

SMITH INTERNATIONAL INC

Form 10-K

February 29, 2008

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

**Form 10-K**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the Fiscal Year Ended December 31, 2007**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**Commission File Number 1-8514**

**SMITH INTERNATIONAL, INC.**

**(Exact name of Registrant as specified in its charter)**

**Delaware**

**(State or other jurisdiction of incorporation or  
organization)**

**95-3822631**

**(I.R.S. Employer Identification No.)**

**16740 East Hardy Road**

**Houston, Texas**

**(Address of principal executive offices)**

**77032**

**(Zip Code)**

**Registrant's telephone number, including area code (281) 443-3370**

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

**Title of Each Class**

**Name of Each Exchange on Which Registered**

**Common Stock, \$1.00 par value**

**New York Stock Exchange, Inc.**

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No .

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No .

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No .

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(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 .

The aggregate market value of the voting stock held by non-affiliates on June 30, 2007 was \$11,592,318,768 (197,686,200) shares at the closing price on the New York Stock Exchange of \$58.64. On June 30, 2007, 216,269,869 shares of common stock were outstanding. For this purpose all shares held by officers and directors and their respective affiliates are considered to be held by affiliates, but neither the Registrant nor such persons concede that they are affiliates of the Registrant.

There were 200,810,969 shares of common stock outstanding, net of shares held in Treasury, on February 22, 2008.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement related to the Registrant's 2008 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form.

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**Table of Contents****PART I****Item 1. Business  
General**

Smith International, Inc. ( Smith or the Company ) is a leading global provider of premium products and services to the oil and gas exploration and production industry. The Company provides a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control and separation equipment, waste-management services, oilfield production chemicals, three-cone and diamond drill bits, turbine products, tubulars, fishing services, drilling tools, underreamers, casing exit and multilateral systems, packers and liner hangers. The Company also offers supply-chain management solutions through an extensive North American branch network providing pipe, valves and fittings as well as mill, safety and other maintenance products.

The Company was incorporated in the state of California in January 1937 and reincorporated under Delaware law in May 1983. The Company's executive offices are headquartered at 16740 East Hardy Road, Houston, Texas 77032 and its telephone number is (281) 443-3370. The Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are made available free of charge on the Company's Internet website at [www.smith.com](http://www.smith.com) as soon as reasonably practicable after the Company has electronically filed such material with, or furnished it to, the Securities and Exchange Commission. The Company's Corporate Governance Guidelines, Code of Business Conduct and Ethics and the charters of the Audit Committee, Compensation and Benefits Committee and Nominating and Corporate Governance Committee are also available on the Investor Relations section of the Company's Internet website. The Company intends to disclose on its website any amendments or waivers to its Code of Business Conduct and Ethics that are required to be disclosed pursuant to Item 5.05 of Form 8-K. Printed copies of these documents are available to stockholders upon request.

The Company's operations are aggregated into two reportable segments: Oilfield and Distribution. The Oilfield segment consists of three business units: M-I SWACO, a 60 percent-owned joint venture which provides drilling and completion fluid systems, engineering and technical services, oilfield production chemicals and manufactures and markets equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management; Smith Technologies, which designs and manufactures three-cone and diamond drill bits, turbines and borehole enlargement tools; and Smith Services, which manufactures and markets products and services used for drilling, work-over, well completion and well re-entry operations. The Distribution segment consists of one business unit, Wilson, which markets pipe, valves and fittings as well as mill, safety and other maintenance products to energy and industrial markets.

Financial information regarding reportable segments and international operations appears in Management's Discussion and Analysis of Financial Condition and Results of Operations and in Note 15 of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K. Information related to business combinations appears in Note 2 of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K.

**Business Operations*****Oilfield Segment******M-I SWACO***

*Fluid Products and Services.* Fluid product offerings, which account for approximately 60 percent of M-I SWACO's total revenues, include premium drilling fluids, reservoir drill-in fluids and other products and engineering services used in the development of oil and natural gas wells. Drilling fluids are used to cool and lubricate the bit during drilling operations, contain formation pressures, suspend and remove rock cuttings from the hole and maintain the stability of the wellbore. Engineering services are provided to ensure that the fluid products are applied effectively to optimize drilling operations. These services include recommending products and services during the well planning phase; monitoring drilling fluid properties; recommending adjustments during the drilling phase; and analyzing/benchmarking well results after completion of the project to improve the efficiencies of future wells.

M-I SWACO offers water-base, oil-base and synthetic-base drilling fluid systems. Water-base drilling fluids are the world's most widely utilized systems, having application in both land and offshore environments. Typically, these systems comprise an engineered blend of weighting materials used to contain formation pressures, and a broad range of chemical additives, designed to yield the specific drilling performance characteristics required for a given drilling project. Oil-base drilling fluids, which primarily are used to drill water-sensitive shales, reduce torque and drag and are widely used in areas where stuck pipe is likely to occur. In certain drilling areas of the world, oil-base systems exhibit comparably higher penetration rates when

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compared to water-base systems, significantly reducing time on location and overall drilling costs. Synthetic-base drilling fluids are used in drilling environments where oil-base fluids are environmentally prohibited and provide the performance benefits of oil-base systems. Synthetic-base systems are particularly advantageous in the deepwater environment. M-I SWACO also provides a comprehensive line of reservoir drill-in fluids which combine the high performance properties of a premium drilling fluid with minimal damaging characteristics of a brine completion fluid.

*Fluid Competition.* The major competitors in the worldwide drilling fluids market, which approximated \$6.9 billion in 2007, are Halliburton Energy Services (a division of Halliburton Company ( Halliburton )) and Baker Hughes Drilling Fluids (a division of Baker Hughes, Inc. ( Baker Hughes )). While M-I SWACO and these companies supply a majority of the market, the drilling fluids industry is highly competitive, with a significant number of smaller, locally based competitors.

Generally competition for sales of drilling and completions fluids is based on a number of factors, including wellsite engineering services, product quality and availability, technical support, service response and price.

*M-I SWACO Environmental Solutions Products and Services.* M-I SWACO manufactures and markets equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management to the worldwide drilling market. Environmental Solution product and service offerings account for approximately 20 percent of M-I SWACO's total revenues.

Solids-control equipment is used to remove drill cuttings from the fluid system, allowing the drilling fluid to be cleaned and recirculated. Solids are normally separated from the drilling fluid using one or a combination of the following: balanced elliptical and linear-motion shale shakers, desanders, desilters, hydroclones, mud cleaners and centrifuges. M-I SWACO designs, manufactures, sells and rents a comprehensive, proprietary line of this equipment for oil and gas drilling processes throughout the world. The Company is also a leading manufacturer and supplier of screens used in solids-control equipment for both oilfield and certain industrial markets. M-I SWACO complements its product offering by providing engineering and technical support to operators and drilling contractors from the planning stages of their projects through waste removal and site remediation.

Operators employ M-I SWACO-manufactured pressure-control equipment to drill in sour-gas and high-pressure zones. Well killing and high-pressure control drilling chokes, together with related operating consoles, are used in the drilling process during well kicks and well clean-up and testing operations. Degassers and mud gas separators are designed to remove and vent entrained gases, including toxic gases such as hydrogen sulfide and corrosive oxygen, from the drilling mud. This equipment reduces the risk of dangerous and costly blowouts caused by recirculating mud that contains natural gas. Key products in M-I SWACO's pressure control product line include the Mud D-Gasser<sup>®</sup> and Super Choke<sup>®</sup>, both of which hold strong market positions as do the Super Mud Gas Separator<sup>®</sup> and the Super Autochoke<sup>®</sup>.

With drilling operations expanding into more environmentally sensitive areas, there has been increased focus on the effective collection, treatment and disposal of waste produced during the drilling of a well. M-I SWACO provides operators with solutions designed to minimize and treat drilling waste. The Company provides a suite of waste handling, minimization and management products and services, including the CleanCut<sup>®</sup> pneumatic conveyance system for collection and transportation of drill cuttings related to offshore drilling programs. M-I SWACO also provides rig vacuum systems for cuttings recovery, high-gravity force drying equipment for liquid/solid separation and cuttings slurification and re-injection processes for reducing haul-off waste. In addition, through the Thermal Phase Separation<sup>®</sup> process, M-I SWACO provides operators a proven technology for maximizing the recovery of drilling fluids, while minimizing wastes. M-I SWACO's waste treatment services encompass a wide range of activities, including site assessment, drill cuttings injection, water treatment, pit closure and remediation, bioremediation, dewatering and thermal processing. The Company has established EnviroCenters<sup>®</sup> in Norway, Germany and the United States designed specifically for recovering, treating and recycling solid and liquid drilling wastes.

*M-I SWACO Environmental Solutions Competition.* M-I SWACO competes with Brandt/Rigtech (a subsidiary of National Oilwell Varco, Inc. ( National-Oilwell Varco )) and Derrick/Oil Tools. Additionally, there are a number of regional suppliers that provide a limited range of equipment and services tailored for local markets. Competition is based on product availability, equipment performance, technical support and price.

*M-I SWACO Wellbore Assurance Products and Services.* Wellbore Assurance product offerings, which account for approximately 15 percent of M-I SWACO's total revenues, include completion fluids, completion tools and completion fluid filtration services. These offerings are used during the completion phase of the well to facilitate maximum production.



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Completion fluids (clear brines) are solids-free, clear-salt solutions that are non-damaging to the producing formation. Operators use these specially designed fluid systems in combination with a comprehensive range of specialty chemicals to control bottom-hole pressures, while meeting the specific corrosion inhibition, viscosity and fluid loss requirements necessary during the completion and workover phase of a well. These systems are specially engineered to maximize well production by minimizing formation damage that can be caused by solids-laden systems. M-I SWACO provides a complete line of completion fluids products, including low- and high-density brines, specialty chemicals, wellsite engineering and technical and laboratory support services.

Completion tools, also known as specialized tools, are used in the critical stage of displacing drilling fluids with completion fluids. The tools work in connection with completion fluids to promote a clean wellbore, facilitating the installation of essential hardware used in the completion process. M-I SWACO provides a broad range of tools including casing cleaning, debris recovery and circulating tools. Filtration services are used to remove solids from brine fluids during completion operations.

*Wellbore Assurance Competition.* The major competitors in the worldwide wellbore assurance market, which approximated \$1.5 billion in 2007, are Baroid Completion Fluids (a division of Halliburton), Tetra Technologies, Inc. and Baker Hughes. Generally, competition is based on a number of factors including wellsite engineering services, product quality and availability, technical support, service response and price.

*Oilfield Production Chemicals.* M-I SWACO provides a line of oilfield specialty chemicals and related technical services through its Oilfield Production Chemical division. Oilfield production chemicals are used to enhance the flow of hydrocarbons from the wellbore by eliminating paraffin, scale and other byproducts encountered during the production process. Oilfield production chemicals are also used to protect piping and other equipment associated with the production, transportation and processing of oil and gas.

*Production Chemical Competition.* The major competitors in the worldwide oilfield production chemical market include Baker Petrolite (a division of Baker Hughes), Nalco Energy Services (a division of Nalco Company) and Champion Technologies, Inc. Generally, competition is based on product quality, product performance, technical support and price.

*Smith Technologies*

*Products and Services.* Smith Technologies is a worldwide leader in the design, manufacture and marketing of drill bits primarily used in drilling oil and natural gas wells. In addition, Smith Technologies is a leading provider of borehole enlargement tools and downhole turbine drilling products (referred to as turbodrills) and services that enhance the operating performance of petroleum drill bits in certain applications. Smith Technologies product offerings are designed principally for the premium market segments where faster drilling rates and greater footage drilled provide significant economic benefits in reducing the total cost of a well.

Smith Technologies designs, manufactures and markets three-cone drill bits for the petroleum industry, ranging in size from 3<sup>1</sup>/<sub>2</sub> to 32 inches in diameter. Three-cone bits work by crushing and shearing the rock formation as the bit is turned. These three-cone bits comprise two major components—the body and the cones, which contain different types of pointed structures referred to as cutting structures or teeth. The cutting structures are either an integral part of the steel cone with a hardmetal-applied surface (referred to as milled tooth) or made of an inserted material (referred to as insert), which is usually tungsten carbide. The Company also produces three-cone drill bits in which the tungsten carbide insert is coated with polycrystalline diamond. In certain formations, bits produced with diamond-enhanced inserts last longer and increase penetration rates, which substantially decreases overall drilling costs. For the year ended December 31, 2007, three-cone drill bits accounted for approximately 50 percent of the Company's total drill bit sales.

In addition, Smith Technologies designs, manufactures and markets diamond drill bits. Diamond bits consist of a single body made of either a matrix powder alloy or steel. The cutting structures of diamond bits consist of either polycrystalline diamond cutters, which are brazed on the bit, or natural or synthetic diamonds, which are impregnated in the bit. These bits, which range in size from 2<sup>3</sup>/<sub>4</sub> to 26 inches in diameter, work by shearing the rock formation with a milling action as the bit is turned. Over the past few years, the drill bit market has shifted towards a higher mix of diamond bit products as improved designs and manufacturing processes have enabled diamond products to be used in a wider array of drilling applications. For the year ended December 31, 2007, diamond drill bits accounted for

approximately 50 percent of the Company's total drill bit sales.

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Additionally, the Company manufactures and markets hole openers and underreamers which are designed to create larger hole diameters in certain sections of the wellbore. The patented Rhino® Reamer, Reamaster® and simultaneous drilling and hole enlargement system are three examples of products that aid the customer in realizing lower drilling costs through technology. Through the use of the simultaneous drilling and hole enlargement system above the drill bit, the operator may drill the main well bore with the bit and enlarge the diameter of the hole above the drill bit in the same run.

Smith Technologies also designs, assembles and markets a comprehensive line of turbodrills and provides related technical support. Turbodrills, which operate directly above the drill bit, use the hydraulic energy provided by drilling fluid pumps on the rig floor to deliver torque to and rotate the drill bit. These proprietary tools are designed to provide faster rates of penetration, operate in much higher temperature formations, deliver longer downhole life and produce better wellbore quality than conventional positive displacement drilling motors. The turbine drilling motor provides operators with cost effective solutions in demanding environments such as horizontal applications, hard formations and high-temperature zones.

The Company manufactures polycrystalline diamond and cubic boron nitride materials that are used in the Company's three-cone and diamond drill bits and other specialized cutting tools. The Company believes that it is one of the world's largest manufacturers of polycrystalline diamond for use in oilfield applications. Smith Technologies also develops and uses patented processes for applying diamonds to a curved surface which optimize the performance of inserts used in drill bits. As a result, the Company believes that Smith Technologies enjoys a competitive advantage in both material cost and technical ability over other drill bit companies. In addition, the Company's in-house diamond research, engineering and manufacturing capabilities enhance the Company's ability to develop the application of diamond technology across other Smith product lines and into non-energy markets.

*Competition.* Smith Technologies' major competitors in the drill bit business are Hughes Christensen (a division of Baker Hughes), Security DBS (a division of Halliburton) and ReedHycalog (a division of Grant Prideco, Inc.). While Smith Technologies and these companies supply the majority of the worldwide drill bit market, which approximated \$2.9 billion in 2007, they compete with more than 20 companies. The main competitors in the borehole enlargement business are Andergauge (a division of Grant Prideco, Inc.), Security DBS and Sperry Drilling Services (divisions of Halliburton). Generally, competition in these markets is based on a number of factors, including performance, quality, reliability, service, price, technological advances and breadth of products.

*Smith Services*

*Products and Services.* Smith Services is a leading global provider of technologically advanced drilling, tubular, fishing, remedial, multilateral and completion products, services and solutions to the oil and gas drilling industry.

Smith Services' Drilling Products and Services business provides a broad range of downhole impact tools for drilling applications as well as numerous other specialized downhole drilling products and services. Smith Services sells and rents impact drilling tools such as the Hydra-Jar® Tool and the Accelerator® Tool, which are used to free stuck drill strings during the drilling process. Additionally, Drilling on Gauge Subs and Borrox AP Reamers are some of the Company's tools used by operators for maintaining hole gauge and quality of the wellbore. Smith Services also offers tubular drill string components, such as drill collars, subs, stabilizers, kellys and Hevi-Wate DrillPipe, and provides related inspection services, including drillstring repair and rebuild services. These components and their placement in the drillstring are supported by engineering and field technical services in order to optimize bottom hole management techniques. Through state-of-the-art software, Smith Services aids the customer in maximizing the life of drillstring components. Rotating control devices for flow control in underbalanced / managed pressure drilling applications, such as the Hold 1500® Tool and the Hold 2500® Tool, and automatic connection torque monitoring and control systems are designed and manufactured by Smith Services.

Smith Services' Fishing and Remedial Services business provides a comprehensive package of fishing, remedial and thru-tubing services. Fishing operations clear and remove obstructions from a wellbore that may arise during drilling, completion or workover activities or during a well's production phase. This operation requires a wide variety of specialty tools, including fishing jars, milling tools and casing cutters, most of which are manufactured by Smith Services. These tools are operated by Company service personnel or sold or rented to third-party fishing companies.



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Smith Services provides Wellbore Departure Systems through the manufacture of proprietary casing exit tools which are installed by trained technicians. These systems, which include the patented Trackmaster® Plus Whipstock System, allow the operator to divert around obstructions in the main wellbore or reach multiple production zones from the main wellbore (known as multilateral completions). In addition, Smith Services Geotrack Whipstock System mills the casing exit and continues to drill several hundred feet of formation in a single trip, saving the customer time and reducing their overall drilling costs. The Company also provides mechanical, hydraulic and explosive pipe-cutting services to remove casing during well or platform abandonment.

Smith Services Completion Systems business specializes in providing fit-for-purpose liner hanger systems, liner cementing equipment, isolation packers, retrievable and permanent packers, and drillable bridge and frac plugs. Liner hangers allow strings of casing to be suspended within the wellbore without having to extend the string all the way to the surface and are also used to isolate production zones and formations. Most directional and multilateral wells include one or more hangers due to complex casing programs and need for zonal isolation. Using Smith Services Pocket Slip liner hanger system, long or heavy liners can be suspended with minimal casing distortion and maximum flow-by area. Packers are mechanically or hydraulically actuated devices which lock into place at specified depths in the well and provide a seal between zones through expanding-element systems. The devices therefore create isolated zones within the wellbore to permit either specific formation production or allow for certain operations, such as cementing or acidizing, to take place without damaging the reservoir. The Smith Services Isofrac packer selectively isolates multiple zones in a single trip to reduce fracturing job time, while the Long Reach packer facilitates successful liner deployment in vertical and long reach horizontal wellbores without excessive work string manipulation. In addition, Smith Services top drive cementing manifold eliminates cement contamination of top drive components by creating a flow path for cement that bypasses the drilling rig's top drive assembly.

*Competition.* Smith Services major competitors in the drilling, remedial, re-entry and fishing services markets are Weatherford International, Inc. ( Weatherford ), Baker Oil Tools (a division of Baker Hughes) and numerous small local companies. The main competitors in the liner hanger and packer markets are Baker Oil Tools, Weatherford and TIW Corporation. The main competitors in the drilling and fishing jar market and the fishing product and service market are Weatherford and National-Oilwell Varco. Competition in the drilling and completions sales, rental and services market is primarily based on performance, quality, reliability, service, price and response time and, in some cases, breadth of products.

***Distribution Segment******Wilson***

*Products and Services.* Wilson is a supply-chain management company which provides products and services to the energy, refining, petrochemical, power generation and mining industries. Wilson operates an extensive network of supply branches, service centers and sales offices through which it markets pipe, valves and fittings as well as mill, safety and other maintenance products, predominately in the United States and Canada. In addition, Wilson provides warehouse management, vendor integration and various surplus and inventory management services. The majority of Wilson's operations are focused on North American distribution of maintenance, repair and operating supplies and equipment with the remainder associated with line pipe and automated valve products (including valve, actuator and control packages).

Approximately three-fourths of Wilson's 2007 revenues were generated in the energy sector, which includes exploration and production companies and companies with operations in the petroleum industry's pipeline sector. The remainder related to sales in the downstream and industrial market, including refineries, petrochemical and power generation plants and other energy-focused operations. Approximately 20 percent of Wilson's 2007 revenues were reported in Canada, attributable to the CE Franklin Ltd. operations, a publicly-traded distribution business in which the Company owns the majority of the outstanding common stock.

*Competition.* Wilson's competitors in its energy sector operations include National-Oilwell Varco, McJunkin Red Man Corporation and a significant number of smaller, locally based operations. Wilson's competitors in the downstream and industrial market include Hagemeyer NV, Ferguson Enterprises, Inc., McJunkin Red Man Corporation and W.W. Grainger, Inc. The distribution market that Wilson participates in is highly competitive. Generally, competition involves numerous factors, including price, experience, customer service and equipment

availability.

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### **Non-U.S. Operations**

Sales to oil and gas exploration and production markets outside the United States are a key strategic focus of Smith's management. The Company markets its products and services through subsidiaries, joint ventures and sales agents located in virtually all petroleum-producing areas of the world, including Canada, Latin America, Europe/Africa, and Middle East/Asia. Approximately 55 percent, 54 percent and 55 percent of the Company's revenues in 2007, 2006 and 2005, respectively, were derived from equipment or services sold or provided outside the United States. The Company's Distribution operations constitute a significant portion of the consolidated revenue base and are concentrated in North America which serves to distort the geographic revenue mix of the Company's Oilfield segment operations. Excluding the impact of the Distribution operations, approximately 64 percent, 63 percent and 65 percent of the Company's revenues were generated in non-U.S. markets in 2007, 2006 and 2005, respectively.

Historically, drilling activity outside the United States has been less volatile than U.S.-based activity as the high cost exploration and production programs outside the United States are generally undertaken by major oil companies, consortiums and national oil companies. These entities operate under longer-term strategic priorities than do the independent drilling operators that are more common in the U.S. market.

### **Sales and Distribution**

Sales and service efforts are directed to end users in the exploration and production industry, including major and independent oil companies, national oil companies and independent drilling contractors. The Company's products and services are primarily marketed through the direct sales force of each business unit. In certain non-U.S. markets where direct sales efforts are not practicable, the Company utilizes independent sales agents, distributors or joint ventures.

Smith maintains field service centers, which function as repair and maintenance facilities for rental tools, operations for remedial and completion services and a base for the Company's global sales force, in all major oil and gas producing regions of the world. The location of these service centers near the Company's customers is an important factor in maintaining favorable customer relations.

### **Manufacturing**

The Company's manufacturing operations, along with quality control support, are designed to ensure that all products and services marketed by the Company will meet standards of performance and reliability consistent with the Company's reputation in the industry.

Management believes that it generally has sufficient internal manufacturing capacity to meet anticipated demand for its products and services. During periods of peak demand, certain business units utilize outside resources to provide additional manufacturing capacity.

### **Raw Materials**

Through its company-owned mines in and outside the United States, M-I SWACO has the capability to produce a large portion of its requirements for barite and bentonite, which are typically added to engineered fluid systems. Barite reserves are mined in the United States, the United Kingdom and Morocco. Bentonite is produced from ore deposits in the U.S. Mining exploration activities continue worldwide to locate and evaluate ore bodies to ensure deposits are readily available for production when market conditions dictate. In addition to its own production, M-I SWACO purchases the majority of its worldwide barite requirement from suppliers outside the United States, mainly the People's Republic of China, India and Morocco.

The Company purchases a variety of raw materials for its Smith Technologies and Smith Services units, including alloy and stainless steel bars, tungsten carbide inserts and forgings. Generally, the Company is not dependent on any single source of supply for any of its raw materials or purchased components, and believes that numerous alternative supply sources are available for all such materials. The Company does not expect any interruption in supply, but there can be no assurance that there will be no price or supply issues over the long-term. The Company produces polycrystalline diamond materials in Provo, Utah and Scurelle, Italy for utilization in various Company products as well as direct customer sales.

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**Product Development, Engineering and Patents**

The Company's business units maintain product development and engineering departments whose activities are focused on improving existing products and services and developing new technologies to meet customer demands for improved drilling performance and environmental-based solutions for drilling and completion operations. The Company's primary research facilities are located in Houston, Texas; Stavanger, Norway; Aberdeen, Scotland; and Florence, Kentucky.

The Company also maintains a drill bit database which records the performance of drill bits over the last 20 years, including those manufactured by competitors. This database gives the Company the ability to monitor, among other things, drill bit failures and performance improvements related to product development. The Company believes this proprietary database gives it a competitive advantage in the drill bit business.

The Company has historically invested significant resources in research and engineering in order to provide customers with broader product lines and technologically-advanced products and services. The Company's expenditures for research and engineering activities are attributable to the Company's Oilfield segment and totaled \$110.7 million in 2007, \$88.3 million in 2006 and \$73.6 million in 2005. Research and engineering expenditures approximated 1.7 percent, 1.6 percent and 1.8 percent of the Company's Oilfield segment revenues in 2007, 2006 and 2005, respectively.

Although the Company has over 4,400 issued and pending patents and regards its patents and patent applications as important in the operation of its business, it does not believe that any significant portion of its business is materially dependent upon any single patent.

**Employees**

At December 31, 2007, the Company had 19,865 full-time employees throughout the world. Most of the Company's employees in the United States are not covered by collective bargaining agreements except in certain U.S. mining operations of M-I SWACO and several distribution locations of Wilson. The Company considers its labor relations to be satisfactory.



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**Officers of the Registrant**

The names and ages of all officers of the Company, all positions and offices with the Company presently held by each person named and their business experience are stated below. Positions, unless otherwise specified, are with the Company.

| <b>Name, Age and Positions</b>  | <b>Principal Current Occupation and Other Significant Positions Held</b>   |
|---|--|
| Doug Rock (61)<br>Chairman of the Board, Chief Executive Officer, President and Chief Operating Officer | Chairman of the Board since February 1991, elected Chief Executive Officer in March 1989 and served as President and Chief Operating Officer since December 1987. Held various positions since joining the Company in June 1974.   |
| Malcolm W. Anderson (60)<br>Senior Vice President, Human Resources                                      | Senior Vice President, Human Resources since December 2006. Joined Company as Vice President, Human Resources in May 2004. Vice President Human Resources at Hewlett Packard from January 2001 to April 2004. Vice President Human Resources at Weatherford International Ltd. from April 1996 to December 2000. |
| Richard E. Chandler, Jr. (51)<br>Senior Vice President, General Counsel and Secretary                   | Senior Vice President and Secretary since January 2006 and General Counsel since August 2005. Joined predecessor to M-I SWACO in December 1986 as Vice President, General Counsel and Secretary. Named Senior Vice President Administration, General Counsel and Secretary of M-I SWACO in January 2004.         |
| Margaret K. Dorman (44)<br>Senior Vice President, Chief Financial Officer and Treasurer                 | Senior Vice President, Chief Financial Officer and Treasurer since June 1999. Joined Company as Director of Financial Reporting in December 1995 and named Vice President, Controller and Assistant Treasurer in February 1998.  |
| Bryan L. Dudman (51)<br>President, Smith Services   | President, Smith Services since January 2006. Held various positions since joining the Company in January 1979. Prior to being named to current position, served as Senior Vice President of M-I SWACO's Western Hemisphere Operations since May 1994.   |
| John J. Kennedy (55)<br>President and Chief Executive Officer, Wilson                                   | President and Chief Executive Officer, Wilson since June 1999. Held various positions since joining the Company in November 1986. Elected Vice President, Chief Accounting Officer and Treasurer in March 1994 and named Senior Vice President, Chief Financial Officer and Treasurer in April 1997.             |
| Donald McKenzie (58)<br>President and Chief Executive Officer, M-I SWACO                                | President and Chief Executive Officer, M-I SWACO since May 2006. Held various positions since joining the Company in 1989. Named Senior Vice President of M-I SWACO's Eastern Hemisphere Operations of M-I SWACO in April 1994. Appointed Chief Operating Officer of M-I SWACO in January 2006.                  |
| Michael D. Pearce (60)<br>President, Smith Technologies   | President, Smith Technologies since May 2005. Joined Company as Vice President Sales of the Company's GeoDiamond Division in April 1995 and named Vice President Sales of Smith Technologies in August 1998.   |

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Peter J. Pinta (49)  
Vice President, Corporate Strategy  
and Development

Vice President Corporate Strategy and Development since September 2005.  
Held various positions at DTE Energy Company between October 1997 and  
August 2005, including Director Corporate Development, Managing  
Director Venture Capital Investments, and Director Investor Relations.

Joseph S. Rinando, III (36)  
Vice President and Controller

Vice President and Controller since April 2006. Joined Company as Director  
of Financial Reporting in May 2003. Served as Audit Manager for  
PricewaterhouseCoopers LLP from July 2000 to June 2002 and Senior  
Manager from July 2002 to May 2003.

Geraldine D. Wilde (57)  
Vice President, Taxes and  
Assistant Treasurer

Vice President, Taxes since February 1998. Joined Company as Manager of  
Taxes and Payroll of predecessor to M-I SWACO in December 1986 and  
named Director of Taxes and Assistant Treasurer in April 1997.

All officers of the Company are elected annually by the Board of Directors. They hold office until their successors are  
elected and qualified. There are no family relationships between the officers of the Company.

**Table of Contents****Item 1A. Risk Factors**

This document contains forward-looking statements within the meaning of the Section 21E of the Securities Exchange Act of 1934, as amended, concerning, among other things, our outlook, financial projections and business strategies, all of which are subject to risks, uncertainties and assumptions. These forward-looking statements are identified by their use of terms such as anticipate, believe, could, estimate, expect, project and similar terms. statements are based on certain assumptions and analyses that we believe are appropriate under the circumstances. Such statements are subject to, among other things, general economic and business conditions, the level of oil and natural gas exploration and development activities, global economic growth and activity, political stability of oil-producing countries, finding and development costs of operations, decline and depletion rates for oil and natural gas wells, seasonal weather conditions, industry conditions, and changes in laws or regulations, many of which are beyond the control of the Company. Should one or more of these risks or uncertainties materialize, or should the assumptions prove incorrect, actual results may differ materially from those expected, estimated or projected. Management believes these forward-looking statements are reasonable. However, you should not place undue reliance on these forward-looking statements, which are based only on our current expectations. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to publicly update or revise any of them in light of new information, future events or otherwise.

With this in mind, you should consider the risks discussed elsewhere in this report and other documents we file with the Securities and Exchange Commission from time to time and the following important factors that could cause our actual results to differ materially from those expressed in any forward-looking statement made by us or on our behalf.

***We are dependent on the level of oil and natural gas exploration and development activities.***

Demand for our products and services is dependent upon the level of oil and natural gas exploration and development activities. The level of worldwide oil and natural gas development activities is primarily influenced by the price of oil and natural gas, as well as price expectations. In addition to oil and natural gas prices, the following factors impact exploration and development activity and may lead to significant changes in worldwide activity levels:

Overall level of global economic growth and activity;

Actual and perceived changes in the supply and demand for oil and natural gas;

Political stability and policies of oil-producing countries;

Finding and development costs of operators;

Decline and depletion rates for oil and natural gas wells; and

Seasonal weather conditions that temporarily curtail drilling operations.

Changes in any of these factors could adversely impact our financial condition, results of operations or cash flows. ***There are certain risks associated with conducting business in markets outside of North America.***

We are a multinational oilfield service company and generate the majority of our Oilfield segment revenues in markets outside of North America. Changes in conditions within certain countries that have historically experienced a high degree of political and/or economic instability could adversely impact our financial condition, results of operations or cash flows. Additional risks inherent in our non-North American business activities include:

Changes in political and economic conditions in the countries in which we operate, including civil uprisings, riots and terrorist acts;

Unexpected changes in regulatory requirements;

Fluctuations in currency exchange rates and the value of the U.S. dollar;

Restrictions on repatriation of earnings or expropriation of property without fair compensation;

Governmental actions that result in the deprivation of contract or proprietary rights; and

Governmental sanctions.

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***We operate in a highly technical and competitive environment.***

We operate in a highly-competitive business environment. Accordingly, demand for our products and services is largely dependent on our ability to provide leading-edge, technology-based solutions that reduce the operator's overall cost of developing energy assets. If competitive or other market conditions impact our ability to continue providing superior-performing product offerings, our financial condition, results of operations or cash flows could be adversely impacted.

***Our businesses are subject to a variety of governmental regulations.***

We are exposed to a variety of federal, state, local and international laws and regulations relating to matters such as environmental, health and safety, labor and employment, import/export control, currency exchange, bribery and corruption and taxation. These laws and regulations are complex, change frequently and have tended to become more stringent over time. In the event the scope of these laws and regulations expand in the future, the incremental cost of compliance could adversely impact our financial condition, results of operations or cash flows.

***Our industry is experiencing more litigation involving claims of infringement of intellectual property rights.***

Over the past few years, our industry has experienced increased litigation related to the infringement of intellectual property rights. Although no material matters are pending or threatened at this time, we, as well as certain of our competitors, have been named as defendants in various intellectual property matters in the past. These types of claims are typically costly to defend, involve monetary judgments that, in certain circumstances, are subject to being enhanced and are often brought in venues which have proved to be favorable to plaintiffs. If we are served with an intellectual property claim which we are unsuccessful in defending, it could adversely impact our results of operations and cash flows.

***Item 1B. Unresolved Staff Comments***

None.

**Table of Contents****Item 2. Properties**

The principal facilities and properties utilized by the Company at December 31, 2007 are shown in the table below. Generally, the facilities and properties are owned by the Company.

| Location                     | Principal Products Processed,<br>Manufactured or Distributed  | Land<br>(Acres) | Approx.<br>Bldg.<br>Space (sq.ft.) |
|------------------------------|---|-----------------|------------------------------------|
| <i>Oilfield Segment:</i>     |   |                 |                                    |
| Houston, Texas               | Smith corporate headquarters, tubulars, surface and downhole tools, remedial products, liner hangers, diamond drill bits, turbodrills, drilling and fishing jars and fishing tool equipment | 96              | 1,075,800                          |
| Volgograd, Russia            | Drilling fluid and waste management products  | 17              | 719,350                            |
| Houston, Texas               | M-I SWACO corporate headquarters and research center  | 22              | 268,400                            |
| Macaé, Brazil                | Drilling fluid chemical products  | 5               | 234,870                            |
| Florence, Kentucky           | Separator units, mill units, parts, screens and motors  | 6               | 214,000                            |
| Ponca City, Oklahoma         | Three-cone drill bits   | 15              | 207,000                            |
| Oruro, Bolivia               | Drilling fluids   | 5               | 202,740                            |
| Aberdeen, Scotland           | Downhole tools and remedial products  | 10              | 155,000                            |
| Changzhou, China             | Drilling and downhole tools   | 3               | 146,360                            |
| Greybull, Wyoming            | Bentonite mine and processing   | 8,394           | 110,000                            |
| Saline di Volterra, Italy    | Three-cone drill bits   | 11              | 99,900                             |
| Tulsa, Oklahoma              | Oilfield and industrial screening products  | 7               | 95,000                             |
| Edinburgh, Scotland          | Wire cloth and oilfield screening products  | 3               | 92,450                             |
| Salzwedel, Germany           | Drilling fluid processing   | 2               | 86,000                             |
| Nisku, Alberta, Canada       | Fishing and remedial services   | 10              | 83,000                             |
| Provo, Utah                  | Synthetic diamond materials   | 5               | 68,300                             |
| Aberdeen, Scotland           | Production chemical processing  | 2               | 66,000                             |
| Karmoy, Norway               | Barite and bentonite processing   | 5               | 51,000                             |
| Greystone, Nevada            | Barite mine and processing  | 268             | 50,000                             |
| Macon, Georgia               | Separator units and screens   | 1               | 49,000                             |
| Battle Mountain, Nevada      | Barite processing   | 23              | 43,000                             |
| Zelmou, Morocco              | Barite mine   | 3,954           | 41,000                             |
| Nisku, Alberta, Canada       | Drilling fluid chemical products  | 4               | 37,280                             |
| Zavalla, Texas               | Drilling fluid chemical products  | 33              | 36,000                             |
| Nivellas, Belgium            | Separator units, mill units, parts, screens and motors  | 5               | 31,780                             |
| Scurelle, Italy              | Diamond drill bits and synthetic diamond materials  | 4               | 31,000                             |
| Spruce Grove, Canada         | Drilling fluid processing   | 7               | 30,450                             |
| Amelia, Louisiana            | Barite processing   | 26              | 25,000                             |
| Berra, Italy                 | Solids control equipment  | 4               | 24,930                             |
| Port Fouchon, Louisiana      | Drilling fluid storage, processing and distribution   | 11              | 24,600                             |
| Galveston, Texas             | Barite processing   | 6               | 21,000                             |
| Grand Prairie, Canada        | Fishing and remedial services   | 4               | 13,960                             |
| Foss/Aberfeldy, Scotland     | Barite mine and processing  | 102             | 10,000                             |
| Mountain Springs, Nevada     | Barite mine   | 900             |                                    |
| <i>Distribution Segment:</i> |   |                 |                                    |
| La Porte, Texas              | Pipe, valves and fittings   | 15              | 440,000                            |

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|                       |                           |   |        |
|-----------------------|---------------------------|---|--------|
| Tampa, Florida        | Pipe, valves and fittings | 4 | 86,200 |
| Trainer, Pennsylvania | Pipe, valves and fittings | 3 | 23,000 |

The Company considers its mines and manufacturing and processing facilities to be in good condition and adequately maintained. The Company also believes its facilities are suitable for their present and intended purposes and are generally adequate for the Company's current and anticipated level of operations.

The Company's Corporate headquarters is located in Houston, Texas. The Company also leases various administrative and sales offices, as well as warehouses and service centers in the United States and other countries in which it conducts business. The Company believes that it will be able to renew and extend its property leases on terms satisfactory to the Company or, if necessary, locate substitute facilities on acceptable terms.

**Table of Contents****Item 3. Legal Proceedings**

Information relating to various commitments and contingencies, including legal proceedings, is described in Note 16 of the Consolidated Financial Statements included elsewhere in this report on Form 10-K and is incorporated herein by reference.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**PART II****Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The common stock of the Company is traded on several market exchanges, including the New York Stock Exchange, under the symbol SII. The following are the high and low sale prices for the Company's common stock as reported on the New York Stock Exchange Composite Tape for the periods indicated.

|      | 2006 Common Stock |         |         |         | 2007 Common Stock |         |         |         |
|------|-------------------|---------|---------|---------|-------------------|---------|---------|---------|
|      | Q1                | Q2      | Q3      | Q4      | Q1                | Q2      | Q3      | Q4      |
| High | \$44.63           | \$44.35 | \$45.79 | \$44.11 | \$48.41           | \$60.34 | \$74.00 | \$75.34 |
| Low  | \$35.66           | \$36.17 | \$36.05 | \$35.89 | \$36.01           | \$48.84 | \$56.78 | \$59.16 |

On February 22, 2008, the Company had 1,771 common stock holders of record and the last reported closing price on the New York Stock Exchange Composite Tape was \$62.33.

**Stock Repurchases**

During October 2005, the Company's Board of Directors approved a repurchase program that allows for the purchase of up to 20 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. During the fourth quarter of 2007, the Company repurchased 78,500 shares of common stock in the open market at an aggregate cost, including commissions, of \$4.7 million. As of December 31, 2007, the Company has repurchased 4.3 million shares at an average cost of \$44.03 per share under the current program. The acquired shares have been added to the Company's treasury stock holdings.

The following table summarizes the Company's repurchase activity for the three months ended December 31, 2007:

| Period                       | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Number of Shares that May Yet Be Purchased Under the Program |
|------------------------------|----------------------------------|------------------------------|--|--|
| October 1 - 31               |                                  | \$                           |  | 15,772,413   |
| November 1 - 30              | 78,500                           | 59.64                        | 78,500   | 15,693,913   |
| December 1 - 31              |                                  |                              |  | 15,693,913   |
| 4 <sup>th</sup> Quarter 2007 | 78,500                           | \$ 59.64                     | 78,500   | 15,693,913   |

**Dividend Program**

In February 2005, the Company's Board of Directors approved a regular quarterly cash dividend program. The Board of Directors declared dividends of \$80.1 million, \$64.0 million and \$48.4 million for the years ended December 31, 2007, 2006 and 2005, respectively.

On February 6, 2008, the Company's Board of Directors increased the quarterly cash dividend to \$0.12 per share, beginning with the distribution payable April 14, 2008 to stockholders of record on March 14, 2008. The level of future dividend payments will be at the discretion of the Board of Directors and will depend upon the Company's



financial condition, earnings and cash flow from operations, the level of its capital expenditures, compliance with certain debt covenants, future business prospects and other factors that the Board of Directors deem relevant.

**Table of Contents****Item 6. Selected Financial Data**

|  | <b>For the Years Ended December 31,</b> |             |             |                           |             |
|--|---|-------------|-------------|---------------------------|-------------|
|  | <b>2007</b>                             | <b>2006</b> | <b>2005</b> | <b>2004<sup>(a)</sup></b> | <b>2003</b> |
|  | (In thousands, except per share data)   |             |             |                           |             |
| <b>Statements of Operations Data:</b>  |   |             |             |                           |             |
| Revenues   | \$8,764,330                             | \$7,333,559 | \$5,579,003 | \$4,419,015               | \$3,594,828 |
| Gross profit   | 2,855,657                               | 2,344,271   | 1,685,138   | 1,351,939                 | 1,075,931   |
| Operating income   | 1,369,797                               | 1,080,081   | 670,561     | 438,764                   | 328,747     |
| Income before cumulative effect of change in accounting principle                                    | 647,051                                 | 502,006     | 302,305     | 182,451                   | 124,634     |
| Diluted earnings per share before cumulative effect of change in accounting principle <sup>(b)</sup> | 3.20                                    | 2.49        | 1.48        | 0.89                      | 0.62        |
| <b>Balance Sheet Data:</b>   |   |             |             |                           |             |
| Total assets   | \$6,061,880                             | \$5,335,475 | \$4,059,914 | \$3,506,778               | \$3,097,047 |
| Long-term debt   | 845,624                                 | 800,928     | 610,857     | 387,798                   | 488,548     |
| Total stockholders' equity   | 2,594,897                               | 1,986,937   | 1,578,505   | 1,400,811                 | 1,235,776   |
| Cash dividends declared per common share <sup>(c)</sup>  | 0.40                                    | 0.32        | 0.24        |                           |             |

The Selected Financial Data above should be read together with the Notes to Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-K in order to understand factors, such as business combinations completed during 2007, 2006 and 2005, and unusual items, which may affect the comparability of the Selected Financial Data.

- (a) The 2004 results include a \$31.4 million, or \$0.10 per share, litigation-related charge associated with a patent infringement suit.
- (b) All fiscal years prior to 2005 have been restated for the impact of a two-for-one stock dividend distributed on August 24, 2005.
- (c) In February 2005, the Company's Board of Directors approved a regular quarterly cash dividend program. For additional information regarding the Company's dividend program, see Part II, Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities to this Form 10-K.

**Table of Contents****Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**General**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations is provided to assist readers in understanding the Company's financial performance during the periods presented and significant trends which may impact the future performance of the Company. This discussion should be read in conjunction with the Consolidated Financial Statements of the Company and the related notes thereto included elsewhere in this Form 10-K. This discussion includes forward-looking statements that are subject to risks and uncertainties. Actual results may differ materially from the statements we make in this section due to a number of factors that are discussed beginning on page 10.

**Company Products and Operations**

The Company is a leading global provider of premium products and services to the oil and gas exploration and production industry. The Company provides a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control and separation equipment, waste-management services, oilfield production chemicals, three-cone and diamond drill bits, turbines, borehole enlargement tools, tubulars, fishing services, drilling tools, underreamers, casing exit and multilateral systems, packers and liner hangers. The Company also offers supply chain management solutions through an extensive North American branch network providing pipe, valves and fittings as well as mill, safety and other maintenance products.

The Company's operations are largely driven by the level of exploration and production ( E&P ) spending in major energy-producing regions around the world and the depth and complexity of these projects. Although E&P spending is significantly influenced by the market price of oil and natural gas, it may also be affected by supply and demand fundamentals, finding and development costs, decline and depletion rates, political actions and uncertainties, environmental concerns, the financial condition of independent E&P companies and the overall level of global economic growth and activity. In addition, approximately six percent of the Company's consolidated revenues relate to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely impacted by the general condition of the U.S. economy.

Capital investment by energy companies is largely divided into two markets, which vary greatly in terms of primary business drivers and associated volatility levels. North American drilling activity is primarily influenced by natural gas fundamentals, with approximately 80 percent of the current rig count focused on natural gas finding and development activities. Conversely, drilling in areas outside of North America is more dependent on crude oil fundamentals, which influence over three-quarters of international drilling activity. Historically, business in markets outside of North America has proved to be less volatile as the high cost E&P programs in these regions are generally undertaken by major oil companies, consortiums and national oil companies as part of a longer-term strategic development plan. Although 54 percent of the Company's consolidated revenues were generated in North America during 2007, Smith's profitability was largely dependent upon business levels in markets outside of North America. The Distribution segment, which accounts for 24 percent of consolidated revenues and primarily supports a North American customer base, serves to distort the geographic revenue mix of the Company's Oilfield segment operations. Excluding the impact of the Distribution segment, approximately 60 percent of the Company's 2007 revenues were generated in markets outside of North America.

Finally, over the past few years, a number of factors have driven an increase in the importance of national oil companies (NOCs) in the global energy industry. NOCs currently control approximately 80 percent of world oil reserves and account for nearly three-quarters of production. As we look forward, NOCs and their governments will likely have more control over the pace and the manner in which oil and gas resources are developed which could have implications for Smith and other oilfield service industry participants. We believe we have been successful developing strong business relationships with NOCs, which contribute a sizable portion of our revenues.

**Business Outlook**

After experiencing 14 percent compound annual rig count growth in North America over the past five-year period, North American activity levels are forecasted to remain relatively flat during the near-term. Markets outside North America should continue to expand as the increased number of drilling programs in the Eastern Hemisphere, combined with the addition of a number of newbuild offshore rigs scheduled for delivery in 2008 and beyond,

contribute to increased customer spending levels.

Although a number of factors influence forecasted exploration and production spending, the Company's business is highly dependent on the general economic environment in the United States and other major world economies which ultimately impacts energy consumption and the resulting demand for our products and services. A global economic slowdown could pare energy demand and adversely impact business volumes across our operations and the future financial results of the Company.

**Table of Contents****Results of Operations***Segment Discussion*

The Company markets its products and services throughout the world through four business units which are aggregated into two reportable segments. The Oilfield segment consists of three business units: M-I SWACO, Smith Technologies and Smith Services. The Distribution segment includes the Wilson business unit. The revenue discussion below has been summarized by business unit in order to provide additional information in analyzing the Company's operations.

|   | For the Years Ended December 31, |     |              |     |              |     |
|---|----------------------------------|-----|--------------|-----|--------------|-----|
|   | 2007                             |     | 2006         |     | 2005         |     |
|   | Amount                           | %   | Amount       | %   | Amount       | %   |
| <b>Financial Data:</b> (dollars in thousands) |                                  |     |              |     |              |     |
| <b>Revenues:</b>                              |                                  |     |              |     |              |     |
| M-I SWACO                                     | \$ 4,422,408                     | 50  | \$ 3,573,395 | 49  | \$ 2,682,511 | 48  |
| Smith Technologies <sup>(1)</sup>             | 1,018,578                        | 12  | 884,616      | 12  | 654,611      | 12  |
| Smith Services <sup>(1)</sup>                 | 1,191,583                        | 14  | 929,727      | 12  | 641,877      | 12  |
| Oilfield                                      | 6,632,569                        | 76  | 5,387,738    | 73  | 3,978,999    | 72  |
| Wilson  | 2,131,761                        | 24  | 1,945,821    | 27  | 1,600,004    | 28  |
| Total   | \$ 8,764,330                     | 100 | \$ 7,333,559 | 100 | \$ 5,579,003 | 100 |
| <b>Geographic Revenues:</b>                   |                                  |     |              |     |              |     |
| United States:                                |                                  |     |              |     |              |     |
| Oilfield                                      | \$ 2,396,281                     | 27  | \$ 2,009,997 | 27  | \$ 1,393,564 | 25  |
| Distribution                                  | 1,571,525                        | 18  | 1,374,732    | 19  | 1,127,142    | 20  |
| Total United States                           | 3,967,806                        | 45  | 3,384,729    | 46  | 2,520,706    | 45  |
| Canada:                                       |                                  |     |              |     |              |     |
| Oilfield                                      | 338,692                          | 4   | 404,121      | 5   | 313,912      | 6   |
| Distribution                                  | 432,738                          | 5   | 487,167      | 7   | 399,653      | 7   |
| Total Canada                                  | 771,430                          | 9   | 891,288      | 12  | 713,565      | 13  |
| Non-North America:                            |                                  |     |              |     |              |     |
| Oilfield                                      | 3,897,596                        | 45  | 2,973,620    | 41  | 2,271,523    | 41  |
| Distribution                                  | 127,498                          | 1   | 83,922       | 1   | 73,209       | 1   |
| Total Non-North America                       | 4,025,094                        | 46  | 3,057,542    | 42  | 2,344,732    | 42  |
| Total Revenue                                 | \$ 8,764,330                     | 100 | \$ 7,333,559 | 100 | \$ 5,579,003 | 100 |
| <b>Operating Income:</b>                      |                                  |     |              |     |              |     |
| Oilfield                                      | \$ 1,315,644                     | 20  | \$ 1,012,295 | 19  | \$ 625,384   | 16  |
| Distribution                                  | 94,629                           | 4   | 101,830      | 5   | 64,714       | 4   |
| General Corporate                             | (40,476)                         | *   | (34,044)     | *   | (19,537)     | *   |

|       |              |    |              |    |            |    |
|-------|--------------|----|--------------|----|------------|----|
| Total | \$ 1,369,797 | 16 | \$ 1,080,081 | 15 | \$ 670,561 | 12 |
|-------|--------------|----|--------------|----|------------|----|

**Market Data:****Average Worldwide Rig Count:<sup>(2)</sup>**

|                   |       |    |       |    |       |    |
|-------------------|-------|----|-------|----|-------|----|
| United States     | 1,961 | 46 | 1,901 | 47 | 1,666 | 47 |
| Canada            | 311   | 7  | 413   | 10 | 408   | 11 |
| Non-North America | 2,009 | 47 | 1,747 | 43 | 1,517 | 42 |

|       |       |     |       |     |       |     |
|-------|-------|-----|-------|-----|-------|-----|
| Total | 4,281 | 100 | 4,061 | 100 | 3,591 | 100 |
|-------|-------|-----|-------|-----|-------|-----|

|          |       |    |       |    |       |    |
|----------|-------|----|-------|----|-------|----|
| Onshore  | 3,719 | 87 | 3,523 | 87 | 3,069 | 85 |
| Offshore | 562   | 13 | 538   | 13 | 522   | 15 |

|       |       |     |       |     |       |     |
|-------|-------|-----|-------|-----|-------|-----|
| Total | 4,281 | 100 | 4,061 | 100 | 3,591 | 100 |
|-------|-------|-----|-------|-----|-------|-----|

**Average Commodity Prices:**

|                                     |          |          |          |
|-------------------------------------|----------|----------|----------|
| Crude Oil (\$/Bbl) <sup>(3)</sup>   | \$ 72.36 | \$ 66.25 | \$ 56.71 |
| Natural Gas (\$/mcf) <sup>(4)</sup> | 7.12     | 6.98     | 9.01     |

(1) In 2007, the Company formed the Smith Borehole Enlargement ( SBE ) group, combining various product and service offerings from Smith Technologies and Smith Services. Due to the formation of SBE, prior period revenues were reclassified to conform to the current presentation.

(2) Source: M-I SWACO.

(3) Average daily West Texas Intermediate ( WTI ) spot

closing prices,  
as quoted by  
NYMEX.

- (4) Average daily  
Henry Hub,  
Louisiana spot  
closing prices,  
as quoted by  
NYMEX.

\* not meaningful

**Table of Contents****Oilfield Segment****Revenues**

M-I SWACO primarily provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry. Additionally, these operations provide oilfield production chemicals and manufacture and market equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management. M-I SWACO is significantly influenced by its exposure to the global offshore market, which constitutes 50 percent of the revenue base, and to exploration and production spending for land-based projects outside of North America, which contributes approximately 30 percent of the unit's revenues. Offshore drilling programs, which accounted for approximately 13 percent of the worldwide rig count in 2007, are generally more revenue-intensive than land-based projects due to the complex nature of the related drilling environment. For the year ended December 31, 2007, M-I SWACO reported revenues of \$4.4 billion, an increase of 24 percent over the amounts reported in the 2006 fiscal year. Three-quarters of the revenue improvement was attributable to growth in Eastern Hemisphere markets, largely reflecting a 40 percent increase in offshore business volumes related to new contract awards and increased customer activity in the North Sea, Middle East/Asia and West Africa regions. Western Hemisphere revenues grew 13 percent above the prior year level due to the impact of new land-based contract awards in Mexico and higher customer spending in the deepwater markets of the United States and Brazil. M-I SWACO's revenues totaled \$3.6 billion for the year ended December 31, 2006, an increase of 33 percent over the prior year. Excluding the impact of acquired operations, revenues grew 31 percent over the prior year. Approximately two-thirds of the base revenue increase was generated in markets outside of North America, primarily reflecting new contract awards and increased customer activity in the Europe/Africa and Middle East offshore markets. North American base revenues grew 33 percent above the prior year level, largely attributable to increased investment by exploration and production companies in land-based drilling projects and the impact of price increases implemented in late 2005.

Smith Technologies designs and manufactures three-cone and diamond drill bits, turbines and borehole enlargement tools for use in the oil and gas industry. Due to the nature of its product offerings, revenues for these operations typically correlate more closely to the rig count than any of the Company's other businesses. For the year ended December 31, 2007, Smith Technologies reported revenues of \$1.0 billion, an increase of 15 percent over the prior year—significantly above the comparable five percent growth in worldwide activity levels. Approximately 60 percent of the year-over-year revenue growth was reported outside North America, driven by significant growth in demand for borehole enlargement products, strong three-cone drill bit sales volumes in Europe/Africa and, to a lesser extent, increased activity levels. Revenue growth in North America compared favorably to the prior year and the corresponding change in activity levels, largely reflecting the influence of improved diamond bit rental volumes and improved market penetration for three-cone products in the United States. For the year ended December 31, 2006, Smith Technologies reported revenues of \$884.6 million, an increase of 35 percent over the prior year level. The majority of the revenue increase was reported by the Western Hemisphere operations, influenced by higher U.S. land-based drilling activity, improved pricing and, to a lesser extent, strong demand for turbine products in the Latin America market. Revenues generated in the Eastern Hemisphere region increased 35 percent, contributing one-third of the revenue improvement over the prior year. The year-over-year increase reflects growth in the Middle East, Former Soviet Union and the North Sea area, attributable to new contract awards and improved market penetration.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, work-over, well completion and well re-entry. Smith Services' revenues are heavily influenced by the complexity of drilling projects, which drive demand for a wider range of its product offerings. In recent years, growth in the number of U.S. land-based drilling programs has resulted in strong demand for additional rigs and related drilling equipment, including the Company's premium tubular products and drill pipe. Excluding the impact of tubular sales volumes, revenues for Smith Services are relatively balanced between North America and the international markets. Smith Services revenues totaled \$1.2 billion for the year ended December 31, 2007, up 28 percent from the 2006 level. Approximately two-thirds of the year-over-year revenue growth was attributable to increased demand for tubular products, predominantly in the United States. Excluding the impact of tubular product sales and rentals, business volumes rose 15 percent from the prior year—favorably impacted by increased demand for high-performance drilling, fishing and remedial products and services, including the hydra-jar<sup>®</sup> tool, in the U.S. and North Sea markets. For the



year ended December 31, 2006, Smith Services reported revenues of \$929.7 million, 45 percent above the 2005 fiscal year. The year-over-year revenue growth was significantly influenced by increased demand for tubular products in the U.S. market. Excluding the impact of tubular product sales, business volumes increased 24 percent above the prior year. The majority of the non-tubular business growth was reported in North America, reflecting increased customer demand for premium remedial product and service lines. The revenue growth in markets outside of North America was driven by increased demand for remedial product offerings, primarily in the Middle East, North Sea and Former Soviet Union regions.

**Table of Contents***Operating Income*

Operating income for the Oilfield segment was \$1.3 billion, or 19.8 percent of revenues for the year ended December 31, 2007. The segment operating margins were 1.0 percentage point above the prior year level, reflecting incremental operating margins of 24 percent. The period-to-period improvement was influenced by higher gross profit margins, attributable to offshore business volume growth and the impact of pricing initiatives, and improved fixed cost coverage in general and administrative support functions. On an absolute dollar basis, fiscal 2007 operating income increased \$303.3 million over the prior year, largely attributable to the impact of higher revenue volumes on reported gross profit, partially offset by growth in variable-based operating expenses associated with the expanding business base. For the 2006 fiscal year, operating income for the Oilfield segment was \$1.0 billion, or 18.8 percent of revenues. The segment operating margins were 3.1 percentage points above the prior year level with incremental operating income approximating 28 percent of revenues. The operating margin growth was predominantly driven by increased business volumes, but was also favorably impacted by an improved business mix and pricing initiatives. To a lesser extent, the margin improvement was influenced by improved general and administrative cost coverage. On an absolute dollar basis, fiscal 2006 operating income increased \$386.9 million over the prior year, largely attributable to the impact of a 35 percent increase in business volumes on gross profit, mitigated by higher variable-based operating expenses.

*Distribution Segment**Revenues*

Wilson markets pipe, valves and fittings, as well as mill, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. The segment has the most significant North American revenue exposure of any of the Company's operations with 94 percent of Wilson's 2007 revenues generated in those markets. Moreover, approximately 25 percent of Wilson's revenues relate to sales to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely influenced by the general state of the U.S. economic environment. Additionally, certain customers in this sector utilize petroleum products as a base material and, accordingly, are adversely impacted by increases in crude oil and natural gas prices. For the year ended December 31, 2007, Wilson reported revenues of \$2.1 billion, 10 percent above the 2006 fiscal year. The revenue growth was reported by the energy operations, influenced by higher U.S. drilling activity levels and increased line pipe project spending. The impact of lower Canadian business volumes during 2007, related to the corresponding decline in drilling activity levels, was substantially offset by project-related spending in Europe/Africa. For the year ended December 31, 2006, Wilson reported revenues of \$1.9 billion, 22 percent above the prior year. Two-thirds of the revenue growth was generated by the upstream energy operations, reflecting higher spending by exploration and production companies associated with increased North American drilling and completion activity and the impact of new contract awards. Industrial and downstream sales volumes grew 13 percent, influenced by increased customer spending related to line pipe projects.

*Operating Income*

Operating income for the Distribution segment in fiscal 2007 was \$94.6 million, or 4.4 percent of revenues. Segment operating margins deteriorated 80 basis points, reflecting the impact on gross profit of an increased proportion of line pipe and international project business volumes, which carry relatively lower margins, and the influence of the year-over-year decline in Canadian drilling activity levels. On an absolute dollar basis, operating income was \$7.2 million below the amount reported in 2006, largely due to the impact of the unfavorable business mix on gross profit and higher variable-based operating expenses. For the year ended December 31, 2006, operating income for the Distribution segment in fiscal 2006 was \$101.8 million, or 5.2 percent of revenues. The operating margin improvement of 1.2 percentage points reflects lower operating expenses as a percentage of revenues and, to a lesser extent, gross margin expansion. Incremental operating income was 11 percent of revenues, with the majority of the growth attributable to the energy sector operations, influenced by increased coverage of fixed sales and administrative costs. On an absolute dollar basis, segment operating income was \$37.1 million above the amount reported in 2005, impacted by a 22 percent increase in revenue volumes on the segment's reported gross profit, partially offset by higher variable-based operating expenses.



**Table of Contents***Consolidated Discussion*

For the periods indicated, the following table summarizes the consolidated results of operations of the Company and presents these results as a percentage of total revenues (dollars in thousands):

|   | For the Years Ended December 31, |     |              |     |              |     |
|---|----------------------------------|-----|--------------|-----|--------------|-----|
|   | 2007                             |     | 2006         |     | 2005         |     |
|   | Amount                           | %   | Amount       | %   | Amount       | %   |
| Revenues  | \$ 8,764,330                     | 100 | \$ 7,333,559 | 100 | \$ 5,579,003 | 100 |
| Gross profit                                      | 2,855,657                        | 33  | 2,344,271    | 32  | 1,685,138    | 30  |
| Operating expenses                                | 1,485,860                        | 17  | 1,264,190    | 17  | 1,014,577    | 18  |
| Operating income                                  | 1,369,797                        | 16  | 1,080,081    | 15  | 670,561      | 12  |
| Interest expense                                  | 69,990                           | 1   | 62,967       | 1   | 44,446       | 1   |
| Interest income                                   | (4,068)                          |     | (2,982)      |     | (1,692)      |     |
| Income before income taxes and minority interests | 1,303,875                        | 15  | 1,020,096    | 14  | 627,807      | 11  |
| Income tax provision                              | 408,471                          | 5   | 326,674      | 4   | 202,743      | 4   |
| Minority interests                                | 248,353                          | 3   | 191,416      | 3   | 122,759      | 2   |
| Net income  | \$ 647,051                       | 7   | \$ 502,006   | 7   | \$ 302,305   | 5   |

*2007 versus 2006*

Consolidated revenues increased to \$8.8 billion for the year ended December 31, 2007, 20 percent above the prior year. Oilfield segment business volumes contributed more than 85 percent of the revenue increase influenced by significant growth in offshore business volumes outside North America and the impact of new land-based contracts in Latin America and the Former Soviet Union. To a lesser extent, the year-over-year revenue expansion reflects higher demand for tubular and drill bit products in the United States.

Gross profit totaled \$2.9 billion, or 33 percent of revenues, 60 basis points above the gross profit margins generated in the 2006 fiscal year. The results reflect improved Oilfield margins and, to a lesser extent, an increased proportion of Oilfield revenues, which generate higher comparable margins. On an absolute dollar basis, gross profit was \$511.4 million, or 22 percent, above the prior year primarily reflecting the increased sales volumes in the Oilfield operations.

Operating expenses, consisting of selling, general and administrative expenses increased \$221.7 million from the amount reported in 2006; however, as a percentage of revenues decreased 30 basis points. Improved fixed cost coverage in the general and administrative functions accounted for the operating expense percentage decline. The majority of the absolute dollar increase was attributable to variable-related costs associated with the improved business volumes, including increased investment in personnel and infrastructure.

Net interest expense, which represents interest expense less interest income, totaled \$65.9 million in 2007. Net interest expense increased \$5.9 million from the prior year, influenced by the inclusion of certain acquisition-related

borrowings in the later half of 2006.

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The effective tax rate approximated 31 percent, approximately 70 basis points below the prior year level. The favorable comparison to the 2006 effective rate, as well as the U.S. statutory rate, was influenced by the higher proportion of M-I SWACO's U.S. partnership earnings and lower state income tax accrual rates. Based on the structure of M-I SWACO's U.S. operations, the minority partner is directly responsible for taxes on its share of U.S. partnership earnings. Accordingly, the Company properly consolidates the pretax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision.

Minority interest expense reflects the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interest expense totaled \$248.4 million in 2007, a \$56.9 million increase from the prior year. The year-over-year increase primarily reflects the improved profitability levels in the M-I SWACO joint venture.

*2006 versus 2005*

Consolidated revenues increased to \$7.3 billion for the year ended December 31, 2006, 31 percent above the prior year. The majority of the year-over-year revenue growth was reported in the Oilfield segment attributable to a combination of higher worldwide drilling activity, a favorable product and business mix and, to a lesser extent, improved pricing. On a geographic basis, two-thirds of the revenue improvement was generated in the Western Hemisphere market, which accounted for the majority of the year-over-year increase in drilling activity levels. The year-over-year revenue variance was also driven by the strength in the Company's international operations which reported a 33 percent increase in revenues.

Gross profit totaled \$2.3 billion, or 32 percent of revenues, two percentage points above the gross profit margins generated in 2005. Although the margin expansion was largely driven by the impact of increased sales volumes on fixed manufacturing and service infrastructure costs, an improved business mix and product pricing also had a favorable effect. On an absolute dollar basis, gross profit was \$659.1 million above the prior year period primarily reflecting the increased sales volumes in the Oilfield operations.

Operating expenses, consisting of selling, general and administrative expenses increased \$249.6 million from the amount reported in the 2005 fiscal year; however, as a percentage of revenues decreased 95 basis points. Improved fixed cost coverage in the sales and administrative functions accounted for the operating expense percentage decline. The majority of the absolute dollar increase was attributable to variable costs directly associated with the improved business volumes, including increased investment in personnel and infrastructure. To a lesser extent, increased employee profit-sharing amounts directly attributable to the reported profitability levels, incremental operating expenses of acquired operations and stock-based compensation expense also contributed to the year-over-year operating expense growth.

Net interest expense, which represents interest expense less interest income, totaled \$60.0 million in 2006. Net interest expense increased \$17.2 million from the 2005 level reflecting higher average debt levels in 2006 due to borrowings related to the financing of several acquisitions and, to a lesser extent, an increase in variable interest rates.

The effective tax rate approximated 32 percent, partially impacted by the settlement of a U.S. tax audit that resulted in the release of certain deferred tax reserves during the second quarter of 2006. Excluding the tax settlement, the effective rate was comparable to the level reported in the prior year, but below the U.S. statutory rate due to the impact of M-I SWACO's U.S. partnership earnings for which the minority partner is directly responsible for its related income taxes. The Company properly consolidates the pretax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision.

Minority interest expense reflects the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interest expense totaled \$191.4 million in 2006, a \$68.7 million increase from 2005. The year-over-year increase primarily reflects the higher profitability of the M-I SWACO joint venture and, to a lesser extent, improved earnings reported by CE Franklin Ltd.

**Table of Contents****Liquidity and Capital Resources***General*

At December 31, 2007, cash and cash equivalents equaled \$158.3 million. During 2007, the Company generated \$688.5 million of cash flows from operations, which is \$410.0 million above the amount reported in 2006. The year-over-year improvement is attributable to lower comparable working capital investment, associated with slower growth in global drilling activity, combined with higher profitability levels experienced in the Company's Oilfield operations.

In 2007, cash flows used in investing activities totaled \$347.6 million, primarily consisting of amounts required to fund capital expenditures and, to a lesser extent, acquisitions. The Company invested \$310.8 million in property, plant and equipment, net of cash proceeds associated with certain asset disposals. Acquisition funding, which largely related to the purchase of D.S.I. Inspection Services, Inc. and CE Franklin's acquisition of Jen Supply Ltd., resulted in cash outflows of \$53.5 million.

Projected net capital expenditures for 2008 are forecasted to total \$325 million, relatively consistent with spending levels reported for 2007. The majority of the forecasted expenditures relate to routine additions of rental tool and manufacturing equipment to support the Company's business operations and maintain the existing capital equipment base.

Cash flows used in financing activities totaled \$265.8 million in 2007. The Company's strong operating cash flow performance enabled the funding of investing activities and \$159.6 million of combined share repurchases and dividend payments, while still having sufficient availability to repay \$103.5 million of outstanding borrowings under various loan agreements.

The Company's primary internal source of liquidity is cash flow generated from operations. Cash flow generated from operations is primarily influenced by the level of worldwide drilling activity, which affects profitability levels and working capital requirements. Capacity under revolving credit agreements is also available, if necessary, to fund operating or investing activities. As of December 31, 2007, the Company had \$245.0 million drawn and \$4.5 million of letters of credit issued under various U.S. revolving credit facilities, resulting in \$170.5 million of capacity available for future operating or investing needs. The Company also has revolving credit facilities in place outside of the United States, which are generally used to finance local operating needs. At the end of fiscal 2007, the Company had available borrowing capacity of \$164.1 million under the non-U.S. borrowing facilities.

The Company's external sources of liquidity include debt and equity financing in the public capital markets, if needed. The Company carries an investment-grade credit rating with recognized rating agencies, generally providing the Company with access to debt markets. The Company's overall borrowing capacity is, in part, dependent on maintaining compliance with financial covenants under the various credit agreements. As of December 31, 2007, the Company was well within the covenant compliance thresholds under its various loan indentures, as amended, providing the ability to access available borrowing capacity. Management believes funds generated by operations, amounts available under existing credit facilities and external sources of liquidity will be sufficient to finance capital expenditures and working capital needs of the existing operations for the foreseeable future.

Management continues to evaluate opportunities to acquire products or businesses complementary to the Company's operations. Additional acquisitions, if they arise, may involve the use of cash or, depending upon the size and terms of the acquisition, may require debt or equity financing.

The Company makes regular quarterly distributions under a dividend program. On February 6, 2008, the Company's Board of Directors increased the quarterly cash dividend to \$0.12 per share. The current annualized payout of approximately \$96 million is expected to be funded with cash flows from operations and, if necessary, amounts available under existing credit facilities. The level of future dividend payments will be at the discretion of the Company's Board of Directors and will depend upon the Company's financial condition, earnings, cash flows, compliance with certain debt covenants and other relevant factors.

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The Company's Board of Directors has authorized a share buyback program that allows for the repurchase of up to 20 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. As of December 31, 2007, the Company had 15.7 million shares remaining under the current authorization. Future repurchases under the program may be executed from time to time in the open market or in privately negotiated transactions and will be funded with cash flows from operations or amounts available under existing credit facilities.

The Company believes it has sufficient existing manufacturing capacity to meet current demand for its products and services. Additionally, inflation has had a modest impact on the Company's financial results in the three most recent fiscal years, with the Company experiencing escalation in wages, transportation costs and, to some extent, petrochemical and other commodity prices during 2007. The Company expects to be able to continue to offset the impact of future cost inflation through productivity gains and pricing initiatives.

The Company has not engaged in off-balance sheet financing arrangements through special purpose entities, and the consolidation of the Company's minority ownership positions would not result in an increase in reported leverage ratios. The Company has no contractual arrangements in place that could result in the issuance of additional shares of the Company's common stock at a future date other than the Company's stock-based compensation program, which is discussed in Note 1, Summary of Significant Accounting Policies, and Note 14, Long-Term Incentive Compensation.

**Contractual Obligations, Commitments and Contingencies***Contractual Obligations*

The following table summarizes the Company's debt maturities, estimated interest on fixed rate long-term debt and future minimum payments under non-cancelable operating leases having initial terms in excess of one year as of December 31, 2007 (in thousands):

|                                       | Total        | Amount of Commitment Expiration per Period |              |              |                      |
|---------------------------------------|--------------|--|--------------|--------------|----------------------|
|                                       |              | Less than<br>1 year                        | 1-3<br>years | 3-5<br>years | More than<br>5 years |
| Debt maturities                       | \$ 985,105   | \$ 139,481                                 | \$ 298,060   | \$ 272,797   | \$ 274,767           |
| Interest on fixed rate long-term debt | 186,657      | 31,350                                     | 62,700       | 34,857       | 57,750               |
| Operating lease commitments           | 317,053      | 72,775                                     | 91,449       | 45,523       | 107,306              |
| Total                                 | \$ 1,488,815 | \$ 243,606                                 | \$ 452,209   | \$ 353,177   | \$ 439,823           |

Amounts related to commitments under capital lease agreements, purchase obligations and other long-term liabilities reflected in the accompanying consolidated balance sheet, including pension and other postretirement obligations, have been excluded from the above table due to immateriality.

Moreover, the required disclosure related to the Company's \$45.9 million of liabilities associated with uncertain tax positions has been omitted from the above table. Due to the complex application of tax regulations, combined with our inability to predict when tax audits in various jurisdictions may be concluded, the Company is unable to reasonably estimate the timing of cash settlements, if any, related to its uncertain tax positions.

*Standby Letters of Credit*

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies which reinsure certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$17.8 million of related liabilities are reflected in the accompanying consolidated balance sheet, the Company was contingently liable for approximately \$136.2 million of standby letters of credit and bid, performance and surety bonds at December 31, 2007. Management does not expect any material amounts to be drawn on these instruments.





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*Insurance*

The Company maintains insurance coverage for various aspects of its business and operations. The Company has elected to retain a portion of losses that occur through the use of deductibles and retentions under its insurance programs. Amounts in excess of the self-insured retention levels are fully insured to limits believed appropriate for the Company's operations. Self-insurance accruals are based on claims filed and an estimate for claims incurred but not reported. While management believes that amounts accrued in the accompanying consolidated financial statements are adequate for expected liabilities arising from the Company's portion of losses, estimates of these liabilities may change as circumstances develop.

*Litigation*

The Company is a defendant in various legal proceedings arising in the ordinary course of business. In the opinion of management, these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

*Environmental*

The Company routinely establishes and reviews the adequacy of reserves for estimated future environmental clean-up costs for properties currently or previously operated by the Company.

As of December 31, 2007, the Company's environmental reserve totaled \$7.6 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at December 31, 2007, the Company does not believe that these differences will have a material impact on the Company's consolidated financial position, results of operations or cash flows.

**Critical Accounting Policies and Estimates**

The discussion and analysis of financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates its estimates on an on-going basis, based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

The Company believes the following describes significant judgments and estimates used in the preparation of its consolidated financial statements:

*Allowance for doubtful accounts.* The Company extends credit to customers and other parties in the normal course of business. Management regularly reviews outstanding receivables and provides for estimated losses through an allowance for doubtful accounts. In evaluating the level of established reserves, management makes judgments regarding the parties' ability to make required payments, economic events and other factors. As the financial condition of these parties change, circumstances develop or additional information becomes available, adjustments to the allowance for doubtful accounts may be required.

*Inventory reserves.* The Company has made significant investments in inventory to service its customers around the world. On a routine basis, the Company uses judgments in determining the level of reserves required to state inventory at the lower of cost or market. Management's estimates are primarily influenced by technological innovations, market fundamentals and the physical condition of products. Changes in these or other factors may result in adjustments to the carrying value of inventory.

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*Goodwill.* The Company has acquired a number of operations during the past decade, which has resulted in the recording of a material amount of goodwill. Under SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company is required to perform an annual goodwill impairment evaluation, which is largely influenced by future cash flow projections. Estimating future cash flows of the Company's operations requires management to make judgments about future operating results and working capital requirements. Although the majority of the goodwill relates to the Company's Oilfield operations, \$51.5 million of goodwill relates to Distribution transactions. Changes in cash flow assumptions or other factors that negatively impact the fair value of the operations would influence the evaluation and may result in the determination that a portion of the goodwill is impaired when the annual analysis is performed.

*Self-Insurance.* The Company maintains insurance coverage for various aspects of its business and operations. The Company retains a portion of losses that occur through the use of deductibles and retentions under self-insurance programs. Management regularly reviews estimates of reported and unreported claims and provides for losses through insurance reserves. As claims develop and additional information becomes available, adjustments to loss reserves may be required.

*Income taxes.* Deferred tax assets and liabilities are recognized for differences between the book basis and tax basis of the net assets of the Company. In providing for deferred taxes, management considers current tax regulations, estimates of future taxable income and available tax planning strategies. In certain cases, management has established reserves to reduce deferred tax assets to estimated realizable value. If tax regulations, operating results or the ability to implement tax planning strategies vary, adjustments to the carrying value of deferred tax assets and liabilities may be required. The Company recognizes tax benefits related to uncertain tax positions when, based on technical merits, it is more likely than not the respective positions will be sustained on examination by the taxing authorities. Adjustments to the recorded liabilities for uncertain tax positions may be required pursuant to the ultimate settlement of an income tax audit, the refinement of an estimate in light of changes to any facts or circumstances, or the expiration of a statute of limitations.

*Environmental Obligations.* The Company records liabilities for environmental obligations when remedial efforts are probable and the costs can be reasonably estimated. Management's estimates are based on currently enacted laws and regulations. As more information becomes available or environmental laws and regulations change, such liabilities may be required to be adjusted. Additionally, in connection with acquisitions, the Company generally obtains indemnifications from the seller related to environmental matters. If the indemnifying parties do not fulfill their obligations, adjustments of recorded amounts may be required.

**Recent Accounting Pronouncements**

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board ( FASB ) that are adopted by the Company as of the specified effective date.

In December 2007, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 141 (revised 2007), *Business Combinations* ( SFAS 141(R) ). SFAS 141(R) establishes accounting and disclosure requirements for business combinations including the recognition and measurement of assets acquired, liabilities assumed, and any noncontrolling ownership interest purchased in a transaction. SFAS 141(R) also sets forth new guidance regarding the treatment of transaction-related costs and establishes additional disclosure requirements that will enable users to evaluate the nature and financial effects of business combinations. We are currently evaluating the provisions of SFAS 141(R) which are effective, and will be adopted by the Company, on January 1, 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, an amendment of ARB No. 51 ( SFAS 160 ) which addresses the accounting and disclosure requirements for subsidiaries which are not wholly-owned. Under SFAS 160, the Company will be required to classify the minority interest liability reflected in the accompanying consolidated balance sheet as a component of stockholders' equity. Moreover, the Company will be required to present net income attributable to the Company and the minority partners ownership interest separately on the consolidated statement of operations. We are currently evaluating the provisions of SFAS 160 which are effective, and will be adopted by the Company, on January 1, 2009 to determine any additional impact on the Company's consolidated financial statements.

Management believes the impact of other recently issued standards, which are not yet effective, will not have a material impact on the Company's consolidated financial statements upon adoption.



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**Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

The Company is exposed to market risks from changes in interest rates and foreign exchange rates and enters into various hedging transactions to mitigate these risks. The Company does not use financial instruments for trading or speculative purposes. See Note 9, Financial Instruments, to the Consolidated Financial Statements for additional discussion of hedging instruments.

The Company's exposure to interest rate changes is managed through the use of a combination of fixed and floating rate debt and by entering into interest rate contracts, from time to time, on a portion of its long-term borrowings. The Company had no interest rate contracts outstanding as of December 31, 2007 and 2006. At December 31, 2007 and 2006, 43 percent and 35 percent, respectively, of the Company's long-term debt carried a variable interest rate. Management believes that significant interest rate changes will not have a material near-term impact on the Company's future earnings or cash flows.

The Company's exposure to changes in foreign exchange rates is managed primarily through the use of forward exchange contracts. These contracts increase or decrease in value as foreign exchange rates change, to protect the value of the underlying transactions denominated in foreign currencies. All currency contracts are components of the Company's hedging program and are entered into for the sole purpose of hedging an existing or anticipated currency exposure. The gains and losses on these contracts offset changes in the value of the related exposures. The terms of these contracts generally do not exceed two years. As of December 31, 2007, the notional amounts of fair value hedge contracts and cash flow hedge contracts outstanding were \$110.3 million and \$12.7 million, respectively, and the fair value was greater than the notional amount of these contracts by \$0.8 million. As of December 31, 2006, the notional amount of fair value hedge contracts and cash flow hedge contracts outstanding were \$126.9 million and \$20.8 million, respectively, and the fair value was less than the notional amount of these contracts by \$0.2 million. In some areas, where hedging is not cost effective, the Company addresses foreign currency exposure utilizing working capital management.

The Company utilizes a Value-at-Risk (VAR) model to determine the maximum potential one-day loss in the fair value of its foreign exchange sensitive financial instruments. The VAR model estimates were made assuming normal market conditions and a 95 percent confidence level. The Company's VAR computations are based on the historical price movements in various currencies (a historical simulation) during the year. The model includes all of the Company's foreign exchange derivative contracts. Anticipated transactions, firm commitments and assets and liabilities denominated in foreign currencies, which certain of these instruments are intended to hedge, were excluded from the model. The VAR model is a risk analysis tool and does not purport to represent actual losses in fair value that will be incurred by the Company, nor does it consider the potential effect of favorable changes in market factors. The estimated maximum potential one-day loss in fair value of currency sensitive instruments, calculated using the VAR model, was not material to the Company's financial position or results of operations.

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**Item 8. Financial Statements and Supplementary Data**

**Management's Report on Internal Control Over Financial Reporting**

Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is designed to provide reasonable, not absolute, assurance to the Company's management and board of directors regarding the preparation and fair presentation of published financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable, not absolute, assurance with respect to financial statement preparation and presentation.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that the Company's internal control over financial reporting was effective as of December 31, 2007.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2007 has been audited by Deloitte & Touche LLP, the independent registered public accounting firm who also audited the Company's consolidated financial statements. The Deloitte & Touche LLP audit report on the effectiveness of the Company's internal control over financial reporting appears on page 27 of this Annual Report on Form 10-K.

/s/ Doug Rock

/s/ Margaret K. Dorman

Doug Rock  
Chairman of the Board and  
Chief Executive Officer

Margaret K. Dorman  
Senior Vice President,  
Chief Financial Officer and  
Treasurer

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of  
Smith International, Inc.

Houston, Texas

We have audited the internal control over financial reporting of Smith International, Inc. and subsidiaries (the Company) as of December 31, 2007, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2007 of the Company and our report dated February 29, 2008 expressed an unqualified opinion on those financial statements and financial statement schedule and included an explanatory paragraph regarding the Company's adoption of new accounting standards.

DELOITTE & TOUCHE LLP

Houston, Texas

February 29, 2008

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of  
Smith International, Inc.

Houston, Texas

We have audited the accompanying consolidated balance sheets of Smith International, Inc. and subsidiaries (the Company ) as of December 31, 2007 and 2006, and the related consolidated statements of operations, stockholders equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2007. Our audits also included the financial statement schedule listed in Part IV, Item 15 (a) (2). These financial statements and the financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Smith International, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 123r, Share-Based Payment as of January 1, 2006 and Financial Accounting Standards Board Interpretation ( FASB ) No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 on January 1, 2007. Additionally, as discussed in Note 13 to the consolidated financial statements, the Company adopted SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans as of December 31, 2006.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 29, 2008 expressed an unqualified opinion on the Company s internal control over financial reporting.

DELOITTE & TOUCHE LLP

Houston, Texas

February 29, 2008



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**SMITH INTERNATIONAL, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except par value data)

|   | <b>December 31,</b> |                     |
|---|---------------------|---------------------|
|   | <b>2007</b>         | <b>2006</b>         |
| <b>Assets</b>   |                     |                     |
| <b>Current Assets:</b>                                      |                     |                     |
| Cash and cash equivalents                                   | \$ 158,267          | \$ 80,379           |
| Receivables, net (Note 1)                                   | 1,750,561           | 1,592,230           |
| Inventories, net  | 1,658,172           | 1,457,371           |
| Deferred tax assets, net                                    | 46,220              | 51,070              |
| Prepaid expenses and other                                  | 114,515             | 89,977              |
| <b>Total current assets</b>                                 | <b>3,727,735</b>    | <b>3,271,027</b>    |
| <b>Property, Plant and Equipment, net</b>                   | <b>1,105,880</b>    | <b>887,044</b>      |
| <b>Goodwill, net</b>  | <b>896,442</b>      | <b>867,647</b>      |
| <b>Other Intangible Assets, net</b>                         | <b>128,359</b>      | <b>141,140</b>      |
| <b>Other Assets</b>   | <b>203,464</b>      | <b>168,617</b>      |
| <b>Total Assets</b>   | <b>\$ 6,061,880</b> | <b>\$ 5,335,475</b> |
| <b>Liabilities and Stockholders Equity</b>                  |                     |                     |
| <b>Current Liabilities:</b>                                 |                     |                     |
| Short-term borrowings and current portion of long-term debt | \$ 139,481          | \$ 287,704          |
| Accounts payable  | 655,413             | 654,215             |
| Accrued payroll costs                                       | 153,453             | 154,756             |
| Income taxes payable  | 80,181              | 130,339             |
| Other   | 144,772             | 152,454             |
| <b>Total current liabilities</b>                            | <b>1,173,300</b>    | <b>1,379,468</b>    |
| <b>Long-Term Debt</b>                                       | <b>845,624</b>      | <b>800,928</b>      |
| <b>Deferred Tax Liabilities</b>                             | <b>160,244</b>      | <b>143,124</b>      |
| <b>Other Long-Term Liabilities</b>                          | <b>157,042</b>      | <b>102,904</b>      |
| <b>Minority Interests</b>                                   | <b>1,130,773</b>    | <b>922,114</b>      |

**Commitments and Contingencies** (Note 16)**Stockholders Equity:**

Preferred stock, \$1 par value; 5,000 shares authorized; no shares issued or outstanding in 2007 or 2006

Common stock, \$1 par value; 250,000 shares authorized; 217,586 shares issued in 2007

|  |                     |                     |
|--|---------------------|---------------------|
| (214,947 shares issued in 2006)  | 217,586             | 214,947             |
| Additional paid-in capital   | 533,429             | 442,155             |
| Retained earnings  | 2,219,224           | 1,653,480           |
| Accumulated other comprehensive income   | 67,840              | 23,227              |
| Less Treasury securities, at cost; 16,825 common shares in 2007 (15,031 common shares in 2006) | (443,182)           | (346,872)           |
| <b>Total stockholders equity</b>   | <b>2,594,897</b>    | <b>1,986,937</b>    |
| <b>Total Liabilities and Stockholders Equity</b>   | <b>\$ 6,061,880</b> | <b>\$ 5,335,475</b> |

The accompanying notes are an integral part of these financial statements.

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**SMITH INTERNATIONAL, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share data)

|   | <b>For the Years Ended December 31,</b> |              |              |
|---|---|--------------|--------------|
|   | <b>2007</b>                             | <b>2006</b>  | <b>2005</b>  |
| Revenues  | \$ 8,764,330                            | \$ 7,333,559 | \$ 5,579,003 |
| Costs and expenses:                               |   |              |              |
| Costs of revenues                                 | 5,908,673                               | 4,989,288    | 3,893,865    |
| Selling expenses                                  | 1,177,359                               | 969,825      | 786,668      |
| General and administrative expenses               | 308,501                                 | 294,365      | 227,909      |
| Total costs and expenses                          | 7,394,533                               | 6,253,478    | 4,908,442    |
| Operating income                                  | 1,369,797                               | 1,080,081    | 670,561      |
| Interest expense                                  | 69,990                                  | 62,967       | 44,446       |
| Interest income                                   | (4,068)                                 | (2,982)      | (1,692)      |
| Income before income taxes and minority interests | 1,303,875                               | 1,020,096    | 627,807      |
| Income tax provision                              | 408,471                                 | 326,674      | 202,743      |
| Minority interests                                | 248,353                                 | 191,416      | 122,759      |
| Net income  | \$ 647,051                              | \$ 502,006   | \$ 302,305   |
| Earnings per share:                               |   |              |              |
| Basic   | \$ 3.23                                 | \$ 2.51      | \$ 1.50      |
| Diluted   | 3.20                                    | 2.49         | 1.48         |
| Weighted average shares outstanding:              |   |              |              |
| Basic   | 200,244                                 | 200,252      | 201,651      |
| Diluted   | 201,947                                 | 202,008      | 204,522      |

The accompanying notes are an integral part of these financial statements.

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**SMITH INTERNATIONAL, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

|   | <b>For the Years Ended December 31,</b> |             |             |
|---|---|-------------|-------------|
|   | <b>2007</b>                             | <b>2006</b> | <b>2005</b> |
| <b>Cash flows from operating activities:</b>  |   |             |             |
| Net income  | \$ 647,051                              | \$ 502,006  | \$ 302,305  |
| <i>Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:</i> |   |             |             |
| Minority interests  | 248,353                                 | 191,416     | 122,759     |
| Depreciation and amortization   | 193,296                                 | 150,384     | 117,722     |
| Share-based compensation expense  | 34,239                                  | 27,280      | 5,947       |
| Increase in LIFO inventory reserves   | 22,712                                  | 18,942      | 22,144      |
| Deferred income tax provision   | 22,265                                  | 3,737       | 10,636      |
| Provision for losses on receivables   | 5,082                                   | 7,578       | 4,216       |
| Foreign currency translation losses   | 4,059                                   | 3,376       | 1,213       |
| Gain on disposal of property, plant and equipment   | (21,133)                                | (18,893)    | (14,812)    |
| Equity earnings, net of dividends received  | (17,170)                                | (9,247)     | (10,420)    |
| Gain on sale of operations  | (1,534)                                 | (6,473)     | (5,898)     |
| <i>Changes in operating assets and liabilities:</i>   |   |             |             |
| Receivables   | (154,355)                               | (364,834)   | (243,882)   |
| Inventories   | (202,436)                               | (412,748)   | (197,204)   |
| Accounts payable  | (9,760)                                 | 161,111     | 105,832     |
| Other current assets and liabilities  | (58,262)                                | 48,975      | 3,487       |
| Other non-current assets and liabilities  | (23,920)                                | (24,126)    | (15,996)    |
| Net cash provided by operating activities   | 688,487                                 | 278,484     | 208,049     |
| <b>Cash flows from investing activities:</b>  |   |             |             |
| Acquisition-related payments, net of cash acquired  | (53,452)                                | (226,727)   | (81,328)    |
| Purchases of property, plant and equipment  | (355,821)                               | (308,470)   | (177,845)   |
| Proceeds from disposal of property, plant and equipment   | 45,045                                  | 35,743      | 26,426      |
| Proceeds from settlement of property insurance claims   |   | 15,026      |             |
| Proceeds from sale of operations  | 16,655                                  | 13,504      | 20,496      |
| Net cash used in investing activities   | (347,573)                               | (470,924)   | (212,251)   |
| <b>Cash flows from financing activities:</b>  |   |             |             |
| Proceeds from issuance of long-term debt  | 146,847                                 | 803,635     | 187,804     |
| Principal payments of long-term debt  | (272,676)                               | (426,557)   | (57,592)    |
| Net change in short-term borrowings   | 22,302                                  | (30,299)    | 14,478      |
| Debt issuance costs   |   | (4,744)     |             |
| Purchases of common stock under Repurchase Program  | (83,529)                                | (102,894)   | (117,820)   |
| Payment of common stock dividends   | (76,026)                                | (60,074)    | (36,353)    |
| Excess tax benefit from share-based compensation  | 27,271                                  | 8,724       | 11,405      |
| Net proceeds related to long-term incentive awards  | 18,101                                  | 20,393      | 39,847      |
| Distributions to minority interest partner  | (48,097)                                |             | (28,000)    |

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|   |            |           |           |
|---|------------|-----------|-----------|
| Net cash provided by (used in) financing activities       | (265,807)  | 208,184   | 13,769    |
| Effect of exchange rate changes on cash                   | 2,781      | 2,092     | (620)     |
| Increase in cash and cash equivalents                     | 77,888     | 17,836    | 8,947     |
| Cash and cash equivalents at beginning of year            | 80,379     | 62,543    | 53,596    |
| Cash and cash equivalents at end of year                  | \$ 158,267 | \$ 80,379 | \$ 62,543 |
| <b>Supplemental disclosures of cash flow information:</b> |            |           |           |
| Cash paid for interest                                    | \$ 74,536  | \$ 62,161 | \$ 44,217 |
| Cash paid for income taxes                                | 384,145    | 291,981   | 177,697   |

The accompanying notes are an integral part of these financial statements.

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**SMITH INTERNATIONAL, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME**  
**For the Years Ended December 31, 2007, 2006 and 2005**  
*(In thousands, except share data)*

|  | Common Stock        |            | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive | Treasury Securities |              | Total<br>Stockholders'<br>Equity |
|--|---------------------|------------|----------------------------------|----------------------|---------------------------------------|---------------------|--------------|----------------------------------|
|  | Number of<br>Shares | Amount     |                                  |                      | Income                                | Number of<br>Shares | Amount       |                                  |
| Balance, January 1, 2005                             | 105,296,653         | \$ 105,297 | \$ 432,395                       | \$ 961,574           | \$ 24,404                             | (4,222,466)         | \$ (122,859) | \$ 1,400,800                     |
| Comprehensive income                                 |                     |            |                                  | 302,305              |                                       |                     |              | 302,305                          |
| Currency translation adjustments                     |                     |            |                                  |                      | (14,635)                              |                     |              | (14,635)                         |
| Changes in unrealized fair value of derivatives      |                     |            |                                  |                      | (2,044)                               |                     |              | (2,044)                          |
| Minimum pension liability adjustments                |                     |            |                                  |                      | (824)                                 |                     |              | (824)                            |
| Comprehensive income                                 |                     |            |                                  | 302,305              | (17,503)                              |                     |              | 284,802                          |
| Acquisitions of common stock under purchase Program  |                     |            |                                  |                      |                                       | (2,198,800)         | (117,820)    | (117,820)                        |
| Dividends declared                                   |                     |            |                                  | (48,396)             |                                       |                     |              | (48,396)                         |
| Exercise of stock options and employee equity awards | 1,749,605           | 1,749      | 51,542                           |                      |                                       |                     |              | 53,291                           |
| Issuance of restricted stock                         | 34,632              | 35         |                                  |                      |                                       | (4,276)             | (165)        | (4,106)                          |
| Share-based compensation                             |                     |            | 5,947                            |                      |                                       |                     |              | 5,947                            |
| 2-for-one common stock split (effective 1 and 11)    | 106,188,814         | 106,189    | (106,189)                        |                      |                                       | (5,875,386)         |              | (5,875,386)                      |
| Balance, December 31, 2005                           | 213,269,704         | 213,270    | 383,695                          | 1,215,483            | 6,901                                 | (12,300,928)        | (240,844)    | 1,578,597                        |
| Comprehensive income                                 |                     |            |                                  | 502,006              |                                       |                     |              | 502,006                          |
| Currency translation adjustments                     |                     |            |                                  |                      | 12,407                                |                     |              | 12,407                           |
| Changes in unrealized fair value of derivatives      |                     |            |                                  |                      | 2,425                                 |                     |              | 2,425                            |
| Minimum pension liability adjustments                |                     |            |                                  |                      | 857                                   |                     |              | 857                              |
| Comprehensive income                                 |                     |            |                                  | 502,006              | 15,689                                |                     |              | 517,695                          |
| Impact of SFAS 158 adoption (Note 1)                 |                     |            |                                  |                      | 637                                   |                     |              | 637                              |
| Acquisitions of common stock under purchase Program  |                     |            |                                  |                      |                                       | (2,656,987)         | (102,894)    | (102,894)                        |
| Dividends declared                                   |                     |            |                                  | (64,009)             |                                       |                     |              | (64,009)                         |
| Exercise of stock options and employee equity awards | 1,376,213           | 1,376      | 31,180                           |                      |                                       |                     |              | 32,556                           |
| Issuance of restricted stock                         | 300,834             | 301        |                                  |                      |                                       | (73,163)            | (3,134)      | (2,833)                          |
| Share-based compensation                             |                     |            | 27,280                           |                      |                                       |                     |              | 27,280                           |
| Balance, December 31, 2006                           | 214,946,751         | 214,947    | 442,155                          | 1,653,480            | 23,227                                | (15,031,078)        | (346,872)    | 1,986,962                        |
| Comprehensive income                                 |                     |            |                                  | 647,051              |                                       |                     |              | 647,051                          |

|  |             |            |            |              |           |              |              |          |              |
|--|-------------|------------|------------|--------------|-----------|--------------|--------------|----------|--------------|
| currency translation adjustments                     |             |            |            |              |           | 46,743       |              |          | 46,743       |
| changes in unrealized fair value of derivatives      |             |            |            |              |           | 506          |              |          | 506          |
| changes in pension and other retirement benefits     |             |            |            |              |           | (2,636)      |              |          | (2,636)      |
| comprehensive income                                 |             |            |            |              |           | 647,051      | 44,613       |          | 691,664      |
| effect of FIN 48 adoption (Note 1)                   |             |            |            |              |           | (1,191)      |              |          | (1,191)      |
| acquisitions of common stock under Purchase Program  |             |            |            |              |           |              | (1,570,300)  | (83,529) | (83,529)     |
| dividends declared                                   |             |            |            |              |           | (80,116)     |              |          | (80,116)     |
| exercise of stock options and employee equity awards | 1,790,706   | 1,790      | 57,035     |              |           |              |              |          | 58,825       |
| vesting of restricted stock                          | 848,760     | 849        |            |              |           |              | (223,892)    | (12,781) | (11,943)     |
| share-based compensation                             |             |            | 34,239     |              |           |              |              |          | 34,239       |
| Balance, December 31, 2007                           | 217,586,217 | \$ 217,586 | \$ 533,429 | \$ 2,219,224 | \$ 67,840 | (16,825,270) | \$ (443,182) |          | \$ 2,594,813 |

The accompanying notes are an integral part of these financial statements.

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**SMITH INTERNATIONAL, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(All dollar amounts are expressed in thousands, unless otherwise noted)

**1. Summary of Significant Accounting Policies**

*Basis of Presentation*

Smith International, Inc. ( Smith or the Company ) provides premium products and services to the oil and gas exploration and production industry. The accompanying consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States and all applicable financial statement rules and regulations of the Securities and Exchange Commission (the Commission ). Management believes the consolidated financial statements present fairly the financial position, results of operations and cash flows of the Company as of the dates indicated.

The consolidated financial statements include the accounts of the Company and all wholly and majority-owned subsidiaries, after the elimination of all significant intercompany accounts and transactions. Investments in affiliates in which ownership interest ranges from 20 to 50 percent, and the Company exercises significant influence over operating and financial policies, are accounted for on the equity method. All other investments are carried at cost, which does not exceed the estimated net realizable value of such investments.

*Stock Split*

In July 2005, the Company s Board of Directors approved a two-for-one stock split, which was effected in the form of a stock dividend. Stockholders of record as of August 5, 2005 were entitled to the dividend, which was distributed on August 24, 2005.

*Use of Estimates*

Preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosed amounts of contingent assets and liabilities and the reported amounts of revenues and expenses. Management believes the most significant estimates and assumptions are associated with the valuation of accounts receivable, inventories, goodwill and deferred taxes as well as the determination of liabilities related to environmental obligations and self-insurance programs. If the underlying estimates and assumptions, upon which the financial statements are based, change in future periods, actual amounts may differ from those included in the accompanying consolidated financial statements.

*Cash and Cash Equivalents*

The Company considers all highly liquid financial instruments purchased with an original maturity of three months or less to be cash equivalents.

*Allowance for Doubtful Accounts*

The Company maintains an allowance for doubtful accounts to provide for receivables which may ultimately be uncollectible. Reserves are determined in light of a number of factors including customer specific conditions, economic events and the Company s historical loss experience. At December 31, 2007 and 2006, the allowance for doubtful accounts was \$17.3 million and \$16.7 million, respectively.

*Inventories*

Inventories are stated at the lower of cost or market. Cost is determined using the average cost method for the majority of the Company s inventories; however, certain of the Company s U.S.-based inventories are valued utilizing the last-in, first-out ( LIFO ) method. Inventory costs consist of materials, labor and factory overhead.



**Table of Contents***Fixed Assets*

Fixed assets, consisting of rental equipment and property, plant and equipment, are stated at cost, net of accumulated depreciation. The Company computes depreciation on fixed assets using principally the straight-line method; however, for income tax purposes, accelerated methods of depreciation are used. The estimated useful lives used in computing depreciation generally range from 20 to 40 years for buildings, three to 25 years for machinery and equipment, and five to ten years for rental equipment. Leasehold improvements are amortized over the initial lease term or the estimated useful lives of the improvements, whichever is shorter. Depreciation expense for the years ended December 31, 2007, 2006 and 2005 was \$161.6 million, \$129.6 million and \$106.8 million, respectively.

Costs of major renewals and betterments are capitalized as fixed assets; however, expenditures for maintenance, repairs and minor improvements are charged to expense when incurred. When fixed assets are sold or retired, the remaining cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is included in the consolidated statement of operations.

*Goodwill and Other Intangible Assets*

Goodwill represents the excess of cost over the fair value of net assets acquired. Recorded goodwill balances are not amortized but, instead, are evaluated for impairment annually or more frequently if circumstances indicate that an impairment may exist. The goodwill valuation, which is prepared during the first quarter of each calendar year, is largely influenced by projected future cash flows and, therefore, is significantly impacted by estimates and judgments.

The Company amortizes other identifiable intangible assets on a straight-line basis over the periods expected to be benefited, ranging from two to 27 years. The components of these other intangible assets generally consist of patents, license agreements, non-compete agreements, trademarks and customer lists and contracts.

*Impairment of Long-Lived Assets*

Management reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If an evaluation is required, the estimated undiscounted future cash flows associated with the asset will be compared to the asset's carrying amount to determine if an impairment exists.

*Environmental Obligations*

Expenditures for environmental obligations that relate to current operations are expensed or capitalized, as appropriate. Liabilities are recorded when environmental clean-up efforts are probable and their cost is reasonably estimated, and are adjusted as further information is obtained. Such estimates are based on currently enacted laws and regulations and are not discounted to present value.

*Liabilities Related to Self-Insurance Programs*

The Company is self-insured for certain casualty and employee medical insurance liabilities of its U.S. operations. Expenditures for casualty and medical claims are recorded when incurred after taking into consideration recoveries available under stop-loss insurance policies. Additionally, reserves are established to provide for the estimated cost of settling known claims as well as medical and casualty exposures projected to have been incurred but not yet reported.

*Foreign Currency Translation and Transactions*

Gains and losses resulting from balance sheet translation of operations outside the United States where the applicable foreign currency is the functional currency are included as a component of accumulated other comprehensive income within stockholders' equity. Gains and losses resulting from balance sheet translation of operations outside the United States where the U.S. dollar is the functional currency are included in the consolidated statements of operations.

Gains and losses resulting from foreign currency transactions, excluding cash flow hedges discussed below, are recognized currently in the consolidated statements of operations.

**Table of Contents***Financial Instruments*

The nature of the Company's business activities involves the management of various financial and market risks, including those related to changes in currency exchange rates and interest rates. The Company utilizes derivative financial instruments such as foreign exchange contracts, foreign exchange options and interest rate contracts to mitigate or eliminate certain of those risks. The Company does not enter into derivative instruments for speculative purposes.

The Company records changes in fair market value related to fair value hedges, which includes foreign exchange contracts, to selling expenses in the consolidated statements of operations. Changes in value related to cash flow hedges, which includes foreign exchange contracts, foreign exchange options and interest rate swaps, are recorded in accumulated other comprehensive income and are recognized in the consolidated statement of operations when the hedged item affects earnings.

*Income Taxes*

The Company accounts for income taxes using an asset and liability approach for financial accounting and income tax reporting based on enacted tax rates. Deferred tax assets are reduced by a valuation allowance when it is more likely than not that some portion, or all, of the deferred tax assets will not be realized.

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ) on January 1, 2007. This interpretation addresses the determination of whether tax benefits claimed, or expected to be claimed, on a tax return should be recorded in the financial statements. The Company recognizes the tax benefit from an uncertain tax position when, based on technical merits, it is more likely than not the position will be sustained on examination by the taxing authorities. In connection with the adoption of FIN 48, the Company was required to record an additional \$1.2 million of tax liabilities, including related interest and penalties, with a corresponding reduction in stockholders' equity during the first quarter of 2007.

The Company records penalty and interest amounts related to income tax matters as income tax expense in the accompanying financial statements. For the year ended December 31, 2007, the Company included \$1.4 million and \$0.9 million of interest and penalties, respectively, in income tax expense.

*Revenue Recognition*

The Company's revenues, which are composed of product, rental, service and other revenues, are generally subject to contractual arrangements which specify price and general terms and conditions. The Company recognizes product revenues, net of applicable provisions for returns, when title and the related risk of loss transfers to the customer. Rental, service and other revenues are recorded when such services are performed and collectibility is reasonably assured.

*Minority Interests*

The Company records minority interest expense which reflects the portion of the earnings of majority-owned operations which are applicable to the minority interest partners. The minority interest amount primarily represents the share of the M-I SWACO profits associated with the minority partner's 40 percent interest in those operations. To a lesser extent, minority interests include the portion of CE Franklin Ltd. and other joint venture earnings applicable to the respective minority shareholders.

*Long-term Incentive Compensation*

The Company's Board of Directors and its stockholders have authorized a long-term incentive plan for the benefit of key employees. Although the Plan provides for the issuance of various stock-based awards, the Compensation Committee has elected to issue restricted stock units and, prior to December, 2005, stock option awards.

Restricted stock units are considered compensatory awards and compensation expense related to these units is recognized over the established vesting period in the accompanying consolidated financial statements.

Accounting for the stock option program was impacted by the mandatory adoption of Statement of Financial Accounting Standards ( SFAS ) No. 123r, Share-Based Payment, ( SFAS No. 123r ) on January 1, 2006. In connection with the implementation, the Company utilized the modified prospective method; and, accordingly, results for prior periods have not been restated. Prior to January 1, 2006, companies could apply Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ), and related interpretations in accounting for its

stock option program. Accordingly, for the 2005 fiscal year, the Company has elected to make pro forma footnote disclosures rather than recognizing the related compensation expense for stock option awards in the consolidated financial statements.

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Had the Company elected to apply the accounting standards of SFAS No. 123, Accounting for Stock-Based Compensation, the 2005 fiscal year's net income and earnings per share would have approximated the pro forma amounts indicated below (in thousands, except per share data):

|   | <b>2005</b> |
|---|-------------|
| Net income, as reported   | \$ 302,305  |
| Add: Stock-based compensation expense included in reported income, net of related tax effect                | 3,952       |
| Less: Total stock-based compensation expense determined under fair value methods, net of related tax effect | (13,056)    |
| Net income, pro forma   | \$ 293,201  |
| Earnings per share:   |             |
| As reported:  |             |
| Basic   | \$ 1.50     |
| Diluted   | 1.48        |
| Pro forma:  |             |
| Basic   | \$ 1.45     |
| Diluted   | 1.43        |

**Recent Accounting Pronouncements**

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board ( FASB ) that are adopted by the Company as of the specified effective date.

In December 2007, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 141 (revised 2007), Business Combinations ( SFAS 141(R) ). SFAS 141(R) establishes accounting and disclosure requirements for business combinations including the recognition and measurement of assets acquired, liabilities assumed, and any noncontrolling ownership interest purchased in a transaction. SFAS 141(R) also sets forth new guidance regarding the treatment of transaction-related costs and establishes additional disclosure requirements that will enable users to evaluate the nature and financial effects of business combinations. We are currently evaluating the provisions of SFAS 141(R) which are effective, and will be adopted by the Company, on January 1, 2009.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 ( SFAS 160 ) which addresses the accounting and disclosure requirements for subsidiaries which are not wholly-owned. Under SFAS 160, the Company will be required to classify the minority interest liability reflected in the accompanying consolidated balance sheet as a component of stockholders' equity. Moreover, the Company will be required to present net income attributable to the Company and the minority partners ownership interest separately on the consolidated statement of operations. We are currently evaluating the provisions of SFAS 160 which are effective, and will be adopted by the Company, on January 1, 2009 to determine any additional impact on the Company's consolidated financial statements.

Management believes the impact of other recently issued standards, which are not yet effective, will not have a material impact on the Company's consolidated financial statements upon adoption.

**2. Acquisitions**

During 2007, the Company completed five acquisitions in exchange for aggregate cash consideration of \$39.9 million and the assumption of certain liabilities. The 2007 transactions primarily consist of the following: On May 16, 2007, Smith Services acquired D.S.I. Inspection Services, Inc. ( DSI ) in exchange for cash consideration of approximately \$16.7 million. DSI, based in the United States, is a provider of inspection, machine shop and other related services. The Company may be required to fund additional cash consideration of up to \$2.0 million related to the DSI transaction upon the lapse of certain contingencies.

On December 3, 2007, CE Franklin acquired the outstanding stock of Jen Supply Ltd. ( Jen Supply ) in exchange for \$12.4 million of cash and a \$0.5 million note. Jen Supply, based in Alberta, Canada is an oilfield equipment distributor. CE Franklin may be required to fund additional cash consideration of \$2.5 million under the terms of an

earn-out arrangement.

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The excess of the purchase price over the estimated fair value of net assets acquired approximated \$19.4 million, primarily pertaining to the DSI and Jen Supply transactions, and has been recorded as goodwill in the consolidated balance sheet. Based on the structure of the transactions, the majority of the goodwill related to the 2007 acquisitions is not expected to be deductible for tax purposes. The purchase price allocations related to these acquisitions are based on preliminary information and are subject to change when additional data concerning final asset and liability valuations is obtained; however, material changes in the preliminary allocations are not anticipated by management.

In certain situations, the Company negotiates transaction terms which provide for the payment of additional consideration if various financial and/or business objectives are met. In addition to the acquisition consideration discussed above, the Company paid \$13.5 million of purchase consideration to settle obligations related to earn-out arrangements during 2007. The acquisition-related payments are reflected in the consolidated balance sheet as goodwill.

During 2006, the Company completed seven acquisitions in exchange for aggregate cash consideration of \$226.7 million and the assumption of certain liabilities. The 2006 transactions primarily consist of the following: On February 23, 2006, M-I SWACO acquired Epcon Offshore AS ( Epcon ) in exchange for cash consideration of approximately \$44.9 million. Epcon, based in Porsgrunn, Norway, is a global provider of proprietary water treatment technology designed to optimize the removal of hydrocarbons from water generated during the oil and gas production process.

On August 3, 2006, M-I SWACO acquired Specialised Petroleum Services Group Limited ( SPS ) in exchange for cash consideration of approximately \$165.4 million. SPS, based in Aberdeen, Scotland, is a global provider of patented well-bore clean-up products and engineering services used to remove debris from the wellbore to facilitate improved well production.

The excess of the purchase price over the estimated fair value of the net assets acquired amounted to \$129.3 million, primarily pertaining to SPS and Epcon, and has been recorded as goodwill in the accompanying consolidated balance sheet.

During 2005, the Company completed six acquisitions in exchange for aggregate cash consideration of \$81.3 million and the assumption of certain liabilities. The 2005 transactions primarily consist of the following: On August 17, 2005, Smith Services acquired certain operating assets of Tubular Technology, Inc. ( TTI ) and associated companies for cash consideration of \$23.2 million. The acquired operations provide a full range of products and services used during the installation of corrosion-resistant alloy tubulars and also offer proprietary products and technical services used during the completion-phase of oil and gas wells, primarily to customers in the U.S. Gulf Coast region.

On November 1, 2005, Smith Services acquired certain operating assets of Nunez Oil Field Pipe, Ltd. ( Nunez ) and associated companies for cash consideration of \$41.4 million. The acquired companies rent and repair premium drill pipe, drill collars, and blow-out preventers and perform machine shop and related inspection services in the United States.

The excess of the purchase price over the estimated fair value of the net assets acquired amounted to \$23.4 million, primarily pertaining to Nunez and TTI, and has been recorded as goodwill in the accompanying consolidated balance sheet.

These acquisitions have been recorded using the purchase method of accounting and, accordingly, the acquired operations have been included in the results of operations since the date of acquisition. Pro forma results of operations have not been presented because the effect of these acquisitions was not material to the Company's consolidated financial statements.

The following schedule summarizes investing activities related to 2007, 2006 and 2005 acquisitions included in the consolidated statements of cash flows:

|   | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|---|-------------|-------------|-------------|
| Fair value of tangible and identifiable intangible assets, net of cash acquired | \$ 26,185   | \$ 171,125  | \$ 68,597   |
| Goodwill acquired   | 19,422      | 129,278     | 23,444      |

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|  |           |            |           |
|--|-----------|------------|-----------|
| Payments to former shareholders of businesses acquired | 13,522    |            |           |
| Total liabilities assumed                              | (5,677)   | (73,676)   | (10,713)  |
| Cash paid for acquisitions, net of cash acquired       | \$ 53,452 | \$ 226,727 | \$ 81,328 |

**Table of Contents****3. Dispositions**

From time to time, the Company divests of select business operations. During 2007, the Company completed the disposition of certain majority-owned venture operations in exchange for aggregate cash consideration of \$16.7 million and eliminated related net assets, including \$10.2 million of goodwill. During the years ended December 31, 2006 and 2005, the Company completed the disposition of its ownership interest in certain Oilfield operations in exchange for aggregate cash consideration of \$13.5 million and \$20.5 million, respectively.

These transactions resulted in an aggregate pre-tax gain of approximately \$1.5 million, \$6.5 million and \$5.9 million for the years ended December 31, 2007, 2006 and 2005, respectively. The impact of these dispositions has been reflected as a reduction in general and administrative expenses in the accompanying consolidated statements of operations for the respective periods. Pro forma results of operations have not been presented because the effect of these dispositions was not material to the Company's consolidated financial statements.

**4. Earnings Per Share**

Basic earnings per share (EPS) is computed using the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to the potential dilution of earnings that could have occurred if additional shares were issued for stock option and restricted stock awards under the treasury stock method. For the years ended December 31, 2007 and 2006, an immaterial number of outstanding stock-based awards, were excluded from the computation of diluted EPS because they were anti-dilutive. The following schedule reconciles the income and shares used in the basic and diluted EPS computations (in thousands, except per share data):

|   | <b>2007</b>    | <b>2006</b>    | <b>2005</b>    |
|---|----------------|----------------|----------------|
| Net Income  | \$ 647,051     | \$ 502,006     | \$ 302,305     |
| Weighted average number of common shares outstanding        | 200,244        | 200,252        | 201,651        |
| <b>Basic EPS</b>  | <b>\$ 3.23</b> | <b>\$ 2.51</b> | <b>\$ 1.50</b> |
| Net Income  | \$ 647,051     | \$ 502,006     | \$ 302,305     |
| Weighted average number of common shares outstanding        | 200,244        | 200,252        | 201,651        |
| Dilutive effect of stock options and restricted stock units | 1,703          | 1,756          | 2,871          |
|   | 201,947        | 202,008        | 204,522        |
| <b>Diluted EPS</b>  | <b>\$ 3.20</b> | <b>\$ 2.49</b> | <b>\$ 1.48</b> |

**5. Inventories**

Inventories consist of the following at December 31:

|  | <b>2007</b> | <b>2006</b> |
|--|-------------|-------------|
| Raw materials  | \$ 139,218  | \$ 117,812  |
| Work-in-process  | 173,836     | 147,543     |
| Finished goods   | 1,461,373   | 1,285,558   |
|  | 1,774,427   | 1,550,913   |
| Reserves to state certain U.S. inventories (FIFO cost of \$611,062 and \$559,943 in 2007 and 2006, respectively) on a LIFO basis | (116,255)   | (93,542)    |



\$ 1,658,172      \$ 1,457,371

During 2007, the Company recorded additional LIFO reserves of \$22.7 million. The increase primarily relates to the revaluation of on-hand inventories to current unit cost standards, reflecting modest cost inflation experienced in the Oilfield manufacturing operations.

**Table of Contents****6. Property, Plant and Equipment**

Property, plant and equipment consist of the following at December 31:

|                               | <b>2007</b>         | <b>2006</b>       |
|-------------------------------|---------------------|-------------------|
| Land and improvements         | \$ 62,546           | \$ 55,138         |
| Buildings                     | 235,545             | 181,419           |
| Machinery and equipment       | 880,562             | 717,761           |
| Rental tools                  | 726,333             | 597,468           |
|                               | 1,904,986           | 1,551,786         |
| Less Accumulated depreciation | (799,106)           | (664,742)         |
|                               | <b>\$ 1,105,880</b> | <b>\$ 887,044</b> |

**7. Goodwill and Other Intangible Assets***Goodwill*

The following table presents goodwill on a segment basis as of the dates indicated, as well as changes in the account during the period shown. Beginning and ending goodwill balances are presented net of accumulated amortization of \$53.6 million:

|   | Oilfield<br>Segment | Distribution<br>Segment | Consolidated |
|---|---------------------|-------------------------|--------------|
| Balance as of December 31, 2005         | \$ 699,142          | \$ 37,906               | \$ 737,048   |
| Goodwill acquired                       | 126,964             | 2,314                   | 129,278      |
| Purchase price and other adjustments    | 890                 | 431                     | 1,321        |
| Balance as of December 31, 2006         | 826,996             | 40,651                  | 867,647      |
| Goodwill acquired                       | 9,255               | 10,167                  | 19,422       |
| Goodwill related to disposed operations | (10,197)            |                         | (10,197)     |
| Purchase price and other adjustments    | 18,843              | 727                     | 19,570       |
| Balance as of December 31, 2007         | \$ 844,897          | \$ 51,545               | \$ 896,442   |

*Other Intangible Assets*

The components of other intangible assets at December 31 are as follows:

|   | <b>2007</b>                 |                             |           | <b>2006</b>                 |                             |           | Weighted<br>Average<br>Amortization<br>Period<br>(years) |
|---|-----------------------------|-----------------------------|-----------|-----------------------------|-----------------------------|-----------|--|
|   | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net       | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net       |  |
| Patents                                     | \$ 112,485                  | \$ 35,190                   | \$ 77,295 | \$ 101,269                  | \$ 19,547                   | \$ 81,722 | 13.5   |
| License agreements                          | 31,688                      | 14,204                      | 17,484    | 31,231                      | 10,661                      | 20,570    | 10.6   |
| Non-compete<br>agreements and<br>trademarks | 36,704                      | 21,032                      | 15,672    | 33,421                      | 15,662                      | 17,759    | 9.7  |
| Customer lists and<br>contracts             | 34,603                      | 16,695                      | 17,908    | 29,403                      | 8,314                       | 21,089    | 8.9  |

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\$ 215,480    \$ 87,121    \$ 128,359    \$ 195,324    \$ 54,184    \$ 141,140    12.0

Amortization expense of other intangible assets was \$31.3 million, \$20.3 million and \$10.4 million for the years ended December 31, 2007, 2006 and 2005, respectively. Amortization expense is expected to approximate \$23.4 million for fiscal year 2008 and is anticipated to range between \$10.4 million and \$18.2 million per year for the 2009 - 2012 fiscal years.

**Table of Contents****8. Debt**

The following summarizes the Company's outstanding debt at December 31:

|   | <b>2007</b> | <b>2006</b> |
|---|-------------|-------------|
| <b>Current:</b>   |             |             |
| Short-term borrowings   | \$ 111,609  | \$ 89,307   |
| Current portion of long-term debt   | 27,872      | 198,397     |
| Short-term borrowings and current portion of long-term debt   | \$ 139,481  | \$ 287,704  |
| <b>Long-Term:</b>   |             |             |
| <i>Notes:</i>   |             |             |
| 6.0% Senior Notes maturing June 2016 with an effective interest rate of 6.11%. Interest payable semi-annually (presented net of unamortized discount of \$262 and \$293 in 2007 and 2006, respectively)   | \$ 274,738  | \$ 274,707  |
| 6.75% Senior Notes maturing February 2011 with an effective interest rate of 6.83%. Interest payable semi-annually (presented net of unamortized discount of \$249 and \$368 in 2007 and 2006, respectively)  | 219,751     | 219,632     |
| 7.0% Senior Notes repaid in September 2007  |             | 149,931     |
| 7.7% Senior Notes repaid in July 2007   |             | 7,143       |
| <i>Bank revolvers payable:</i>  |             |             |
| \$275 million revolving note expiring May 2010. Interest payable quarterly at base rate (7.25% at December 31, 2007) or Eurodollar rate, as defined (5.57% at December 31, 2007) and described below  | 245,000     | 119,000     |
| M-I SWACO \$125 million revolving note expiring May 2010. Interest payable quarterly at base rate or Eurodollar rate, as defined and described below  |             | 41,500      |
| <i>Term Loans:</i>  |             |             |
| M-I SWACO £80 million term loan payable to a financial institution. Principal due in semi-annual installments of £6.7 million through December 2012. Interest payable at Eurocurrency rate of LIBOR plus 35 basis points (6.32% at December 31, 2007) | 133,235     | 157,686     |
| M-I SWACO 27.5 million term loan repaid in June 2007  |             | 28,868      |
| Other   | 772         | 858         |
|   | 873,496     | 999,325     |
| Less-Current portion of long-term debt  | (27,872)    | (198,397)   |
| Long-term debt  | \$ 845,624  | \$ 800,928  |

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Principal payments of long-term debt for years subsequent to 2008 are as follows:

|            |            |
|------------|------------|
| 2009       | \$ 26,523  |
| 2010       | 271,536    |
| 2011       | 246,274    |
| 2012       | 26,524     |
| Thereafter | 274,767    |
|            | \$ 845,624 |

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Short-term borrowings consist of amounts outstanding under lines of credit and short-term notes. Certain subsidiaries of the Company have unsecured credit facilities with non-U.S. banks aggregating \$275.7 million with \$164.1 million of additional borrowing capacity available under these facilities at December 31, 2007. These borrowings had a weighted average interest rate of 6.6 percent and 7.6 percent at December 31, 2007 and 2006, respectively.

In addition to the credit facilities discussed above, the Company has a \$400 million unsecured revolving credit facility provided by a syndicate of nine financial institutions. The revolving credit agreement (the Agreement) allows for the election of interest at a base rate, or a Eurodollar rate ranging from LIBOR plus 40 to 50 basis points depending on the borrowing levels drawn under the facility. The Agreement also requires the payment of a quarterly commitment fee of 10 basis points on the unutilized portion of the facility and compliance with certain customary covenants, including a 40 percent debt-to-total capitalization limitation.

The 6.0 percent and 6.75 percent Senior Notes (the Public Notes) are unsecured obligations of the Company issued under an Indenture dated September 8, 1997. The Indenture contains no financial covenants, nor any restrictions related to the payment of cash dividends to common stockholders. The Company's Public Notes are redeemable by the Company, in whole or in part, at any time prior to maturity at a redemption price equal to accrued interest plus the greater of the principal amount or the present value of the remaining principal and interest payments.

Borrowings under the M-I SWACO £80 million term loan are unsecured and require compliance with certain customary covenants, including debt-to-total capitalization and debt-to-EBITDA limitations. The term loan can be prepaid, in whole or in part, without penalty subject to required notice periods and compliance with minimum prepayment amounts.

The Company was in compliance with its loan covenants under the various loan indentures, as amended, at December 31, 2007.

**9. Financial Instruments***Foreign Currency Contracts*

The Company enters into spot and forward contracts as a hedge against foreign currency denominated assets and liabilities and foreign currency commitments. The term of these contracts generally do not exceed two years. For fair value hedges, realized and unrealized gains and losses are recognized currently through earnings, and the resulting amounts generally offset foreign exchange gains or losses on the related accounts. The Company recognized expense of approximately \$5.8 million, \$5.9 million and \$4.4 million in 2007, 2006 and 2005, respectively, related to net realized and unrealized losses on fair value hedge contracts. Gains or losses on designated cash flow hedge contracts are deferred to accumulated other comprehensive income and recognized in the consolidated statement of operations when the hedged item affects earnings. The Company recognized income of \$1.7 million in 2007, and expense of \$1.6 million and \$0.9 million in 2006 and 2005, respectively, related to cash flow hedge contracts. As of December 31, 2007, the notional amounts of fair value hedge contracts and cash flow hedge contracts outstanding were \$110.3 million and \$12.7 million, respectively, and the fair value was greater than the notional amount of these contracts by \$0.8 million. As of December 31, 2006, the notional amount of fair value hedge contracts and cash flow hedge contracts outstanding were \$126.9 million and \$20.8 million, respectively, and the fair value was less than the notional amount of these contracts by \$0.2 million.

*Fair Value of Other Financial Instruments*

The recorded and fair values of long-term debt at December 31 are as follows:

|                | 2007           |            | 2006           |              |
|----------------|----------------|------------|----------------|--------------|
|                | Recorded Value | Fair Value | Recorded Value | Fair Value   |
| Long-term Debt | \$ 873,496     | \$ 889,104 | \$ 999,325     | \$ 1,015,062 |

The fair value of publicly-traded long-term debt was primarily determined using quoted market prices. The fair value of the remaining financial instruments, including cash and cash equivalents, receivables, payables and short-term and bank borrowings, approximates the carrying value due to the nature of these instruments.



**Table of Contents****10. Income Taxes**

The geographical sources of income before income taxes and minority interests for the three years ended December 31, 2007 were as follows:

|  | <b>2007</b>  | <b>2006</b>  | <b>2005</b> |
|--|--------------|--------------|-------------|
| Income before income taxes and minority interests: |              |              |             |
| United States                                      | \$ 644,283   | \$ 443,453   | \$ 225,207  |
| Non-United States                                  | 659,592      | 576,643      | 402,600     |
| <br>   |              |              |             |
| Total  | \$ 1,303,875 | \$ 1,020,096 | \$ 627,807  |

The income tax provision is summarized as follows:

|                      | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|----------------------|-------------|-------------|-------------|
| Current:             |             |             |             |
| United States        | \$ 172,948  | \$ 127,964  | \$ 62,243   |
| Non-United States    | 208,352     | 183,695     | 124,881     |
| State                | 4,906       | 11,278      | 4,983       |
|                      | 386,206     | 322,937     | 192,107     |
| <br>                 |             |             |             |
| Deferred:            |             |             |             |
| United States        | 21,849      | 2,308       | 8,073       |
| Non-United States    | 381         | 1,289       | 2,349       |
| State                | 35          | 140         | 214         |
|                      | 22,265      | 3,737       | 10,636      |
| <br>                 |             |             |             |
| Income tax provision | \$ 408,471  | \$ 326,674  | \$ 202,743  |

The Company's income tax provision includes amounts related to the anticipated repatriation of certain earnings of its non-U.S. subsidiaries. Undistributed earnings above the amounts upon which taxes have been provided, which approximated \$329.2 million at December 31, 2007, are intended to be permanently invested by the Company. It is not practicable to determine the amount of applicable taxes that would be incurred if any of such earnings were repatriated.

The consolidated effective tax rate (as a percentage of income before income taxes and minority interests) is reconciled to the U.S. federal statutory tax rate as follows:

|  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|-------------|
| U.S. federal statutory tax rate  | 35.0%       | 35.0%       | 35.0%       |
| Minority partners' share of U.S. partnership earnings  | (3.0)       | (2.6)       | (2.5)       |
| Non-deductible expenses  | 1.1         | 0.9         | 1.1         |
| Benefit of extraterritorial income exclusion, manufacturer's production exclusion and research credits | (0.9)       | (0.5)       | (0.8)       |
| State taxes, net   | 0.3         | 1.1         | 0.8         |
| Non-U.S. tax provisions which vary from the U.S. rate/non-U.S. losses with no tax benefit realized     | (1.2)       | (1.3)       | (0.9)       |



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|                               |       |       |       |
|-------------------------------|-------|-------|-------|
| Change in valuation allowance | (0.1) |       | (0.1) |
| Other items, net              | 0.1   | (0.6) | (0.3) |
| Effective tax rate            | 31.3% | 32.0% | 32.3% |

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The components of deferred taxes at December 31 are as follows:

|   | <b>2007</b>         | <b>2006</b>        |
|---|---------------------|--------------------|
| Deferred tax liabilities attributed to the excess of net book basis over remaining tax basis (principally depreciation and amortization): |                     |                    |
| United States   | \$ (116,886)        | \$ (99,443)        |
| Non-United States   | (87,766)            | (84,244)           |
| <b>Total deferred tax liabilities</b>   | <b>(204,652)</b>    | <b>(183,687)</b>   |
| Deferred tax assets attributed to net operating loss and tax credit carryforwards:  |                     |                    |
| United States   |                     |                    |
| Non-United States   | 14,672              | 18,395             |
| Other deferred tax assets (principally accrued liabilities not deductible until paid and inventory reserves):                             |                     |                    |
| United States   | 71,453              | 76,298             |
| Non-United States   | 17,981              | 15,160             |
| <b>Subtotal</b>   | <b>104,106</b>      | <b>109,853</b>     |
| Valuation allowance   | (14,662)            | (16,232)           |
| <b>Total deferred tax assets</b>  | <b>89,444</b>       | <b>93,621</b>      |
| <b>Net deferred tax liabilities</b>   | <b>\$ (115,208)</b> | <b>\$ (90,066)</b> |
| Balance sheet presentation:   |                     |                    |
| Deferred tax assets, net  | \$ 46,220           | \$ 51,070          |
| Other assets  | 8,206               | 8,822              |
| Income taxes payable  | (9,390)             | (6,834)            |
| Deferred tax liabilities  | (160,244)           | (143,124)          |
| <b>Net deferred tax liabilities</b>   | <b>\$ (115,208)</b> | <b>\$ (90,066)</b> |

At December 31, 2007, the accompanying consolidated financial statements include \$14.7 million of deferred tax assets associated with operating loss carryforwards in tax jurisdictions outside the United States. Although a significant portion of these losses will carryforward indefinitely and are available to reduce future tax liabilities of the respective foreign entity, management currently believes that the majority of these assets will not be realized and has, accordingly, established a \$14.7 million valuation reserve. The \$1.6 million decrease from the prior year-end valuation reserve reflects the impact of changes in currency exchange rates, the expiration of operating loss carryforwards and changes in the anticipated realizability of certain foreign deferred tax assets.

*Liability for Uncertain Tax Positions*

In addition to the tax liabilities discussed above, the Company establishes reserves for positions taken on tax matters which, although considered appropriate under the regulations, could potentially be successfully challenged by

authorities during a tax audit or review. The accompanying consolidated balance sheet includes liabilities of \$45.9 million and \$29.6 million to provide for uncertain tax positions taken as of December 31, 2007 and 2006, respectively.

The uncertain tax liability as of December 31, 2007, which is primarily reflected in Other long-term liabilities, consists of \$34.5 million of unrecognized tax benefits, \$7.6 million of interest and \$3.8 million of penalties. Although the Company does not expect to report a significant change in the amount of liabilities recorded for uncertain tax positions during the next twelve-month period, changes in the recorded reserves could impact future reported results. Accordingly, if the Company's uncertain tax positions were allowed by the relevant taxing authorities during a review or expired unchallenged, approximately \$27.1 million of the uncertain tax liability would be recorded as a reduction in tax expense with the remaining \$18.8 million recorded as a decrease to goodwill or other balance sheet accounts.

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A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

|  |           |
|--|-----------|
| Balance as of January 1, 2007                                    | \$ 22,629 |
| Additions for tax positions of prior years                       | 7,271     |
| Reductions for tax positions of prior years                      | (2,758)   |
| Additions for tax positions in the current year                  | 8,324     |
| Settlements with tax authorities                                 | (200)     |
| Reductions due to the lapse of applicable statute of limitations | (728)     |
| Balance as of December 31, 2007                                  | \$ 34,538 |

The Company operates in more than 70 countries and is subject to income taxes in most of those jurisdictions. The following table summarizes the earliest tax years that remain subject to examination by taxing authorities in the major jurisdictions in which the Company operates:

| <b>Jurisdiction</b> | <b>Earliest Open Tax Period</b> |
|---------------------|---------------------------------|
| Canada              | 2000                            |
| Italy               | 2002                            |
| Norway              | 1997                            |
| Russia              | 2004                            |
| United Kingdom      | 2001                            |
| United States       | 2001                            |

**11. Stockholders Equity***Dividend Program*

In February 2005, the Company's Board of Directors approved a regular quarterly cash dividend program. The Board of Directors declared dividends of \$80.1 million, or \$0.40 per share; \$64.0 million, or \$0.32 per share; and \$48.4 million, or \$0.24 per share, for the years ended December 31, 2007, 2006 and 2005, respectively.

The level of future dividend payments will be at the discretion of the Board of Directors and will depend upon the Company's financial condition, earnings and cash flow from operations, the level of its capital expenditures, compliance with certain debt covenants, its future business prospects and other factors that the Board of Directors deem relevant.

*Stock Split*

On July 21, 2005, the Company's Board of Directors approved a two-for-one stock split, which was effected in the form of a stock dividend. Stockholders of record as of August 5, 2005 were entitled to the dividend, which was distributed on August 24, 2005.

*Common Stock Repurchases*

In October 2005, the Company's Board of Directors approved a share repurchase program that allows for the purchase of up to 20 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. The Company has purchased \$83.5 million, \$102.9 million and \$117.8 million of common stock during 2007, 2006, and 2005, respectively, under the existing and a previously authorized repurchase program (collectively the Repurchase Programs). As of December 31, 2007, approximately 15.7 million shares remained available for purchase under the current program which may be executed from time to time in the open market. Common stock obtained by the Company through the Repurchase Programs has been added to the Company's treasury stock holdings.

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In addition, certain participants in the long-term incentive plans surrender shares of common stock in order to satisfy tax withholding obligations. The Company acquired an immaterial number of shares in the prior three year period which have been added to the Company's treasury stock holdings and may be used in the future for acquisitions or other corporate purposes. These shares are not considered acquisitions under the Company's Repurchase Programs.

*Stockholder Rights Plan*

On June 8, 2000, the Company adopted a Stockholder Rights Plan (the "Rights Plan"). As part of the Rights Plan, the Company's Board of Directors declared a dividend of one junior participating preferred stock purchase right ("Right") for each share of the Company's common stock outstanding on June 20, 2000. The Board also authorized the issuance of one such Right for each share of the Company's common stock issued after June 20, 2000 until the occurrence of certain events.

The Rights are exercisable upon the occurrence of certain events related to a person (an "Acquiring Person") acquiring or announcing the intention to acquire beneficial ownership of 20 percent or more of the Company's common stock. In the event any person becomes an Acquiring Person, each holder (except an Acquiring Person) will be entitled to purchase, at an effective exercise price of \$87.50, subject to adjustment, shares of common stock having a market value of twice the Right's exercise price. The Acquiring Person will not be entitled to exercise these Rights. In addition, if at any time after a person has become an Acquiring Person, the Company is involved in a merger or other business combination transaction, or sells 50 percent or more of its assets or earning power to another entity, each Right will entitle its holder to purchase, at an effective exercise price of \$87.50, subject to adjustment, shares of common stock of such other entity having a value of twice the Right's exercise price. After a person or group becomes an Acquiring Person, but before an Acquiring Person owns 50% or more of the Company's common stock, the Board may extinguish the Rights by exchanging one share of common stock, or an equivalent security, for each Right, other than Rights held by the Acquiring Person.

In the event the Rights become exercisable and sufficient shares of the Company's common stock are not authorized to permit the exercise of all outstanding Rights, the Company is required under the Rights Plan to take all necessary action including, if necessary, seeking stockholder approval to obtain additional authorized shares.

The Rights are subject to redemption at the option of the Board of Directors at a price of one-quarter of a cent per Right until the occurrence of certain events. The Rights currently trade with Smith common stock, have no voting or dividend rights and expire on June 8, 2010.

*Accumulated Other Comprehensive Income*

Accumulated other comprehensive income in the accompanying consolidated balance sheets consists of the following:

|   | <b>2007</b> | <b>2006</b> |
|---|-------------|-------------|
| Currency translation adjustments          | \$ 72,298   | \$ 25,555   |
| Unrealized fair value of derivatives      | 755         | 249         |
| Pension and other postretirement benefits | (5,213)     | (2,577)     |
| Accumulated other comprehensive income    | \$ 67,840   | \$ 23,227   |

Approximately \$0.9 million of the unrealized fair value of derivatives is expected to be recognized as after-tax expense during the fiscal year ending December 31, 2008.

**Table of Contents****12. Retirement Plans***Defined Contribution Plans*

The Company established the Smith International, Inc. 401(k) Retirement Plan (the Smith Plan ) for the benefit of all eligible employees. Employees may voluntarily contribute a percentage of their compensation, as defined, to the Smith Plan. The Company makes basic, retirement and, in certain cases, discretionary matching contributions to each participant's account under the Smith Plan. Participants receive a basic match on contributions to the Smith Plan of up to 1½ percent of qualified compensation and a retirement contribution ranging from two percent to six percent of qualified compensation. In addition, the Board of Directors may provide discretionary profit-sharing contributions based upon financial performance to participants who are employed by the Company on December 31.

In 2004, the Company established the Wilson 401(k) Retirement Plan (the Wilson Plan ) under which participating employees may voluntarily contribute a percentage of their compensation, as defined, to the Wilson Plan. Wilson makes matching contributions to each participant's account ranging from ¼ percent to six percent of qualified compensation. In addition, the Board of Directors may provide discretionary profit-sharing contributions based upon financial performance to participants who are employed by Wilson on December 31.

M-I SWACO has a company Profit-Sharing and Savings Plan (the M-I Retirement Plan ) under which participating employees may voluntarily contribute a percentage of their compensation, as defined. At its discretion, M-I SWACO may make basic, matching and in certain cases, discretionary matching contributions to each participant's account under the M-I Retirement Plan. Participants are eligible to receive a basic contribution equal to three percent of qualified compensation, and a full match on employee contributions of up to 1½ percent of qualified compensation. In addition, the Board of Directors may provide discretionary profit-sharing contributions based upon financial performance to participants who are employed by M-I SWACO on December 31.

The Company recognized expense totaling \$43.8 million, \$50.5 million, and \$37.8 million in 2007, 2006 and 2005, respectively, related to Company contributions to the plans.

Certain of the Company's subsidiaries sponsor various defined contribution plans. The Company's contributions under these plans for each of the three years in the period ended December 31, 2007 were immaterial.

*Deferred Compensation Plans*

The Company maintains Supplemental Executive Retirement Plans ( SERP ), non-qualified, deferred compensation programs, for the benefit of officers and certain other eligible employees of the Company. Participants may contribute up to 100 percent of cash compensation, on a pre-tax basis, as defined. Plan provisions allow for retirement and matching contributions, similar to those provided under the Company's defined contribution programs, and, in certain cases, an interest contribution in order to provide a yield on short-term investments equal to 120 percent of the long-term applicable federal rate, as defined.

In the event of insolvency or bankruptcy, plan assets are available to satisfy the claims of all general creditors of the Company. Accordingly, the accompanying consolidated balance sheets reflect the aggregate participant balances as both an asset and a liability of the Company. As of December 31, 2007 and 2006, \$66.7 million and \$59.3 million, respectively, are included in other assets with a corresponding amount recorded in other long-term liabilities.

During the years ended December 31, 2007, 2006 and 2005, Company contributions to the plans totaled \$1.3 million, \$1.9 million and \$2.5 million, respectively.

**Table of Contents****13. Employee Benefit Plans**

Effective December 31, 2006, the Company adopted the recognition provisions of SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106, and 132(R) ( *SFAS 158* ). SFAS 158 requires recognition of the funded status of an entity's defined benefit pension and other postretirement benefit plans as an asset or liability in the Company's consolidated balance sheet. Subsequent changes to the funded status are to be recognized through stockholders' equity as a component of comprehensive income.

The Company currently maintains various defined benefit pension plans covering certain U.S. and non-U.S. employees. Future benefit accruals and the addition of new participants under the U.S. plans were frozen prior to 1998.

The Company and certain subsidiaries have postretirement benefit plans which provide health care benefits to a limited number of current, and in certain cases, future retirees. Individuals who elect to contribute premiums are eligible to participate in the Company's medical and prescription drug programs, with certain limitations. In addition to premiums, the retiree is responsible for deductibles and any required co-payments and is subject to annual and lifetime dollar spending caps.

The following tables disclose the changes in benefit obligations and plan assets during the periods presented and reconcile the funded status of the plans to the amounts included in the accompanying consolidated balance sheets:

|   | <b>Pension Plans</b> |             | <b>Postretirement Benefit Plans</b> |             |
|---|----------------------|-------------|-------------------------------------|-------------|
|   | <b>2007</b>          | <b>2006</b> | <b>2007</b>                         | <b>2006</b> |
| Changes in benefit obligations:                       |                      |             |                                     |             |
| Benefit obligations at beginning of year              | \$ 49,988            | \$ 46,631   | \$ 10,059                           | \$ 10,070   |
| Service cost  | 4,461                | 3,111       | 381                                 | 267         |
| Interest cost   | 3,104                | 2,456       | 563                                 | 538         |
| Plan participants' contributions                      |                      |             | 587                                 | 624         |
| Actuarial loss (gain)                                 | 6,229                | (1,349)     | (1,466)                             | (565)       |
| Other   | 4,210                |             |                                     |             |
| Benefits paid   | (1,066)              | (861)       | (738)                               | (875)       |
| Benefit obligations at end of year                    | \$ 66,926            | \$ 49,988   | \$ 9,386                            | \$ 10,059   |
| Changes in plan assets:                               |                      |             |                                     |             |
| Fair value of plan assets at beginning of year        | \$ 44,616            | \$ 38,993   | \$                                  | \$          |
| Actual return on plan assets                          | 2,182                | 3,797       |                                     |             |
| Employer contributions                                | 3,840                | 4,464       | 151                                 | 251         |
| Plan participants' contributions                      |                      |             | 587                                 | 624         |
| Other   |                      | (1,777)     |                                     |             |
| Benefits paid   | (1,066)              | (861)       | (738)                               | (875)       |
| Fair value of plan assets at end of year              | \$ 49,572            | \$ 44,616   | \$                                  | \$          |
| Funded status   | \$ (17,354)          | \$ (5,372)  | \$ (9,386)                          | \$ (10,059) |
| Amounts recognized in the consolidated balance sheet: |                      |             |                                     |             |
| Non-current assets                                    | \$ 584               | \$ 34       | \$                                  | \$          |

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|                             |             |            |            |             |
|-----------------------------|-------------|------------|------------|-------------|
| Other long-term liabilities | (17,938)    | (5,406)    | (9,386)    | (10,059)    |
| Net amount recognized       | \$ (17,354) | \$ (5,372) | \$ (9,386) | \$ (10,059) |

Amounts in accumulated other comprehensive income:

|                          |          |          |            |            |
|--------------------------|----------|----------|------------|------------|
| Net actuarial loss(gain) | \$ 7,907 | \$ 4,396 | \$ (2,738) | \$ (1,906) |
| Prior service costs      | 44       | 88       |            |            |
| Net amount recognized    | \$ 7,951 | \$ 4,484 | \$ (2,738) | \$ (1,906) |

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**Table of Contents***Net Periodic Benefit Expense*

Net periodic benefit expense and the weighted average assumptions used to determine the net benefit expense for the fiscal years ended December 31, and the projected benefit obligation at December 31 are as follows:

|  | Pension Plans |          |          | Post-retirement Benefit Plans |        |            |
|--|---------------|----------|----------|-------------------------------|--------|------------|
|  | 2007          | 2006     | 2005     | 2007                          | 2006   | 2005       |
| Components of net periodic benefit expense:  |               |          |          |                               |        |            |
| Service cost   | \$ 4,461      | \$ 3,111 | \$ 2,787 | \$ 381                        | \$ 267 | \$ 242     |
| Interest cost  | 3,104         | 2,456    | 2,142    | 563                           | 538    | 548        |
| Return on plan assets  | (3,478)       | (2,365)  | (2,292)  |                               |        |            |
| Amortization of prior service cost   | 8             | 11       | 11       |                               |        | (91)       |
| Amortization of loss (gain)  | 286           | 818      | 706      | (157)                         | (87)   | (130)      |
| Plan termination   |               |          |          |                               |        | (4,467)    |
| Net periodic benefit expense (income)  | \$ 4,381      | \$ 4,031 | \$ 3,354 | \$ 787                        | \$ 718 | \$ (3,898) |
| Other changes in plan assets and benefit obligations recognized in other comprehensive income ( OCI ): |               |          |          |                               |        |            |
| Net (gain)/loss arising during the year  | \$ 3,762      | *        | *        | \$ (989)                      | *      | *          |
| Amortization of prior service (cost)/credit  | (8)           | *        | *        |                               | *      | *          |
| Amortization of net gain/(loss)  | (286)         | *        | *        | 157                           | *      | *          |
| Other comprehensive income   | \$ 3,468      | *        | *        | \$ (832)                      | *      | *          |
| Total net periodic benefit expense and OCI:  | \$ 7,849      | *        | *        | \$ (45)                       | *      | *          |

\* Due to the adoption of SFAS 158, the pension and postretirement benefit plan disclosures are not comparable on a year-to-year basis.

|                                |       |       |       |       |       |       |
|--------------------------------|-------|-------|-------|-------|-------|-------|
| Net periodic benefit expense:  |       |       |       |       |       |       |
| Discount rate                  | 5.75% | 5.50% | 5.75% | 5.75% | 5.50% | 5.75% |
| Expected return on plan assets | 8.50% | 8.50% | 8.50% | N/A   | N/A   | N/A   |
| Projected benefit obligation:  |       |       |       |       |       |       |
| Discount rate                  | 6.30% | 5.75% | 5.50% | 6.30% | 5.75% | 5.50% |
| Expected return on plan assets | 8.50% | 8.50% | 8.50% | N/A   | N/A   | N/A   |

*Additional Pension Plan Information*

In determining the expected return on plan assets, the Company considers the investment mix, the historical market performance and economic and other indicators of future performance. The Company primarily utilizes a mix of common stock and fixed income index funds to generate asset returns comparable with the general market. The investment mix of pension assets at December 31 is summarized in the following table:

|   | <b>2007</b> | <b>2006</b> |
|---|-------------|-------------|
| Common stock and related index funds            | 44%         | 47%         |
| Fixed income securities and related index funds | 44          | 40          |
| Real estate                                     | 7           | 6           |
| Money market funds                              | 5           | 7           |
| Total   | 100%        | 100%        |

For pension plans with accumulated benefit obligations in excess of plan assets, the following table sets forth the projected and accumulated benefit obligations and the fair value of plan assets at December 31:

|                                | <b>2007</b> | <b>2006</b> |
|--------------------------------|-------------|-------------|
| Projected benefit obligation   | \$66,926    | \$49,988    |
| Accumulated benefit obligation | 51,712      | 49,988      |
| Plan assets at fair value      | 49,572      | 44,616      |

Estimated future benefit payments based on projected future service are expected to range between \$1.2 million and \$1.9 million a year for the next five years and approximate \$11.6 million for the five-year period ending December 31, 2017. Company contributions to the pension plans during 2008 are expected to be comparable with 2007 contribution levels.

**Table of Contents***Additional Postretirement Benefit Plan Information*

The assumed health care cost trend rates used to determine the projected postretirement benefit obligation at December 31 are as follows:

|  | 2007  | 2006  |
|--|-------|-------|
| Health care cost trend rate for current year                           | 10.9% | 12.0% |
| Rate that the cost trend rate gradually declines (ultimate trend rate) | 5.0%  | 5.0%  |
| Year that the rate reaches the ultimate trend rate                     | 2016  | 2016  |

A one-percentage point change in assumed health care cost trend rates would have the following effects on the benefit obligations and the aggregate of the service and interest cost components of the postretirement benefits expense:

|   | One-Percentage-<br>Point Increase | One-Percentage-<br>Point Decrease |
|---|-----------------------------------|-----------------------------------|
| Effect on total service and interest cost               | \$ 5                              | \$ (80)                           |
| Effect on accumulated postretirement benefit obligation | 118                               | (867)                             |

Estimated future benefit payments based on projected future service are expected to approximate \$0.5 million a year for the next five years and \$3.2 million for the five-year period ending December 31, 2017. Company contributions to the postretirement benefit plans during 2008 are expected to be comparable to the 2007 levels.

**14. Long-Term Incentive Compensation**

As of December 31, 2007, the Company had outstanding restricted stock and stock option awards granted under the 1989 Long-Term Incentive Compensation Plan (the Plan). As of December 31, 2007, 1,074,185 shares were authorized for future issuance pursuant to the Plan.

*Restricted Stock Units*

The restricted stock program consists of a combination of performance-based restricted stock units ( performance-based units ) and time-based restricted stock units ( time-based units ). The number of performance-based units issued under the program, which can range from zero to 130 percent of the target units granted, is solely dependent upon the return on equity achieved by the Company in the fiscal year subsequent to the award. A summary of the Company's restricted stock program is presented below:

|                                  | Time-based Awards |                              | Performance-based Awards |                              | Total<br>Restricted<br>Stock Units |
|----------------------------------|-------------------|------------------------------|--------------------------|------------------------------|------------------------------------|
|                                  | No. of<br>Units   | Fair<br>Value <sup>(a)</sup> | No. of<br>Units          | Fair<br>Value <sup>(a)</sup> |                                    |
| Outstanding at December 31, 2006 | 524,552           | \$ 40.84                     | 1,601,616 <sup>(b)</sup> | \$ 39.71                     | 2,126,168                          |
| Granted                          | 444,428           | 62.53                        | 400,665                  | 63.76                        | 845,093                            |
| Forfeited                        | (19,913)          | 40.51                        | (25,050)                 | 37.05                        | (44,963)                           |
| Vested                           | (152,380)         | 40.26                        | (696,380)                | 37.39                        | (848,760)                          |
| Outstanding at December 31, 2007 | 796,687           | \$ 53.06                     | 1,280,851                | \$ 48.55                     | 2,077,538                          |

<sup>(a)</sup> Reflects the weighted average grant-date fair value.

<sup>(b)</sup>

*Reflects  
achievement of  
performance  
criteria for  
awards granted  
prior to  
December 2007.*

The total intrinsic value of restricted stock units vested during the years ended December 31, 2007, 2006, and 2005 was \$48.7 million, \$12.5 million, and \$1.2 million, respectively. In addition, restrictions on approximately 684,000 performance-based units and 255,500 time-based units outstanding at December 31, 2007 are expected to lapse during the 2008 fiscal year.

**Table of Contents***Stock Options*

Stock options are generally granted at the fair market value on the date of grant, vest over a four-year period and expire ten years after the date of grant. A summary of the Company's stock option program is presented below:

|                                  | Share       | Weighted<br>Average | Weighted<br>Average              | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|----------------------------------|-------------|---------------------|----------------------------------|--|
|                                  | under       | Exercise<br>Price   | Remaining<br>Contractual<br>Life |  |
| Outstanding at December 31, 2006 | 3,351,381   | \$ 18.78            |                                  |  |
| Granted                          |             |                     |                                  |  |
| Forfeited                        | (55,004)    | 21.33               |                                  |  |
| Exercised                        | (1,748,706) | 17.58               |                                  |  |
| Outstanding at December 31, 2007 | 1,547,671   | \$ 20.04            | 5.5                              | \$ 83,277  |
| Exercisable at December 31, 2007 | 1,411,143   | \$ 19.19            | 5.4                              | \$ 77,135  |

The total intrinsic value of options exercised during the years ended December 31, 2007, 2006, and 2005 was \$69.0 million, \$34.3 million, and \$48.7 million, respectively.

The Company used an open form (lattice) model to determine the fair value of options granted, and accordingly, calculate the share-based compensation expense. The fair value and assumptions used are as follows:

|                                     | 2006    | 2005   |
|-------------------------------------|---------|--------|
| Fair value of stock options granted | \$11.92 | \$8.53 |
| Expected life of option (years)     | 5.0     | 5.0    |
| Expected stock volatility           | 31.0%   | 31.0%  |
| Expected dividend yield             | 0.8%    | 0.8%   |
| Risk-free interest rate             | 4.3%    | 3.9%   |

Expected volatilities are based on both historical volatility of the company's stock price and implied volatility of exchange-traded options on the company's stock. The expected life of options is based on historical data from for options granted by the company after 1994. The risk-free rates are based on yields available at the time of grant on U.S. Treasury bonds for maturities consistent with the expected life assumption.

*Share-based Compensation Expense*

Compensation expense for stock options and time-based units is recognized over the four-year vesting period. For performance-based units, compensation expense is recognized over the three-year vesting period.

Prior to the adoption of SFAS No. 123r, compensation expense for the performance-based units was calculated as the difference between the market value and the exercise price. After adoption of SFAS No. 123r, compensation expense for the performance-based units and time-based units is based on the grant-date fair value. Share-based compensation expense, consisting of restricted stock unit and stock option awards, for the year ended December 31, 2007 and 2006 was \$34.2 million and \$27.3 million, respectively, and net of taxes and minority interests, was \$20.6 million and \$17.5 million, respectively. For the year ended December 31, 2005, compensation expense related to restricted stock unit awards totaled \$5.7 million.

The total unrecognized share-based compensation expense, consisting of restricted stock and stock options, for awards outstanding as of December 31, 2007 was \$92.7 million or approximately \$55.5 million, net of taxes and minority interests, which will be recognized over a weighted-average period of 2.7 years.

**Table of Contents****15. Industry Segments and International Operations**

The Company provides premium products and services to the oil and gas exploration and production industry. The Company aggregates its operations into two reportable segments: Oilfield and Distribution. The Oilfield segment consists of three business units: M-I SWACO, which provides drilling and completion fluid systems, engineering and technical services, oilfield production chemicals and manufactures and markets equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management; Smith Technologies, which designs and manufactures three-cone and diamond drill bits, turbines and borehole enlargement tools; and Smith Services, which manufactures and markets products and services used for drilling, work-over, well completion and well re-entry operations. The principal markets for the Oilfield segment include all major oil and gas-producing regions of the world, with approximately 60 percent of revenues generated in markets outside of North America in 2007. Oilfield segment customers primarily include major multi-national, independent and national, or state-owned, oil companies.

The Distribution segment consists of one business unit, Wilson, which markets pipe, valves and fittings, as well as mill, safety and other maintenance products to energy and industrial markets. The Distribution segment has the most significant North American exposure of any of the Company's operations with approximately 95 percent of revenues derived in the United States and Canada. Approximately three-fourths of Wilson's revenues are generated from customers in the energy sector, which includes major multi-national and independent oil companies, pipeline companies and contract drilling companies. The remainder relates to sales in the downstream and industrial markets, which primarily includes refineries, petrochemical and power generation plants.

The Company's revenues are derived principally from uncollateralized customer sales. The significant energy industry concentration has the potential to impact the Company's exposure to credit risk, either positively or negatively, because customers may be similarly affected by changes in economic or other conditions. The creditworthiness of the Company's customer base is strong, with limited credit losses experienced on such receivables.

The following table presents financial information for each reportable segment:

|                          | <b>2007</b>         | <b>2006</b>         | <b>2005</b>         |
|--------------------------|---------------------|---------------------|---------------------|
| Revenues:                |                     |                     |                     |
| Oilfield                 | \$ 6,632,569        | \$ 5,387,738        | \$ 3,978,999        |
| Distribution             | 2,131,761           | 1,945,821           | 1,600,004           |
|                          | <b>\$ 8,764,330</b> | <b>\$ 7,333,559</b> | <b>\$ 5,579,003</b> |
| Operating Income (Loss): |                     |                     |                     |
| Oilfield                 | \$ 1,315,644        | \$ 1,012,295        | \$ 625,384          |
| Distribution             | 94,629              | 101,830             | 64,714              |
| General corporate        | (40,476)            | (34,044)            | (19,537)            |
|                          | <b>\$ 1,369,797</b> | <b>\$ 1,080,081</b> | <b>\$ 670,561</b>   |
| Capital Expenditures:    |                     |                     |                     |
| Oilfield                 | \$ 333,856          | \$ 292,073          | \$ 173,510          |
| Distribution             | 6,929               | 5,153               | 2,354               |
| General corporate        | 15,036              | 11,244              | 1,981               |
|                          | <b>\$ 355,821</b>   | <b>\$ 308,470</b>   | <b>\$ 177,845</b>   |

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|                                |              |              |              |
|--------------------------------|--------------|--------------|--------------|
| Depreciation and Amortization: |              |              |              |
| Oilfield                       | \$ 187,112   | \$ 144,335   | \$ 110,160   |
| Distribution                   | 4,763        | 4,840        | 6,435        |
| General corporate              | 1,421        | 1,209        | 1,127        |
|                                | \$ 193,296   | \$ 150,384   | \$ 117,722   |
|                                |              |              |              |
| Total Assets:                  |              |              |              |
| Oilfield                       | \$ 5,169,331 | \$ 4,474,401 | \$ 3,356,112 |
| Distribution                   | 752,221      | 737,445      | 596,867      |
| General corporate              | 140,328      | 123,629      | 106,935      |
|                                | \$ 6,061,880 | \$ 5,335,475 | \$ 4,059,914 |

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The following table presents consolidated revenues by region:

|                   | <b>2007</b>         | <b>2006</b>         | <b>2005</b>         |
|-------------------|---------------------|---------------------|---------------------|
| United States     | \$ 3,967,806        | \$ 3,384,729        | \$ 2,520,706        |
| Canada            | 771,430             | 891,288             | 713,565             |
| North America     | 4,739,236           | 4,276,017           | 3,234,271           |
| Latin America     | 738,026             | 543,844             | 452,349             |
| Europe/Africa     | 2,105,745           | 1,605,559           | 1,188,038           |
| Middle East/Asia  | 1,181,323           | 908,139             | 704,345             |
| Non-North America | 4,025,094           | 3,057,542           | 2,344,732           |
|                   | <b>\$ 8,764,330</b> | <b>\$ 7,333,559</b> | <b>\$ 5,579,003</b> |

The following table presents net property, plant and equipment by region:

|                   | <b>2007</b>         | <b>2006</b>       | <b>2005</b>       |
|-------------------|---------------------|-------------------|-------------------|
| United States     | \$ 588,345          | \$ 458,273        | \$ 353,370        |
| Canada            | 52,596              | 48,510            | 43,908            |
| North America     | 640,941             | 506,783           | 397,278           |
| Latin America     | 95,834              | 67,377            | 53,911            |
| Europe/Africa     | 266,437             | 230,607           | 156,632           |
| Middle East/Asia  | 102,668             | 82,277            | 57,568            |
| Non-North America | 464,939             | 380,261           | 268,111           |
|                   | <b>\$ 1,105,880</b> | <b>\$ 887,044</b> | <b>\$ 665,389</b> |

The Company's expenditures for research and engineering activities are attributable to the Company's Oilfield segment and totaled \$110.7 million in 2007, \$88.3 million in 2006 and \$73.6 million in 2005.

**16. Commitments and Contingencies***Leases*

The Company routinely enters into operating and capital leases for certain of its facilities and equipment. Amounts related to assets under capital lease were immaterial for the periods presented. Rent expense totaled \$166.5 million, \$127.1 million, and \$102.1 million in 2007, 2006, and 2005, respectively.

Future minimum payments under non-cancelable operating leases having initial terms of one year or more are as follows:

|           | <b>Amount</b> |
|-----------|---------------|
| 2008      | \$ 72,775     |
| 2009      | 54,589        |
| 2010      | 36,860        |
| 2011      | 25,832        |
| 2012      | 19,691        |
| 2013-2017 | 63,437        |



Thereafter

43,869

\$ 317,053

In the normal course of business, the Company enters into lease agreements with cancellation provisions as well as agreements with initial terms of less than one year. The costs related to these leases have been reflected in rent expense but have been appropriately excluded from the future minimum payments presented above.

**Table of Contents***Standby Letters of Credit*

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment to insurance companies which reinsure certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$17.8 million of related liabilities are reflected in the accompanying consolidated balance sheet, the Company was contingently liable for approximately \$136.2 million of standby letters of credit and bid, performance and surety bonds at December 31, 2007. Management does not expect any material amounts to be drawn on these instruments.

*Insurance*

The Company maintains insurance coverage for various aspects of its business and operations. The Company has elected to retain a portion of losses that occur through the use of deductibles and retentions under its insurance programs. Amounts in excess of the self-insured retention levels are fully insured to limits believed appropriate for the Company's operations. Self-insurance accruals are based on claims filed and an estimate for claims incurred but not reported. While management believes that amounts accrued in the accompanying consolidated financial statements are adequate for expected liabilities arising from the Company's portion of losses, estimates of these liabilities may change as circumstances develop.

*Litigation*

The Company is a defendant in various legal proceedings arising in the ordinary course of business. In the opinion of management, these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

*Environmental*

The Company routinely establishes and reviews the adequacy of reserves for estimated future environmental clean-up costs for properties currently or previously operated by the Company.

As of December 31, 2007, the Company's environmental reserve totaled \$7.6 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at December 31, 2007, the Company does not believe that these differences will have a material impact on the Company's consolidated financial position, results of operations or cash flows.

**17. Quarterly Information (Unaudited)**

|              | <b>First</b>                          | <b>Second</b> | <b>Third</b> | <b>Fourth</b> | <b>Year</b> |
|--------------|---------------------------------------|---------------|--------------|---------------|-------------|
|              | (In thousands, except per share data) |               |              |               |             |
| <b>2007</b>  |                                       |               |              |               |             |
| Revenues     | \$2,107,724                           | \$2,114,373   | \$2,245,059  | \$2,297,174   | \$8,764,330 |
| Gross profit | 675,965                               | 696,546       | 728,906      | 754,240       | 2,855,657   |
| Net income   | 160,158                               | 153,053       | 166,833      | 167,007       | 647,051     |
| EPS:         |                                       |               |              |               |             |
| Basic        | 0.80                                  | 0.76          | 0.83         | 0.83          | 3.23        |
| Diluted      | 0.80                                  | 0.76          | 0.83         | 0.83          | 3.20        |
| <b>2006</b>  |                                       |               |              |               |             |
| Revenues     | \$1,682,121                           | \$1,738,263   | \$1,914,184  | \$1,998,991   | \$7,333,559 |
| Gross profit | 526,603                               | 545,013       | 618,213      | 654,442       | 2,344,271   |
| Net income   | 107,216                               | 118,833       | 132,925      | 143,032       | 502,006     |
| EPS:         |                                       |               |              |               |             |
| Basic        | 0.53                                  | 0.59          | 0.66         | 0.72          | 2.51        |
| Diluted      | 0.53                                  | 0.59          | 0.66         | 0.71          | 2.49        |

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**Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

**Item 9A. *Controls and Procedures***

*Evaluation of disclosure controls and procedures.* Our management, with the participation of our principal executive and principal financial officers, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act )) as of December 31, 2007. Based upon that evaluation, our principal executive and financial officers concluded that as of December 31, 2007, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms, and (2) accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

*Changes in internal control over financial reporting.* There has been no change in the Company's internal control over financial reporting during the quarter ended December 31, 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

*Design and evaluation of internal control over financial reporting.* Management's Report on Internal Control over Financial Reporting and the Report of the Independent Registered Public Accounting Firm on the effectiveness of the Company's internal control over financial reporting are set forth in Part II, Item 8 of this report on Form 10-K and are incorporated herein by reference.

**Item 9B. *Other Information***

None.

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**PART III**

**Item 10. *Directors, Executive Officers and Corporate Governance***

Information concerning the directors is set forth following the caption "Proposal 1: Election of Directors" in the Company's definitive proxy statement to be filed no later than 120 days after the end of the fiscal year covered by this Form 10-K (the "Proxy Statement"), which information is incorporated herein by reference. Information concerning our executive officers and Code of Ethics are set forth in Item 1 appearing in Part I of this Form 10-K. Information concerning compliance with Section 16(a) of the Exchange Act is set forth following the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement and is incorporated herein by reference.

Information concerning the Corporate Governance of the Company is set forth following the caption "Corporate Governance" in the Proxy Statement and is incorporated herein by reference.

**Item 11. *Executive Compensation***

Information for this item is set forth following the captions "Executive Compensation" and "Corporate Governance" in the Company's Proxy Statement and is incorporated herein by reference.

**Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

Information for this item is set forth following the captions "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation Plan Information" in the Company's Proxy Statement and is incorporated herein by reference.

**Item 13. *Certain Relationships and Related Transactions, and Director Independence***

Information for this item is set forth following the captions "Certain Relationships and Related Transactions" and "Corporate Governance" in the Company's Proxy Statement and is incorporated herein by reference.

**Item 14. *Principal Accountant Fees and Services***

Information for this item is set forth following the captions "Fees Paid to Deloitte & Touche LLP" and "Services Provided by Deloitte & Touche LLP" in the Company's Proxy Statement and is incorporated herein by reference.

**Table of Contents****PART IV****Item 15. Exhibits and Financial Statement Schedules**

|   | <b>Page<br/>Reference</b> |
|---|---------------------------|
| (a)(1) Financial statements included in this report:  |                           |
| <u>Management's Report on Internal Control Over Financial Reporting</u>   | 26                        |
| <u>Reports of Independent Registered Public Accounting Firm</u>   | 27                        |
| <u>Consolidated Balance Sheets at December 31, 2007 and 2006</u>  | 29                        |
| <u>Consolidated Statements of Operations for the years ended December 31, 2007, 2006 and 2005</u>   | 30                        |
| <u>Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005</u>   | 31                        |
| <u>Consolidated Statements of Stockholders' Equity and Comprehensive Income<br/>for the years ended December 31, 2007, 2006 and 2005</u>  | 32                        |
| <u>Notes to Consolidated Financial Statements</u>   | 33                        |
| <br>(2) <u>Financial Statement Schedule II-Valuation and Qualifying Accounts and Reserves</u>   | <br>59                    |
| All other schedules have been omitted since the required information is not present or not present in amounts sufficient to require submission of the schedule or because the information required is included in the consolidated financial statements or notes thereto.                                       |                           |
| (3) Exhibits  |                           |
| Exhibits designated with an * are filed, and with an ** are furnished, as an exhibit to this Annual Report on Form 10-K. Exhibits designated with a + are identified as management contracts or compensatory plans or arrangements. Exhibits previously filed as indicated below are incorporated by reference. |                           |
| 3.1 - Restated Certificate of Incorporation of the Company dated July 26, 2005. Filed as Exhibit 3.4 to the Company's report on Form 10-Q for the quarter ended June 30, 2005 and incorporated herein by reference.   |                           |
| 3.2 - Restated Bylaws of the Company. Filed as Exhibit 3.3 to the Company's report on Form 10-K for the year ended December 31, 2004 and incorporated herein by reference.  |                           |
| 4.1 - Rights Agreement, dated as of June 8, 2000, between the Company and First Chicago Trust Company of New York, as Rights Agent. Filed as Exhibit 4.1 to the Company's report on Form 8-A, dated June 15, 2000, and incorporated herein by reference.  |                           |
| 4.2 - Amendment to Rights Agreement dated June 8, 2000, by and among the Company and First Chicago Trust Company of New York and effective as of October 1, 2001. Filed as Exhibit 4.1 to the Company's report on Form 10-Q for the quarter ended September 30, 2001 and incorporated herein by reference.      |                           |
| 4.3 - Amendment No. 2 to Rights Agreement by and among the Company and EquiServe Trust Company, N.A. and effective as of December 31, 2002. Filed as Exhibit 4.3 to the Company's report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.                                |                           |
| 4.4 - Form of Indenture between the Company and The Bank of New York, as Trustee. Filed as Exhibit 4.1 to the Company's Registration Statement on Form S-3 dated August 22, 1997 and incorporated herein by reference.  |                           |
| 4.5 - Form of Senior Note due 2007. Filed as Exhibit 4.2 to Amendment No. 1 to the Company's Registration Statement on Form S-3 dated September 9, 1997 and incorporated herein by reference.   |                           |



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- 4.6 - Form of Senior Note due 2011. Filed as Exhibit 4.1 to the Company's report on Form 8-K dated February 13, 2001 and incorporated herein by reference.
- 4.7 - Form of Senior Note due 2016. Filed as Exhibit 4.1 to the Company's report on Form 8-K dated June 12, 2006 and incorporated herein by reference.
- 10.1+ - Smith International, Inc. Second Amended and Restated 1989 Long-Term Incentive Compensation Plan, effective January 1, 2005. Filed as Exhibit 10.1 to the Company's report on Form 8-K dated April 24, 2007 and incorporated herein by reference.
- 10.2+\* - First Amendment to the Smith International, Inc. Second Amended and Restated 1989 Long-Term Incentive Compensation Plan, dated October 23, 2007.
- 10.3+ - Smith International, Inc. Form of Nonstatutory Option Agreement as amended December 2005. Filed as Exhibit 10.3 to the Company's report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.
- 10.4+ - Smith International, Inc. Form of Nonstatutory Option Agreement as amended December 2006. Filed as Exhibit 10.5 to the Company's report on Form 10-K for the year ended December 31, 2006 and incorporated herein by reference.
- 10.5+ - Smith International, Inc. Form of Restricted Stock Unit Agreement as amended December 2005. Filed as Exhibit 10.4 to the Company's report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.
- 10.6+ - Smith International, Inc. Form of Restricted Stock Unit Agreement as amended December 2006. Filed as Exhibit 10.7 to the Company's report on Form 10-K for the year ended December 31, 2006 and incorporated herein by reference.
- 10.7+\* - Smith International, Inc. Form of Restricted Stock Unit Agreement as amended December 2007.
- 10.8+ - Smith International, Inc. Form of Performance-Based Restricted Stock Unit Agreement as amended December 2005. Filed as Exhibit 10.5 to the Company's report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.
- 10.9+ - Smith International, Inc. Form of Performance-Based Restricted Stock Unit Agreement as amended December 2006. Filed as Exhibit 10.9 to the Company's report on Form 10-K for the year ended December 31, 2006 and incorporated herein by reference.
- 10.10+\* - Smith International, Inc. Form of Performance-Based Restricted Stock Unit Agreement as amended December 2007.
- 10.11+\* - Director Compensation Summary of Smith International, Inc. effective January 1, 2008.
- 10.12+ - Smith International, Inc. Supplemental Executive Retirement Plan, as amended to date. Filed as Exhibit 10.1 to the Company's report on Form 10-Q for the quarter ended September 30, 2001 and incorporated herein by reference.

Edgar Filing: SMITH INTERNATIONAL INC - Form 10-K

- 10.13+ - Smith International, Inc. Amended and Restated Post-2004 Supplemental Executive Retirement Plan effective as of January 1, 2006. Filed as Exhibit 10.13 to the Company's report on Form 10-K for the year ended December 31, 2006 and incorporated herein by reference.
- 10.14+\* - Smith International, Inc. Amended and Restated Executive Officer Annual Incentive Plan effective as of January 1, 2008, dated October 17, 2007.
- 10.15+ - Employment Agreement dated December 10, 1987 between the Company and Douglas L. Rock. Filed as Exhibit 10.11 to the Company's report on Form 10-K for the year ended December 31, 1993 and incorporated herein by reference.



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- 10.16+ - Employment Agreement dated December 10, 1987 between the Company and Bryan L. Dudman. Filed as Exhibit 10.13 to the Company's report on Form 10-K for the year ended December 31, 1993 and incorporated herein by reference.
- 10.17+ - Change-of-Control Employment Agreement dated January 4, 2000 between the Company and Douglas L. Rock. Filed as Exhibit 10.11 to the Company's report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference.
- 10.18+ - Change-of-Control Employment Agreement dated January 4, 2000 between the Company and Loren K. Carroll. Filed as Exhibit 10.14 to the Company's report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference.
- 10.19+ - Change-of-Control Employment Agreement dated January 4, 2000 between the Company and Margaret K. Dorman. Filed as Exhibit 10.15 to the Company's report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference.
- 10.20+ - Change-of-Control Employment Agreement dated January 4, 2000 between the Company and John J. Kennedy. Filed as Exhibit 10.16 to the Company's report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference.
- 10.21+ - Change-of-Control Employment Agreement dated May 15, 2005 between the Company and Michael Pearce. Filed as Exhibit 10.1 to the Company's report on Form 8-K dated May 15, 2005 and incorporated herein by reference.
- 10.22+ - Form of Change-of-Control Employment Agreement as of April 2006. Filed as Exhibit 10.2 to the Company's report on Form 8-K dated April 25, 2006 and incorporated herein by reference.
- 10.23+ - Form of Employment Agreement for Advisors as of April 2006. Filed as Exhibit 10.3 to the Company's report on Form 8-K dated April 25, 2006 and incorporated herein by reference.
- 10.24 - Credit Agreement dated as of May 5, 2005 among the Company and M-I L.L.C., the Lenders From Time to Time Party Thereto and Comerica Bank, as Administrative Agent, ABN AMRO Bank N.V., as Syndication Agent, Den Norske Bank ASA, as Documentation Agent, and Calyon New York Branch and RBS Securities Corporation, as Co-Lead Arrangers and Joint Bookrunners. Filed as Exhibit 10.1 to the Company's report on Form 10-Q for the quarter ended March 31, 2005 and incorporated herein by reference.
- 10.25+ - Form of Director Indemnification Agreement as of February 28, 2007. Filed as Exhibit 10.28 to the Company's report on Form 10-K for the year ended December 31, 2006 and incorporated herein by reference.
- 21.1 - Subsidiaries of the Company. Filed as Exhibit 21.1 to the Company's report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.
- 23.1\* - Consent of Independent Registered Public Accounting Firm.
- 31.1\* - Certification of Chief Executive Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 31.2\* - Certification of Chief Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\*\* - Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SCHEDULE II**  
**SMITH INTERNATIONAL, INC.**  
**VALUATION AND QUALIFYING ACCOUNTS AND RESERVES**  
(In thousands)

|                                  | <b>Balance at<br/>Beginning<br/>of Year</b> | <b>Charged<br/>to<br/>Expense</b> | <b>Write-offs</b> | <b>Balance<br/>at End<br/>of Year</b> |
|----------------------------------|---|-----------------------------------|-------------------|---------------------------------------|
| Allowance for doubtful accounts: |   |                                   |                   |                                       |
| Year ended December 31, 2007     | \$ 16,709                                   | \$ 5,082                          | \$ (4,513)        | \$ 17,278                             |
| Year ended December 31, 2006     | 13,884                                      | 7,578                             | (4,753)           | 16,709                                |
| Year ended December 31, 2005     | 12,558                                      | 4,216                             | (2,890)           | 13,884                                |
|                                  | 59  |                                   |                   |                                       |

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**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

SMITH INTERNATIONAL, INC.

February 29, 2008

By: /s/ Doug Rock  
 Doug Rock  
*Chief Executive Officer,  
 President and Chief Operating Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities on the date indicated:

|  |   |                   |
|--|---|-------------------|
| /s/ Doug Rock<br>(Doug Rock)                   | Chairman of the Board, Chief Executive Officer, President and Chief Operating Officer (principal executive officer) | February 29, 2008 |
| /s/ Margaret K. Dorman<br>(Margaret K. Dorman) | Senior Vice President, Chief Financial Officer and Treasurer (principal financial and accounting officer)           | February 29, 2008 |
| /s/ G. Clyde Buck<br>(G. Clyde Buck)           | Director  | February 29, 2008 |
| /s/ Loren K. Carroll<br>(Loren K. Carroll)     | Director  | February 29, 2008 |
| /s/ Dod A. Fraser<br>(Dod A. Fraser)           | Director  | February 29, 2008 |
| /s/ James R. Gibbs<br>(James R. Gibbs)         | Director  | February 29, 2008 |
| /s/ Robert Kelley<br>(Robert Kelley)           | Director  | February 29, 2008 |
| /s/ John Yearwood<br>(John Yearwood)           | Director  | February 29, 2008 |

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**Exhibit Index**

Exhibits designated with an \* are filed, and with an \*\* are furnished, as an exhibit to this Annual Report on Form 10-K. Exhibits designated with a + are identified as management contracts or compensatory plans or arrangements. Exhibits previously filed as indicated below are incorporated by reference.

- 3.1 - Restated Certificate of Incorporation of the Company dated July 26, 2005. Filed as Exhibit 3.4 to the Company's report on Form 10-Q for the quarter ended June 30, 2005 and incorporated herein by reference.
- 3.2 - Restated Bylaws of the Company. Filed as Exhibit 3.3 to the Company's report on Form 10-K for the year ended December 31, 2004 and incorporated herein by reference.
- 4.1 - Rights Agreement, dated as of June 8, 2000, between the Company and First Chicago Trust Company of New York, as Rights Agent. Filed as Exhibit 4.1 to the Company's report on Form 8-A, dated June 15, 2000, and incorporated herein by reference.
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December 31, 1999 and incorporated herein by reference.

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**Table of Contents**

- 10.22+ - Form of Change-of-Control Employment Agreement as of April 2006. Filed as Exhibit 10.2 to the Company's report on Form 8-K dated April 25, 2006 and incorporated herein by reference.
- 10.23+ - Form of Employment Agreement for Advisors as of April 2006. Filed as Exhibit 10.3 to the Company's report on Form 8-K dated April 25, 2006 and incorporated herein by reference.
- 10.24 - Credit Agreement dated as of May 5, 2005 among the Company and M-I L.L.C., the Lenders From Time to Time Party Thereto and Comerica Bank, as Administrative Agent, ABN AMRO Bank N.V., as Syndication Agent, Den Norske Bank ASA, as Documentation Agent, and Calyon New York Branch and RBS Securities Corporation, as Co-Lead Arrangers and Joint Bookrunners. Filed as Exhibit 10.1 to the Company's report on Form 10-Q for the quarter ended March 31, 2005 and incorporated herein by reference.
- 10.25+ - Form of Director Indemnification Agreement as of February 28, 2007. Filed as Exhibit 10.28 to the Company's report on Form 10-K for the year ended December 31, 2006 and incorporated herein by reference.
- 21.1 - Subsidiaries of the Company. Filed as Exhibit 21.1 to the Company's report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.
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- 31.1\* - Certification of Chief Executive Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* - Certification of Chief Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\*\* - Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.