which resulted in an increase of $4 million to operating income in our condensed consolidated statements of income.

Barracuda-Caratinga Project Arbitration

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

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

In 2009, we received an unfavorable ruling from the arbitration panel on the legal and factual issues as the panel decided the original design specification for the bolts originated with KBR and its subcontractors. The ruling concluded that KBR s express warranties in the contract regarding the fitness for use of the design specifications for the bolts took precedence over any implied warranties provided by the project owner. Our potential exposure includes the costs of the bolts replaced to date by Petrobras, any incremental monitoring costs incurred by Petrobras and damages for any other bolts that are subsequently found to be defective. We believe that it is probable that we have incurred some liability in connection with the replacement of bolts that have failed during the contract warranty period which expired June 30, 2006. In May 2010, the arbitration tribunal heard arguments from both parties regarding various damage scenarios and estimates of the amount of KBR s overall liability in this matter. The final arbitration arguments were made in August of 2010. Based on the damage estimates presented at this hearing, we estimate our minimum exposure, excluding interest, to be approximately $12 million representing our estimate for replacement of bolts that failed during the warranty period and were not replaced. As of March 31, 2011 and December 31, 2010, we have recorded a liability of $12 million to Petrobras for the failed bolts. We also have recorded an indemnification receivable from Halliburton of $12 million pursuant to the indemnification under the Master Separation Agreement. The amount of any remaining liability will be dependent upon the legal and factual issues to be determined by the arbitration tribunal in the final arbitration hearings. For the remaining bolts at dispute, we cannot determine that we have liability nor determine the amount of any such liability and no additional amounts have been accrued.

Any liability incurred by us in connection with the replacement of bolts that have failed to date or related to the remaining bolts at dispute in the bolt arbitration is covered by an indemnity from our former parent Halliburton. Under the MSA, Halliburton has agreed to indemnify us and any of our greater than 50%-owned subsidiaries as of November 2006, for all out-of-pocket cash costs and expens