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)

þ **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

o **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	**95-3822631**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

16740 East Hardy Road Houston, Texas	**77032**
(Address of principal executive offices)	**(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 þ No o.

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 o No þ.

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 þ No o.

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. o

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 þ Accelerated filer o Non-accelerated filer o Smaller reporting company o
(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 o No þ.

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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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 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® and Super Choke , both of which hold strong market positions as do the Super Mud Gas SeparatorÔ and the Super AutochokeÔ.

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® 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 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® 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 $3^1/2$ 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 $2^3/4$ 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.

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.

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.

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.

Name, Age and Positions	Principal Current Occupation and Other Significant Positions Held
Doug Rock (61) 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) 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) 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) 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) 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) 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) 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) 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.

Peter J. Pintar (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.

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.

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.

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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, Manufactured or Distributed	Land (Acres)	Approx. Bldg. Space (sq.ft.)
Oilfield Segment:			
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
Macae, 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
Salzweld, 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	
Distribution Segment:			
La Porte, Texas	Pipe, valves and fittings	15	440,000

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.

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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
4th 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.

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Item 6. ***Selected Financial Data***

	For the Years Ended December 31,				
	2007	2006	2005	2004[a]	2003
	(In thousands, except per share data)				
Statements of Operations Data:					
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[b]	3.20	2.49	1.48	0.89	0.62
Balance Sheet Data:					
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[c]	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.

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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.

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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**	**%**
Financial Data: *(dollars in thousands)*						
Revenues:						
M-I SWACO	$ 4,422,408	50	$ 3,573,395	49	$ 2,682,511	48
Smith Technologies[1]	1,018,578	12	884,616	12	654,611	12
Smith Services[1]	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
Geographic Revenues:						
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
Operating Income:						
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:[2]						
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)[3]	$ 72.36		$ 66.25		$ 56.71	
Natural Gas ($/mcf)[4]	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

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® 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.

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.

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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.

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.

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.

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):

		Amount of Commitment Expiration per Period			
	Total	Less than 1 year	1-3 years	3-5 years	More than 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.

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