

SMITH INTERNATIONAL INC

Form 10-Q

August 06, 2010

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

**Form 10-Q**

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2010**
- OR**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from        to**

**Commission file number 1-8514**

**Smith International, Inc.**

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

**Delaware**

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

**95-3822631**

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

**1310 Rankin Road**

**Houston, Texas**

*(Address of principal executive offices)*

**77073**

*(Zip Code)*

**(281) 443-3370**

*(Registrant's telephone number, including area code)*

**Not Applicable**

*(Former name, former address and former fiscal year, if changed since last report)*

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

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

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

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

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

There were 248,583,517 shares of common stock outstanding, net of treasury shares held, on August 3, 2010.

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****SMITH INTERNATIONAL, INC.****CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(Unaudited)</b>			
	<b>(In thousands, except per share data)</b>			
Revenues:				
Oilfield operations	\$ 1,805,751	\$ 1,533,483	\$ 3,491,772	\$ 3,375,220
Distribution operations	490,312	410,806	942,102	980,548
Total revenues	2,296,063	1,944,289	4,433,874	4,355,768
Costs and expenses:				
Cost of oilfield revenues	1,224,807	1,052,644	2,385,968	2,281,835
Cost of distribution revenues	412,587	362,615	798,057	852,601
Selling, general and administrative expenses	467,216	395,726	933,517	846,350
Total costs and expenses	2,104,610	1,810,985	4,117,542	3,980,786
Operating income	191,453	133,304	316,332	374,982
Interest expense	36,917	42,803	74,639	70,327
Interest income	(890)	(729)	(1,568)	(1,087)
Income before income taxes	155,426	91,230	243,261	305,742
Income tax provision	50,229	27,957	91,468	98,275
Net income	105,197	63,273	151,793	207,467
Noncontrolling interests in net income of subsidiaries	40,123	38,887	75,178	86,146
Net income attributable to Smith	\$ 65,074	\$ 24,386	\$ 76,615	\$ 121,321
Earnings per share:				
Basic	\$ 0.26	\$ 0.11	\$ 0.31	\$ 0.55
Diluted	0.26	0.11	0.31	0.55
Weighted average shares outstanding:				
Basic	248,539	219,307	248,450	219,254
Diluted	250,333	220,245	250,059	219,925

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

**Table of Contents****SMITH INTERNATIONAL, INC.****CONSOLIDATED CONDENSED BALANCE SHEETS**

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
	<b>(Unaudited)</b>	
	<b>(In thousands, except par value data)</b>	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 497,660	\$ 988,346
Receivables, net	1,930,784	1,791,498
Inventories, net	1,880,623	1,820,355
Deferred tax assets, net	90,289	65,667
Prepaid expenses and other	164,320	149,370
Total current assets	4,563,676	4,815,236
Property, plant and equipment, net	1,972,242	1,923,465
Goodwill, net	3,131,840	3,068,828
Other intangible assets, net	624,260	614,086
Other assets	288,713	317,800
Total assets	\$ 10,580,731	\$ 10,739,415
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Short-term borrowings and current portion of long-term debt	\$ 316,549	\$ 358,768
Accounts payable	693,556	589,748
Accrued payroll costs	172,709	146,364
Income taxes payable	109,072	82,260
Other	260,170	233,649
Total current liabilities	1,552,056	1,410,789
Long-term debt	1,481,927	1,814,254
Deferred tax liabilities	502,520	533,537
Other long-term liabilities	152,525	150,905
Commitments and contingencies (Note 15)		
Stockholders Equity:		
Preferred stock, \$1 par value; 5,000 shares authorized; no shares issued or outstanding in 2010 or 2009		
Common stock, \$1 par value; 500,000 shares authorized; 266,531 shares issued in 2010 (266,125 shares issued in 2009)	266,531	266,125
Additional paid-in capital	2,735,089	2,706,564

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Retained earnings	2,942,446	2,925,467
Accumulated other comprehensive income	(14,158)	24,115
Less Treasury securities, at cost; 17,956 common shares in 2010 (17,891 common shares in 2009)	(483,769)	(481,704)
Smith stockholders' equity	5,446,139	5,440,567
Noncontrolling interests in subsidiaries	1,445,564	1,389,363
Total stockholders' equity	6,891,703	6,829,930
Total liabilities and stockholders' equity	\$ 10,580,731	\$ 10,739,415

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



**Table of Contents****SMITH INTERNATIONAL, INC.****CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
	<b>(Unaudited)</b>	
	<b>(In thousands)</b>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 151,793	\$ 207,467
<i>Adjustments to reconcile net income to net cash provided by operating activities:</i>		
Depreciation and amortization	190,510	182,807
LIFO inventory reserves	(8,458)	4,969
Share-based compensation expense	24,183	23,139
Deferred income tax provision	(40,805)	8,286
Provision for losses on receivables	5,611	7,346
Foreign currency transaction (gain) loss	39,388	(5,611)
Gain on disposal of property, plant and equipment	(18,028)	(22,364)
Equity earnings, net of dividends received	(3,227)	(6,549)
Gain on remeasurement of equity interest in @Balance B.V.	(20,773)	
<i>Changes in operating assets and liabilities:</i>		
Receivables	(171,692)	518,720
Inventories	(76,397)	266,775
Accounts payable	112,350	(384,502)
Other current assets and liabilities	38,502	(117,778)
Other non-current assets and liabilities	(885)	(31,451)
Net cash provided by operating activities	222,072	651,254
<b>Cash flows from investing activities:</b>		
Acquisition-related payments, net of cash acquired	(83,920)	(14,268)
Purchases of property, plant and equipment	(231,501)	(169,730)
Proceeds from disposal of property, plant and equipment	36,679	38,701
Proceeds from sale of operations	8,400	65,019
Net cash used in investing activities	(270,342)	(80,278)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of long-term debt		1,000,000
Principal payments of long-term debt	(363,958)	(340,352)
Principal payment of short-term bridge loan		(1,000,000)
Net change in short-term borrowings	(10,588)	(8,790)
Debt issuance costs		(9,855)
Settlement of interest rate derivative contract		(33,383)
Payment of common stock dividends	(59,596)	(52,598)
Distributions to noncontrolling joint venture partner		(64,000)
Other financing activities	1,713	(2,937)

Net cash used in financing activities	(432,429)	(511,915)
Effect of exchange rate changes on cash	(9,987)	2,615
Increase (decrease) in cash and cash equivalents	(490,686)	61,676
Cash and cash equivalents at beginning of period	988,346	162,508
Cash and cash equivalents at end of period	\$ 497,660	\$ 224,184
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid for interest	\$ 74,793	\$ 47,526
Cash paid for income taxes	45,649	173,603

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

**Table of Contents****SMITH INTERNATIONAL, INC.****CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS EQUITY AND  
COMPREHENSIVE INCOME****For the Six Months Ended June 30, 2010 and 2009**

	<b>Common Stock</b>	<b>Additional Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Unaudited) (In thousands)</b>	<b>Treasury Securities</b>	<b>Smith Stockholders Equity</b>	<b>Noncontrolling Interests in Subsidiaries</b>	<b>Total Stockholders' Equity</b>
Balance, December 31, 2009	\$ 236,726	\$ 1,975,102	\$ 2,885,792	\$ (73,833)	\$ (474,448)	\$ 4,549,339	\$ 1,310,970	\$ 5,860,000
Net income			121,321			121,321	86,146	207,467
Changes in fair value of derivatives, net of tax				39,676		39,676		39,676
Currency translation adjustments and other				27,350		27,350	9,549	36,849
Comprehensive income			121,321	67,026		188,347	95,695	284,368
Dividend on stock								
Dividends declared			(52,690)			(52,690)		(52,690)
Contribution to noncontrolling joint venture partner							(64,000)	(64,000)
Share-based payment activity	269	23,358			(1,044)	22,583		22,583
Balance, June 30, 2009	\$ 236,995	\$ 1,998,460	\$ 2,954,423	\$ (6,807)	\$ (475,492)	\$ 4,707,579	\$ 1,342,665	\$ 6,050,350
Balance, December 31, 2009	\$ 266,125	\$ 2,706,564	\$ 2,925,467	\$ 24,115	\$ (481,704)	\$ 5,440,567	\$ 1,389,363	\$ 6,829,000
Net income			76,615			76,615	75,178	151,793
Changes in fair value of derivatives, net of tax				(1,208)		(1,208)	282	(926)
Currency translation adjustments and other				(37,065)		(37,065)	(19,259)	(56,329)
Comprehensive income			76,615	(38,273)		38,342	56,201	94,675
Dividend on stock								
Dividends declared			(59,636)			(59,636)		(59,636)
Share-based payment activity	406	28,525			(2,065)	26,866		26,866
Balance, June 30, 2010	\$ 266,531	\$ 2,735,089	\$ 2,942,446	\$ (14,158)	\$ (483,769)	\$ 5,446,139	\$ 1,445,564	\$ 6,891,000

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

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**SMITH INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(All dollar amounts are expressed in thousands, unless otherwise noted)**  
**(Unaudited)**

**1. Significant Accounting Policies**

***Basis of Presentation***

The accompanying unaudited consolidated condensed financial statements of Smith International, Inc. and subsidiaries ( Smith or the Company ) were prepared in accordance with U.S. generally accepted accounting principles and applicable rules and regulations of the Securities and Exchange Commission (the Commission ) pertaining to interim financial information. These interim financial statements do not include all information or footnote disclosures required by generally accepted accounting principles for complete financial statements and, therefore, should be read in conjunction with the audited financial statements and accompanying notes included in the Company s 2009 Annual Report on Form 10-K and other current filings with the Commission. All adjustments that are, in the opinion of management, of a normal and recurring nature and are necessary for a fair presentation of the interim financial statements have been included.

Preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosed amounts of contingent assets and liabilities and the reported amounts of revenues and expenses.

Management believes the most significant estimates and assumptions are associated with the valuation of accounts receivables, inventories, goodwill, indefinite-lived intangibles and deferred taxes as well as the determination of liabilities related to self-insurance programs. If the underlying estimates and assumptions, upon which the financial statements are based, change in future periods, actual amounts may differ from those included in the accompanying consolidated condensed financial statements.

Management believes the consolidated condensed financial statements present fairly the financial position, results of operations and cash flows of the Company as of the dates indicated. The results of operations for the interim period presented may not be indicative of results which may be reported on a fiscal year basis.

***Recent Accounting Pronouncements***

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board ( FASB ). On January 1, 2010, the Company adopted a new accounting standard, which amends previous guidance on the consolidation of variable interest entities ( VIE ). The standard modifies how an enterprise determines the primary beneficiary that would consolidate the VIE from a quantitative risks and rewards calculation to a qualitative approach. Such assessment is required to be performed on a continuous basis and is influenced by, among other things, an enterprise s ability to direct the most significant activities that influence the VIE s operating performance. The adoption of this accounting standard did not have a material impact on the Company s consolidated condensed financial statements.

In October 2009, the FASB issued an update to existing guidance with respect to revenue recognition for arrangements with multiple deliverables. This update will allow allocation of consideration received for qualified separate deliverables based on estimated selling prices for both delivered and undelivered items when vendor-specific or third-party evidence is not available. Additionally, disclosure of the nature of multiple element arrangements, the general timing of their delivery, and significant factors and estimates used to determine estimated selling prices are

required. The Company is currently evaluating this update, which will be adopted for new revenue arrangements entered into or materially modified beginning January 1, 2011.

Management believes the impact of other recently issued standards and updates, which are not yet effective, will not have a material impact on the Company's consolidated financial position, results of operations or cash flows upon adoption.

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**SMITH INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

**2. Schlumberger Limited Merger Agreement**

On February 21, 2010, the Company, Schlumberger Limited ( Schlumberger ) and Turnberry Merger Sub, Inc., a wholly-owned subsidiary of Schlumberger, entered into an Agreement and Plan of Merger (the Merger Agreement ), pursuant to which Turnberry Merger Sub, Inc. will merge with and into the Company, with the Company surviving as a wholly-owned subsidiary of Schlumberger, and each share of Company common stock will be converted into the right to receive 0.6966 shares of Schlumberger common stock (the Merger ). Completion of the Merger is subject to (i) approval of the Merger by the stockholders of the Company, (ii) applicable regulatory approvals and (iii) other customary closing conditions. The European Commission has cleared the Merger under the EC Merger Regulation without any conditions, and the U.S. Department of Justice has cleared the Merger without any conditions, granting early termination of the waiting period required by the Hart-Scott-Rodino Antitrust Improvements Act of 1976 with respect to the proposed merger.

Under the Merger Agreement, the Company agreed to conduct its business in the ordinary course while the Merger is pending, and, except as permitted under the Merger Agreement, to generally refrain from, among other things, acquiring new or selling existing businesses, incurring new indebtedness, repurchasing Company shares, issuing new common stock or equity awards, or entering into new material contracts or commitments outside the normal course of business, without the consent of Schlumberger. The Company recorded \$23.0 million and \$38.4 million, respectively, for the three-month and six-month periods ended June 30, 2010, in expenses associated with the proposed Merger, which expenses are included within selling, general and administrative expenses in the consolidated condensed statements of operations.

**3. Devaluation of Venezuelan Bolivar Fuertes**

In January 2010, the Venezuelan government announced a devaluation of the Venezuelan Bolivar Fuertes which modified the official fixed rate from 2.15 Venezuelan Bolivar Fuertes per U.S. dollar to a multi-rate system. The Company accounts for its operations in Venezuela using the U.S. dollar as its functional currency. Exchange rates used in translating Venezuelan Bolivar Fuertes denominated transactions, assets and liabilities subsequent to the devaluation date are dependent upon a number of factors, including the nature of contracts and the types of goods and services provided, which range between 2.6 and 4.3 Venezuelan Bolivar Fuertes per U.S. dollar. During the second quarter of 2010, the Venezuelan government modified its practices with respect to certain U.S. dollar based billings indicating it would settle such commitments at 2.6 rather than 4.3 Venezuelan Bolivar Fuertes per U.S. dollar. This change resulted in a further reduction in the U.S. dollar value of receivables outstanding as of March 31, 2010 and revenues recognized during the second quarter of 2010. The Company recorded a pre-tax loss of \$11.9 million in the second quarter of 2010 in connection with the impact of the Venezuelan government's action on outstanding receivables. For the six months ended June 30, 2010, the Company recorded a pre-tax loss totaling \$34.9 million related to the revaluation of its Venezuelan Bolivar Fuertes denominated net asset position and certain U.S. dollar based billings, which is included within selling, general and administrative expenses in the consolidated condensed statements of operations.

**4. Acquisitions and Dispositions**

*Acquisitions*

From time to time, the Company enters into transactions involving the purchase of a full or partial ownership interest in complementary business operations.

On April 16, 2010, the Company acquired the remaining 65-percent ownership interest in @Balance, B.V. ( @Balance ) in exchange for cash consideration of \$74.0 million. @Balance is a supplier of managed pressure drilling services. Generally accepted accounting principles require that an acquirer remeasure its previously held equity interest in an acquiree at its acquisition date fair value and recognize the resulting gain



Table of Contents**SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

or loss in earnings. The Company recognized a pre-tax gain of \$20.8 million in the second quarter of 2010, as a result of remeasuring its previously held equity interest in @Balance, which is included within selling, general and administrative expenses in the consolidated condensed statements of operations. No other material acquisitions were finalized during the first six months of 2010 or 2009.

The acquired operations have been included in the results of operations since the date of acquisition. The excess of the purchase price over the estimated fair value of net assets acquired, which is primarily associated with the @Balance transaction, approximated \$56.5 million and has been recorded as goodwill in the June 30, 2010 consolidated condensed balance sheet. The purchase price allocations related to the 2010 acquisitions are based on preliminary information and are subject to change when additional data concerning final asset and liability valuations is obtained; however, material changes in the preliminary allocations are not anticipated by management. Pro forma results of operations have not been presented because the effect of these transactions was not material to the Company's consolidated condensed financial statements.

**Dispositions**

During the first six months of 2009, the Company disposed of certain non-core operations acquired in connection with the W-H Energy Services, Inc. transaction. The Company received cash proceeds of \$65.0 million and is entitled to future consideration in the event financial metrics established under earn-out arrangements are met. The accompanying consolidated condensed financial statements reflect no gain or loss associated with the sale of these operations.

**5. Earnings Per Share**

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Net income attributable to Smith	\$ 65,074	\$ 24,386	\$ 76,615	\$ 121,321
Weighted average number of common shares outstanding	248,539	219,307	248,450	219,254
<b>Basic EPS</b>	\$ 0.26	\$ 0.11	\$ 0.31	\$ 0.55
Net income attributable to Smith	\$ 65,074	\$ 24,386	\$ 76,615	\$ 121,321

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Weighted average number of common shares outstanding	248,539	219,307	248,450	219,254
Dilutive effect of stock options and restricted stock units	1,794	938	1,609	671
	250,333	220,245	250,059	219,925
<b>Diluted EPS</b>	\$ 0.26	\$ 0.11	\$ 0.31	\$ 0.55

**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****6. Inventories**

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

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
Raw materials	\$ 190,042	\$ 173,953
Work-in-process	236,563	163,489
Finished goods	1,619,295	1,656,648
	2,045,900	1,994,090
Reserves to state certain U.S. inventories (FIFO cost of \$706,598 and \$840,326 in 2010 and 2009, respectively) on a LIFO basis	(165,277)	(173,735)
	\$ 1,880,623	\$ 1,820,355

**7. Property, Plant and Equipment**

Property, plant and equipment consist of the following:

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
Land and improvements	\$ 88,266	\$ 88,154
Buildings	367,149	357,521
Machinery and equipment	1,197,614	1,181,269
Rental tools	1,546,984	1,435,870
	3,200,013	3,062,814
Less Accumulated depreciation	(1,227,771)	(1,139,349)
	\$ 1,972,242	\$ 1,923,465

**8. Goodwill and Other Intangible Assets*****Goodwill***

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The following table presents goodwill on a segment basis as of the dates indicated as well as changes in the account during the period shown.

	<b>M-I SWACO</b>	<b>Smith Oilfield</b>	<b>Distribution</b>	<b>Consolidated</b>
Balance as of December 31, 2009	\$ 752,821	\$ 2,264,920	\$ 51,087	\$ 3,068,828
Acquisitions		56,487		56,487
Purchase price revisions	6,813	(288)		6,525
Balance as of June 30, 2010	\$ 759,634	\$ 2,321,119	\$ 51,087	\$ 3,131,840

**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)****Other Intangible Assets**

The components of other intangible assets are as follows:

	June 30, 2010			December 31, 2009		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Patents	\$ 446,898	\$ 99,070	\$ 347,828	\$ 445,973	\$ 83,387	\$ 362,586
Trademarks(a)	212,807	5,095	207,712	205,031	4,390	200,641
License agreements	42,710	23,572	19,138	41,677	20,517	21,160
Non-compete agreements	38,445	30,652	7,793	37,928	28,410	9,518
Customer relationships and contracts	85,713	43,924	41,789	58,438	38,257	20,181
	\$ 826,573	\$ 202,313	\$ 624,260	\$ 789,047	\$ 174,961	\$ 614,086

(a) Included within the gross carrying amount of trademarks is \$195.7 million of indefinite-lived assets.

Intangible amortization expense totaled \$13.5 million and \$12.9 million for the for the three-month periods ended June 30, 2010 and 2009, respectively, and \$27.3 million and \$25.8 million for the six months ended June 30, 2010 and 2009, respectively. The weighted average life for other intangible assets subject to amortization, which excludes certain indefinite-lived trademarks, approximates 13 years. Amortization expense on existing intangible assets is expected to approximate \$53 million for fiscal year 2010 and is anticipated to range between \$36 million and \$48 million per year for the 2011 – 2014 fiscal years.

**9. Debt**

The following summarizes the Company's outstanding debt:

	June 30, 2010	December 31, 2009
<b>Current:</b>		
Short-term borrowings	\$ 76,679	\$ 87,267
Current portion of long-term debt	239,870	271,501
Short-term borrowings and current portion of long-term debt	\$ 316,549	\$ 358,768

**Long-Term:**

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Notes, net of unamortized discounts	\$ 1,493,783	\$ 1,493,634
Revolving credit facilities		
Term loans	228,014	592,121
	1,721,797	2,085,755
Less Current portion of long-term debt	(239,870)	(271,501)
Long-term debt	\$ 1,481,927	\$ 1,814,254

During the first six months of 2010, the Company used a portion of the cash received in the November 2009 equity offering to repay \$350 million of outstanding borrowings under various loan agreements. Additionally, \$220.0 million of senior notes maturing in February 2011 and classified as long-term debt as of December 31, 2009 are classified within the current portion of long-term debt as of June 30, 2010.

**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

In December 2009, the Company entered into a \$1.0 billion unsecured revolving credit facility provided by a syndicate of financial institutions, under which M-I SWACO can utilize up to \$125 million. The revolving credit agreement allows for the election of interest at a base rate or a Eurodollar rate of LIBOR plus 250 basis points, and requires the payment of a quarterly commitment fee of 37.5 basis points on the unutilized portion of the facility. The credit facility, which expires in March 2013, contains customary covenants, a debt-to-total capitalization limitation and remained undrawn at June 30, 2010. Additionally, the Company had a \$375.0 million unsecured revolving credit facility, which expired in July 2010 and was undrawn at June 30, 2010.

Principal payments of long-term debt for the twelve-month periods ending subsequent to June 30, 2011 are as follows:

2012	\$ 197,816
2013	10,066
2014	299,459
2015	
Thereafter	974,586
	\$ 1,481,927

The Company was in compliance with its loan covenants under the various loan agreements, as amended, at June 30, 2010.

**10. Derivative Financial Instruments**

The nature of the Company's business activities involves the management of various financial and market risks, including those related to changes in currency exchange rates and interest rates. In an effort to mitigate these risks, the Company enters into derivative financial instruments, which are accounted for as cash flow or fair value hedges in accordance with the authoritative accounting standard. The Company does not enter into derivative instruments for speculative purposes.

For foreign exchange and interest rate derivative instruments that do not qualify as cash flow hedges, realized and unrealized gains and losses are recognized currently through earnings. Foreign exchange hedge contracts not designated as cash flow hedges with a notional amount of \$164.5 million and \$114.5 million were outstanding at June 30, 2010 and December 31, 2009, respectively.

For foreign exchange and interest rate derivative instruments that qualify as cash flow hedges, realized and unrealized gains and losses are deferred to accumulated other comprehensive income ( AOCI ) and recognized in the consolidated statements of operations when the hedged item affects earnings. At June 30, 2010, the Company had one outstanding interest rate cash flow hedge contract with a notional amount of \$50.3 million and various outstanding foreign exchange cash flow hedge contracts with notional amounts totaling \$15.8 million. At December 31, 2009, the Company had one outstanding interest rate cash flow hedge contract with a notional amount of \$63.9 million and no outstanding foreign exchange cash flow hedge contracts. Approximately \$2.6 million of losses deferred in AOCI related to cash flow foreign exchange and interest rate derivative contracts, or \$1.4 million net of taxes and noncontrolling interests, will be reclassified into earnings during the second half of 2010.

The Company has recognized \$4.1 million and \$11.1 million of derivative contract losses in the consolidated condensed statements of operations for the three-month and six-month periods ended June 30, 2010, respectively. During the three-month and six-month periods ended June 30, 2009, the Company recognized \$3.8 million and \$10.9 million, respectively, in derivative contract losses.



**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

The following table provides required information with respect to the classification and loss amounts recognized in income as well as the derivative-related contract losses deferred in AOCI for the three-month and six-month periods ended June 30, 2010 and 2009:

	Gain (Loss) Recognized in AOCI				Location of Gain (Loss) Reclassified from AOCI to Income	Gain (Loss) Reclassified from AOCI to Income			
	Three Months Ended June 30,		Six Months Ended June 30,			Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009		2010	2009	2010	2009
Interest rate contracts	\$ (290)	\$ (464)	\$ (647)	\$ (954)	Interest expense	\$ (837)	\$ (725)	\$ (1,705)	\$ (1,705)
Oilfield revenues	(13)		(1,144)	(1,061)	Cost of oilfield revenues	(367)	(908)	(418)	(418)
	\$ (303)	\$ (464)	\$ (1,791)	\$ (2,015)		\$ (1,204)	\$ (1,633)	\$ (2,123)	\$ (2,123)

	Gain (Loss) Recognized in Income				Classification
	Three Months Ended June 30,		Six Months Ended June 30,		
	2010	2009	2010	2009	
<b>Derivatives Designated as Cash Flow Hedging Instruments</b>					
Interest rate contracts	\$	\$	\$	\$ (76)	Selling, general and administrative expenses
<b>Derivatives Not Designated</b>					
Foreign exchange contracts	\$ (2,932)	\$ (2,216)	\$ (8,975)	\$ (7,161)	Selling, general and administrative expenses

The fair value of outstanding foreign exchange derivative instruments is determined using composite pricing from published financial market sources whereas the fair value of the outstanding interest rate derivative instruments is determined by obtaining quoted prices in active markets for similar contracts. Both measurement methodologies are classified as Level Two tier under the applicable accounting standard. The recorded fair value of derivative instruments is as follows:

<b>Asset Derivatives</b>	<b>Fair Value of Derivatives</b>		<b>Classification</b>
	<b>June 30, 2010</b>	<b>December 31, 2009</b>	
<b>Derivatives Not Designated</b>			
Foreign exchange contracts	\$ 4,381	\$ 2,648	Prepaid expenses and other
<b>Liability Derivatives</b>			
<b>Derivatives Designated as Hedging Instruments</b>			
Interest rate contracts	\$ (3,650)	\$ (4,623)	Other current liabilities
<b>Derivatives Not Designated</b>			
Foreign exchange contracts	(8,394)	(4,138)	Other current liabilities
Total	\$ (12,044)	\$ (8,761)	

***Other Financial Instruments***

The fair value of outstanding long-term debt instruments is determined using quoted prices for similar debt instruments, which is classified as a Level Two tier measurement methodology under the applicable accounting standard. At June 30, 2010, the fair value of long-term debt instruments approximated \$2.05 billion

**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

and the recorded value totaled \$1.72 billion. The fair and recorded values of long-term debt instruments totaled \$2.33 billion and \$2.09 billion, respectively, at December 31, 2009.

The fair value of the remaining financial instruments, including cash and cash equivalents, receivables, payables and short-term borrowings, approximates the carrying value due to the nature of these instruments.

**11. Accumulated Other Comprehensive Income**

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

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
Currency translation adjustments	\$ (5,888)	\$ 31,290
Fair value of derivatives	(3,482)	(2,274)
Pension and other postretirement benefits	(4,788)	(4,901)
Accumulated other comprehensive income	\$ (14,158)	\$ 24,115

**12. Long-Term Incentive Compensation**

As of June 30, 2010, the Company had outstanding restricted stock and stock option awards granted under the Third Amended and Restated 1989 Long-Term Incentive Compensation Plan (the "LTIC Plan"). As of June 30, 2010, approximately 640 thousand shares were authorized for future issuance pursuant to the LTIC Plan.

**Restricted Stock**

The restricted stock program consists of a combination of performance-based restricted stock units ( "performance-based units" ) and time-based restricted stock units ( "time-based units" ). The number of performance-based units issued under the program, which can range from zero to 150 percent of the target units granted, is solely dependent upon financial metrics achieved by the Company in the fiscal year subsequent to the award. Activity under the Company's restricted stock program for the six-month period ended June 30, 2010 is presented below (in thousands, except per share data):

	<b>Time-Based Awards</b>		<b>Performance-Based Awards</b>		<b>Total Restricted Stock Units</b>
	<b>No. of Units</b>	<b>Fair Value(a)</b>	<b>No. of Units(b)</b>	<b>Fair Value(a)</b>	
Outstanding at December 31, 2009	2,366	\$ 29.33	1,795	\$ 27.52	4,161

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Granted	196	41.17			196
Forfeited	(78)	35.52	(6)	33.38	(84)
Vested			(250)	26.80	(250)
Outstanding at June 30, 2010	2,484	30.07	1,539	27.62	4,023

(a) Reflects the weighted average grant date fair value.

(b) Performance-based units outstanding assume achievement of target level financial metrics related to the December 2009 grants.

Restrictions on approximately 1.2 million restricted stock units outstanding at June 30, 2010 are expected to lapse and issue during the 2010 fiscal year.

**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)*****Stock Options***

Activity under the Company's stock option program for the six-month period ended June 30, 2010 is presented below (in thousands, except per share data):

	<b>Shares Under Option</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at December 31, 2009	1,059	\$ 20.05		
Exercised	(132)	20.20		
Outstanding and exercisable at June 30, 2010	927	20.02	3.1	\$ 16,348

***Share-based Compensation Expense***

Share-based compensation expense, consisting of restricted stock and stock option awards, was \$12.0 million and \$10.8 million for the three-month periods ended June 30, 2010 and 2009, respectively, and \$24.2 million and \$23.1 million for each of the six-month periods ended June 30, 2010 and 2009, respectively.

Assuming achievement of target-level financial metrics for performance-based awards granted in December 2009, unrecognized share-based compensation expense totaled \$90.4 million for awards outstanding as of June 30, 2010. After adjusting for taxes and noncontrolling interests, approximately \$59.8 million of additional share-based compensation is expected to be recognized over a weighted average period of 2.6 years.

**13. Income Taxes**

The effective tax rate for the three-month period ended June 30, 2010 was 32 percent and compares to 31 percent for the prior-year quarter. For the six-months ended June 30, 2010 and 2009, the effective tax rate was 38 percent and 32 percent, respectively. The Company's current quarter and year-to-date results include \$7.6 million and \$30.6 million, respectively, of losses related to devaluation of the Venezuelan local currency denominated net asset position and certain business combination transaction-related expenses for which no tax benefit was recognized. Additionally, during the second quarter of 2010, approximately \$13.2 million of the pre-tax gain recognized on the Company's remeasurement of its previous investment in @Balance did not attract income tax expense, which favorably impacted the effective tax rate. On a combined basis, the effect of these items accounted for the majority of the year-over-year variance in the effective tax rates. The consolidated tax provision assumes completion of the proposed Merger as well as other business combination transactions. If these transactions do not close, an additional tax benefit will be recorded.

**14. Industry Segments and International Operations**

The Company is a global provider of products and services used during the drilling, completion and production phases of oil and natural gas development activities. Our business is segregated into three operating segments, M-I SWACO, Smith Oilfield and Distribution, which is the basis upon which we report our results.

The M-I SWACO segment consists of a majority-owned drilling fluid and environmental services joint venture operation. The Smith Oilfield segment is comprised of our wholly-owned drilling and completion services operations, which includes drill bits, directional drilling services and downhole tools. The Distribution segment consists of the Wilson distribution operations and a majority-owned interest in CE Franklin Ltd., a publicly-traded Canadian distribution company. Finally, general corporate primarily reflects expenses related to corporate personnel, administrative support functions and long-term incentive compensation programs.

**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

The following table presents consolidated revenues by region:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
United States	\$ 995,703	\$ 772,535	\$ 1,834,135	\$ 1,862,075
Canada	177,344	133,612	405,057	325,896
North America	1,173,047	906,147	2,239,192	2,187,971
Latin America	261,762	227,499	532,571	503,606
Europe/Africa	558,782	510,689	1,100,236	1,050,504
Middle East/Asia	302,472	299,954	561,875	613,687
Non-North America	1,123,016	1,038,142	2,194,682	2,167,797
	\$ 2,296,063	\$ 1,944,289	\$ 4,433,874	\$ 4,355,768

The following table presents financial information for each reportable segment:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Revenues:				
M-I SWACO	\$ 1,155,600	\$ 1,013,016	\$ 2,266,790	\$ 2,172,353
Smith Oilfield	650,151	520,467	1,224,982	1,202,867
Distribution	490,312	410,806	942,102	980,548
	\$ 2,296,063	\$ 1,944,289	\$ 4,433,874	\$ 4,355,768
Operating Income:				
M-I SWACO	\$ 132,589	\$ 121,325	\$ 252,993	\$ 268,833
Smith Oilfield	80,987	47,622	137,535	153,387
Distribution	13,599	(9,799)	18,301	5,722
General corporate	(35,722)	(25,844)	(92,497)	(52,960)
	\$ 191,453	\$ 133,304	\$ 316,332	\$ 374,982





**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

The following tables summarize charges and gains, included within selling, general and administrative expenses, on a reportable segment basis:

For the three months ended June 30, 2010:

	<b>Pre-Tax Cost</b>	<b>Tax (Provision) Benefit</b>	<b>Noncontrolling Interest</b>	<b>Net</b>
Venezuelan currency-related losses:				
M-I SWACO	\$ 7,404	\$ 1,773	\$ 2,252	\$ 3,379
General corporate	4,487	1,526		2,961
	11,891	3,299	2,252	6,340
Business combination transaction-related costs:				
M-I SWACO	654	222	173	259
General corporate	23,032	5,630		17,402
	23,686	5,852	173	17,661
Gain on remeasurement of investment in @Balance:				
General corporate	(20,773)	(3,389)		(17,384)
	\$ 14,804	\$ 5,762	\$ 2,425	\$ 6,617

For the six months ended June 30, 2010:

	<b>Pre-Tax Cost</b>	<b>Tax (Provision) Benefit</b>	<b>Noncontrolling Interest</b>	<b>Net</b>
Venezuelan currency-related losses:				
M-I SWACO	\$ 19,050	\$ (1,393)	\$ 8,177	\$ 12,266
General corporate	15,817	2,034		13,783
	34,867	641	8,177	26,049
Business combination transaction-related costs:				
M-I SWACO	1,817	222	638	957

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General corporate	38,424	6,422		32,002
	40,241	6,644	638	32,959
Gain on remeasurement of investment in @Balance:				
General corporate	(20,773)	(3,389)		(17,384)
	\$ 54,335	\$ 3,896	\$ 8,815	\$ 41,624

Charges incurred in the June 2010 quarter include an \$11.9 million charge associated with the revaluation of certain U.S. dollar based billings payable in Venezuelan Bolivar Fuertes, \$23.7 million in transaction-related charges, primarily attributable to expenses associated with the proposed Merger, and a \$20.8 million gain recognized in connection with the @Balance transaction. During the six months ended June 30, 2010, the Company recorded a \$34.9 million charge associated with the Venezuelan government's devaluation of the Venezuelan Bolivar Fuertes and revaluation of certain U.S. dollar based billings payable in Venezuelan Bolivar Fuertes, \$40.2 million in business combination transaction-related charges, primarily attributable to expenses associated with the proposed Merger, and a \$20.8 million gain recognized in connection with the @Balance transaction.

**Table of Contents****SMITH INTERNATIONAL, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

For the three months ended June 30, 2009:

	<b>Pre-Tax Cost</b>	<b>Tax (Provision) Benefit</b>	<b>Noncontrolling Interest</b>	<b>Net</b>
Employee severance and other costs:				
M-I SWACO	\$ 2,983	\$ 626	\$ 1,193	\$ 1,164
Smith Oilfield	8,593	3,006		5,587
Distribution	1,265	443		822
General corporate	160	56		104
	\$ 13,001	\$ 4,131	\$ 1,193	\$ 7,677

For the six months ended June 30, 2009:

	<b>Pre-Tax Cost</b>	<b>Tax (Provision) Benefit</b>	<b>Noncontrolling Interest</b>	<b>Net</b>
Employee severance and other costs:				
M-I SWACO	\$ 22,284	\$ 5,376	\$ 8,216	\$ 8,692
Smith Oilfield	20,952	7,331		13,621
Distribution	1,916	671		1,245
General corporate	160	56		104
	45,312	13,434	8,216	23,662
Derivative contract-related costs:				
General corporate	2,481	869		1,612
	\$ 47,793	\$ 14,303	\$ 8,216	\$ 25,274

Charges incurred during the first six months of 2009 are primarily attributable to severance-related expenses. The Company incurred charges of \$12.5 million and \$43.5 million for the three-month and six-month periods ended June 30, 2009, respectively, associated with a reduction in North American personnel levels. In addition, the Company incurred \$0.5 million and \$1.8 million in facility closure costs for the three-month and six-month periods ended June 30, 2009, respectively. During the six-month period ended June 30, 2009, the Company also recognized a \$2.5 million loss on an interest rate derivative contract.

**15. Commitments and Contingencies**

***Litigation***

Subsequent to the announcement of the Merger, five putative class action lawsuits were commenced on behalf of stockholders of the Company against the Company and its directors, and in certain cases against Schlumberger and one of its affiliates, challenging the Merger. Four of the lawsuits were filed in the District Court of Harris County, Texas, and have been consolidated into a single action in the 164th District Court of Harris County, Texas (the Texas Action ), and one lawsuit is pending in the Delaware Court of Chancery (the Delaware Action, and collectively with the Texas Action, the Actions ). The parties in the Actions have agreed to an expedited discovery schedule and to the coordination of pleadings and discovery in advance of any preliminary injunction hearing, which will be heard only in the Texas Action. On April 19, 2010, the court in the Delaware Action approved the parties' agreement concerning the coordination of the Actions and agreed to otherwise stay the Delaware proceedings through any preliminary injunction hearing in Texas. Plaintiffs in the Actions have served a consolidated amended petition for breach of fiduciary duty and a verified amended class action complaint, respectively. The amended pleadings are substantively similar and allege that the Company's directors breached their fiduciary duties by, among other things, causing the

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**SMITH INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

Company to enter into the Merger Agreement at an allegedly inadequate and unfair price, agreeing to transaction terms that improperly inhibit alternative transactions and failing to provide material information to the Company's stockholders in the preliminary proxy statement filed in connection with the Merger. Specifically, the pleadings allege that the preliminary proxy statement omits material information relating to, among other things: the analyses performed by, and the information relied upon by, UBS; any strategic alternatives to the Merger considered by UBS; UBS's involvement in the negotiations between the Company and Schlumberger; the fee to be paid to UBS in connection with the Merger; and any negotiations or plans concerning the employment of Smith management after consummation of the Merger. The pleadings also allege that the Company and Schlumberger aided and abetted the directors' breaches of fiduciary duties. The pleadings seek, among other things, an injunction barring defendants from consummating the proposed transaction, declaratory relief and attorneys' fees.

On May 28, 2010, a purported Company stockholder filed an individual lawsuit in the United States District Court for the Southern District of Texas, Houston Division, against the Company and its directors, alleging that the Company had disseminated a false and materially misleading preliminary proxy statement in connection with the Merger in violation of Sections 14(a) and 20(a) of the Securities Exchange Act of 1934 and the rules promulgated thereunder. The lawsuit alleges that the preliminary proxy statement omits and/or misrepresents material information relating to, among other things: negotiations, if any, with other potential acquirers of the Company; any market check conducted by the Company in connection with the Merger; any strategic alternatives considered by the Company's directors in connection with the Merger; whether the Merger consideration includes any compensation for the synergies to be achieved in the Merger; the financial information and forecasts provided by the Company's directors to UBS in connection with its fairness opinion; the discounted cash flow, comparable transaction and selected companies analyses performed by UBS; and business ties between any of the Company's directors and Schlumberger. The complaint seeks, among other things, injunctive relief, compensatory damages and reasonable costs and expenses incurred in the action, including counsel fees and expert fees.

The Company believes that the lawsuits in which it is named are without merit and intends to defend these lawsuits vigorously.

On April 20, 2010, a fire and explosion occurred onboard the semisubmersible drilling rig *Deepwater Horizon*, owned by Transocean Ltd. and under contract to a subsidiary of BP plc. Pursuant to a contract between M-I SWACO and BP for the provision of certain services by M-I SWACO under the direction of BP, five employees of M-I SWACO were aboard the *Deepwater Horizon* at the time of the incident and unfortunately two of them were killed (the other three were uninjured). A number of legal actions, certain of which name an M-I SWACO entity as a defendant, have been filed in connection with the *Deepwater Horizon* incident, and additional legal actions may be filed in the future. Smith is currently investigating the incident and the liabilities that could potentially arise therefrom, and is assessing the availability of contractual indemnities and insurance coverage. However, based on information currently known, the amount of any potential loss attributable to M-I SWACO with respect to potential liabilities related to the incident would not be material.

The Company is also a defendant in various other 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.

***M-I SWACO Noncontrolling Interest***

If the proposed Merger is not consummated, pursuant to the joint venture agreement, either the Company or its M-I SWACO joint venture partner, Schlumberger, can offer to sell to the other party its entire ownership interest in the joint venture in exchange for a cash purchase price specified by the offering partner. If the initiating partner's offer to sell is not accepted, such party is obligated to purchase the other party's interest at

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**SMITH INTERNATIONAL, INC.**

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)**

the same valuation per interest. If the Company agrees to purchase Schlumberger's joint venture interest, whether pursuant to these provisions or otherwise, Smith would need to fund the transaction. The Company's funding could include issuing equity, resulting in dilution to existing stockholders, obtaining additional debt, which may require waivers of applicable debt covenants, or obtaining other financing, as well as using available cash to fund the purchase. Should the Company instead not purchase Schlumberger's interest, the Company would no longer have an interest in the joint venture.

***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 with respect to certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$20.3 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately \$245 million of standby letters of credit and bid, performance and surety bonds at June 30, 2010. Management does not expect any material amounts to be drawn on these instruments.

***Insurance***

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

***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. 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.

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

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 includes forward-looking statements that are subject to risks and uncertainties and should be read in conjunction with the Consolidated Condensed Financial Statements of the Company and the related notes thereto included elsewhere in this Form 10-Q, the Company's 2009 Annual Report on Form 10-K and other current filings with the Commission.

**Recent Developments**

***Schlumberger Limited Merger Agreement***

On February 21, 2010, the Company, Schlumberger Limited (Schlumberger) and Turnberry Merger Sub, Inc., a wholly-owned subsidiary of Schlumberger, entered into an Agreement and Plan of Merger (the Merger Agreement), pursuant to which Turnberry Merger Sub, Inc. will merge with and into the Company, with the Company surviving as a wholly-owned subsidiary of Schlumberger, and each share of Company common stock will be converted into the right to receive 0.6966 shares of Schlumberger common stock (the Merger). Completion of the Merger is subject to (i) approval of the Merger by the stockholders of the Company, (ii) applicable regulatory approvals and (iii) other customary closing conditions. The European Commission has cleared the Merger under the EC Merger Regulation without any conditions, and the U.S. Department of Justice has cleared the Merger without any conditions, granting early termination of the waiting period required by the Hart-Scott-Rodino Antitrust Improvements Act of 1976 with respect to the proposed merger.

Under the Merger Agreement, the Company agreed to conduct its business in the ordinary course while the Merger is pending, and, except as permitted under the Merger Agreement, to generally refrain from, among other things, acquiring new or selling existing businesses, incurring new indebtedness, repurchasing Company shares, issuing new capital stock or equity awards, or entering into new material contracts or commitments outside the ordinary course of business, without the consent of Schlumberger. During the three-month and six-month periods ended June 30, 2010, the Company incurred \$23.0 million and \$38.4 million, respectively, in expenses associated with the proposed Merger, which expenses are included within selling, general and administrative expenses in the consolidated condensed statements of operations.

***Stockholder Litigation***

Subsequent to the announcement of the Merger, five putative class action lawsuits were commenced on behalf of stockholders of the Company against the Company and its directors, and in certain cases against Schlumberger and one of its affiliates, challenging the Merger. Four of the lawsuits were filed in the District Court of Harris County, Texas, and have been consolidated into a single action in the 164th District Court of Harris County, Texas (the Texas Action), and one lawsuit is pending in the Delaware Court of Chancery (the Delaware Action, and collectively with the Texas Action, the Actions). The parties in the Actions have agreed to an expedited discovery schedule and to the coordination of pleadings and discovery in advance of any preliminary injunction hearing, which will be heard only in the Texas Action. On April 19, 2010, the court in the Delaware Action approved the parties' agreement concerning the coordination of the Actions and agreed to otherwise stay the Delaware proceedings through any preliminary injunction hearing in Texas. Plaintiffs in the Actions have served a consolidated amended petition for breach of fiduciary duty and a verified amended class action complaint, respectively. The amended pleadings are substantively similar and allege that the Company's directors breached their fiduciary duties by, among other things, causing the Company to enter into the Merger Agreement at an allegedly inadequate and unfair price, agreeing to transaction terms that improperly inhibit alternative transactions and failing to provide material information to the Company's stockholders



in the preliminary proxy statement filed in connection with the Merger. Specifically, the pleadings allege that the preliminary proxy statement omits material information relating to, among other things: the analyses performed by, and the information relied upon by, UBS; any strategic

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alternatives to the Merger considered by UBS; UBS's involvement in the negotiations between the Company and Schlumberger; the fee to be paid to UBS in connection with the Merger; and any negotiations or plans concerning the employment of Smith management after consummation of the Merger. The pleadings also allege that the Company and Schlumberger aided and abetted the directors' breaches of fiduciary duties. The pleadings seek, among other things, an injunction barring defendants from consummating the proposed transaction, declaratory relief and attorneys' fees.

On May 28, 2010, a purported Company stockholder filed an individual lawsuit in the United States District Court for the Southern District of Texas, Houston Division, against the Company and its directors, alleging that the Company had disseminated a false and materially misleading preliminary proxy statement in connection with the Merger in violation of Sections 14(a) and 20(a) of the Securities Exchange Act of 1934 and the rules promulgated thereunder. The lawsuit alleges that the preliminary proxy statement omits and/or misrepresents material information relating to, among other things: negotiations, if any, with other potential acquirers of the Company; any market check conducted by the Company in connection with the Merger; any strategic alternatives considered by the Company's directors in connection with the Merger; whether the Merger consideration includes any compensation for the synergies to be achieved in the Merger; the financial information and forecasts provided by the Company's directors to UBS in connection with its fairness opinion; the discounted cash flow, comparable transaction and selected companies analyses performed by UBS; and business ties between any of the Company's directors and Schlumberger. The complaint seeks, among other things, injunctive relief, compensatory damages and reasonable costs and expenses incurred in the action, including counsel fees and expert fees.

The Company believes that the lawsuits in which it is named are without merit and intends to defend these lawsuits vigorously.

### ***Where to Find Additional Information***

Additional information about Schlumberger is included in documents that it has filed with the Securities and Exchange Commission (SEC). Additional information concerning the Merger is contained in Item 1A, Risk Factors, and in the proxy statement/prospectus and registration statement filed with the SEC on July 16, 2010.

**STOCKHOLDERS ARE URGED TO READ THE PROXY STATEMENT/PROSPECTUS AND REGISTRATION STATEMENT REGARDING THE PROPOSED TRANSACTION AS IT CONTAINS IMPORTANT INFORMATION ABOUT THE PROPOSED TRANSACTION.** These materials are available to the stockholders of Smith at no expense to them. Investors and security holders are able to obtain the documents free of charge at the SEC's website, [www.sec.gov](http://www.sec.gov). In addition, such materials (and all other documents filed with the SEC) are available free of charge at [www.smith.com](http://www.smith.com) or [www.slb.com](http://www.slb.com). A stockholder may also read and copy any reports, statements and other information filed by Smith or Schlumberger with the SEC at the SEC public reference room at 100 F Street N.E., Room 1580, Washington, D.C. 20549. Please call the SEC at (800) 732-0330 or visit the SEC's website for further information on its public reference room.

Each company's directors and executive officers and other persons may be deemed, under SEC rules, to be participants in the solicitation of proxies in connection with the proposed transaction. Information regarding Schlumberger's directors can be found in its proxy statement filed with the SEC on March 4, 2010 and officers can be found in its 2009 Form 10-K filed with the SEC on February 5, 2010. Information regarding Smith's directors can be found in the proxy statement/prospectus filed on July 16, 2010 and officers can be found in Smith's 2009 Form 10-K filed with the SEC on March 1, 2010. Additional information regarding the participants in the proxy solicitation and a description of their direct and indirect interests in the transaction, by security holdings or otherwise, are contained in the proxy statement/prospectus filed on July 16, 2010 and other relevant materials to be filed with the SEC.

### ***Deepwater Horizon Drilling Rig Accident***

On April 20, 2010, a fire and explosion occurred onboard the semisubmersible drilling rig *Deepwater Horizon*, owned by Transocean Ltd. and under contract to a subsidiary of BP plc. Pursuant to a contract between M-I SWACO and BP for the provision of certain services by M-I SWACO under the direction of BP,

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five employees of M-I SWACO were aboard the *Deepwater Horizon* at the time of the incident and unfortunately two of them were killed (the other three were uninjured). A number of legal actions, certain of which name an M-I SWACO entity as a defendant, have been filed in connection with the *Deepwater Horizon* incident, and additional legal actions may be filed in the future. Smith is currently investigating the incident and the liabilities that could potentially arise therefrom, and is assessing the availability of contractual indemnities and insurance coverage. However, based on information currently known, the amount of any potential loss attributable to M-I SWACO with respect to potential liabilities related to the incident would not be material.

The Company's revenue attributable to the U.S. Gulf of Mexico represented approximately six percent of its consolidated revenue for the year ended December 31, 2009. The majority of these revenues related to the high-performance services and products deployed in deepwater operations. At this time, Smith can not predict what further impact the *Deepwater Horizon* incident may have on the regulation of offshore oil and gas exploration and development activity, the cost or availability of insurance coverage to cover the risks of such operations, or what actions may be taken by customers of Smith or other industry participants in response to the incident. Increased costs for the operations of Smith's customers in the U.S. Gulf of Mexico, along with permitting delays, could affect the economics of currently planned activity in the area and demand for their services. A prolonged suspension of drilling activity in the U.S. Gulf of Mexico and resulting new regulations could materially adversely affect the Company's financial condition, results of operations or cash flows.

### ***Devaluation of Venezuelan Bolivar Fuertes***

In January 2010, the Venezuelan government announced a devaluation of the Venezuelan Bolivar Fuertes which modified the official fixed rate from 2.15 Venezuelan Bolivar Fuertes per U.S. dollar to a multi-rate system. The Company accounts for its operations in Venezuela using the U.S. dollar as its functional currency. Exchange rates used in translating Venezuelan Bolivar Fuertes denominated transactions, assets and liabilities subsequent to the devaluation date are dependent upon a number of factors, including the nature of contracts and the types of goods and services provided, which range between 2.6 and 4.3 Venezuelan Bolivar Fuertes per U.S. dollar. During the second quarter of 2010, the Venezuelan government modified its practices with respect to certain U.S. dollar based billings indicating it would settle such commitments at 2.6 rather than 4.3 Venezuelan Bolivar Fuertes per U.S. dollar. This change resulted in a further reduction in the U.S. dollar value of receivables outstanding as of March 31, 2010 and revenues recognized during the second quarter of 2010. The Company recorded a pre-tax loss of \$11.9 million in the second quarter of 2010 in connection with the impact of the Venezuelan government's action on outstanding receivables. For the six months ended June 30, 2010, the Company recorded a pre-tax loss totaling \$34.9 million related to the revaluation of its Venezuelan Bolivar Fuertes denominated net asset position and certain U.S. dollar based billings, which is included within selling, general and administrative expenses in the consolidated condensed statements of operations.

### **Company Products and Operations**

The Company is a leading global provider of premium products and services used during the drilling, completion and production phases of oil and natural gas exploration and development activities. We provide a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control and separation equipment, waste-management services, three-cone and diamond drill bits, borehole enlargement services, tubulars, directional systems, measurement-while-drilling and logging-while-drilling services, coiled tubing, cased-hole wireline and other complementary downhole tools and services. 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 driven principally 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, environmental concerns, the financial condition of independent E&P companies, the overall level of global

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economic growth and activity, and political actions and uncertainties including, but not limited to, increased taxation, regulation and royalties. In addition, approximately five 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 60 percent of the first six months of 2010 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 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 approximately half of the Company's consolidated revenues were generated in North America during the first half of 2010, Smith's profitability was influenced by business levels in markets outside of North America. The Distribution segment, which accounts for 21 percent of consolidated revenues and primarily supports a North American customer base, masks the geographic revenue mix of the Company's oilfield operations. Excluding the impact of the Distribution segment, over 60 percent of the Company's revenues were generated in markets outside of North America during the first half of 2010.

## **Business Outlook**

The Company's current year results will be influenced by worldwide drilling activity and the general state of the global economic environment. On a worldwide basis, drilling activity is currently expected to increase over 2009 levels. The majority of the anticipated increase is expected in the North American market, driven by the reported expansion in non-conventional, oil-directed drilling. Markets outside of North America, which focus on oil-directed activities, will be influenced by global energy demand and oil-targeted drilling projects. Near-term activity levels will likely be influenced by a recovery in Canadian drilling from the seasonal decline experienced in the second quarter of each year due to the spring break-up, which limits land-based drilling activity. Additionally, recent U.S. government moratoriums and pending guidelines and regulations with respect to drilling activity and the permitting of new wells in the U.S. Gulf of Mexico in response to the *Deepwater Horizon* drilling rig accident and resulting oil spill will adversely impact the offshore oil and gas operations of the Company and other industry participants in the near term and may result over the long term in a shift in activity away from the United States. Although prolonged suspension of drilling activity in the U.S. Gulf of Mexico and resulting new regulations or deterioration in the global economic environment could lead to lower exploration and production spending, reducing demand for the Company's products and services and adversely impacting future results, the long-term outlook for the global energy sector is favorable due to supply and demand fundamentals.

The Merger Agreement with Schlumberger contains a number of restrictions on the Company's operations during the pendency of the Merger. Smith's ability to implement its business plan and respond to market conditions will be subject to compliance with these restrictions. Further information on these restrictions can be found in the Merger Agreement and in the proxy statement/prospectus filed with the Commission on July 16, 2010.

## **Forward-Looking Statements**

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, should and similar terms. These statements are based on certain assumptions and analyses that we believe are appropriate under the circumstances.

Such statements are subject to, among other things, satisfaction of the closing conditions to the Merger, the risk that the contemplated Merger does not occur, negative effects from the pendency of the Merger, the ability to successfully integrate the merged

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businesses and to realize expected synergies, the risk that we will not be able to retain key employees, expenses of the Merger, overall demand for and pricing of the Company's products and services, 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, effects of the prospective or suspended drilling moratoriums in the Gulf of Mexico or related changes in laws or regulations, and changes in laws or regulations and other risk factors that are discussed beginning on page 36 of this Form 10-Q, in the Company's Form 10-K for the fiscal year ended December 31, 2009, and other documents filed with the Commission, 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, a stockholder 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.



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

Our business is segregated into three operating segments, M-I SWACO, Smith Oilfield and Distribution, which is the basis upon which we report our results. The M-I SWACO segment consists of a majority-owned drilling fluid and environmental services joint venture operation. The Smith Oilfield segment is comprised of our wholly-owned drilling and completion services operations, which includes drill bits, directional drilling services and downhole tools. The Distribution segment consists of the Wilson distribution operations and a majority-owned interest in CE Franklin, Ltd., a publicly-traded Canadian distribution company. Finally, general corporate primarily reflects expenses related to corporate personnel, administrative support functions and long-term incentive compensation programs.

	Three Months Ended June 30,				Six Months Ended June 30,			
	2010		2009		2010		2009	
	Amount	%	Amount	%	Amount	%	Amount	%

(Dollars in thousands)

**Financial Data:****Revenues:**

M-I SWACO	\$ 1,155,600	51	\$ 1,013,016	52	\$ 2,266,790	51	\$ 2,172,353	50
Smith Oilfield	650,151	28	520,467	27	1,224,982	28	1,202,867	28
Distribution	490,312	21	410,806	21	942,102	21	980,548	22
Total	\$ 2,296,063	100	\$ 1,944,289	100	\$ 4,433,874	100	\$ 4,355,768	100

**Geographic Revenues:**

## United States:

M-I SWACO	\$ 269,668	12	\$ 204,250	11	\$ 509,627	11	\$ 464,139	11
Smith Oilfield	353,565	15	274,208	14	638,097	15	671,689	15
Distribution	372,470	16	294,077	15	686,411	15	726,247	17
Total United States	995,703	43	772,535	40	1,834,135	41	1,862,075	43

## Canada:

M-I SWACO	45,739	2	22,742	1	107,209	2	63,668	1
Smith Oilfield	34,138	2	17,525	1	82,871	2	55,463	1
Distribution	97,467	4	93,345	5	214,977	5	206,765	5
Total Canada	177,344	8	133,612	7	405,057	9	325,896	7

## Non-North America:

M-I SWACO	840,193	37	786,024	40	1,649,954	38	1,644,546	38
Smith Oilfield	262,448	11	228,734	12	504,014	11	475,715	11
Distribution	20,375	1	23,384	1	40,714	1	47,536	1
Total Non-North America	1,123,016	49	1,038,142	53	2,194,682	50	2,167,797	50

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Total Revenues	\$ 2,296,063	100	\$ 1,944,289	100	\$ 4,433,874	100	\$ 4,355,768	100
<b>Operating Income:</b>								
M-I SWACO	\$ 132,589	11	\$ 121,325	12	\$ 252,993	11	\$ 268,833	12
Smith Oilfield	80,987	12	47,622	9	137,535	11	153,387	13
Distribution	13,599	3	(9,799)	(2)	18,301	2	5,722	1
General corporate	(35,722)	*	(25,844)	*	(92,497)	*	(52,960)	*
Total	\$ 191,453	8	\$ 133,304	7	\$ 316,332	7	\$ 374,982	9

\* not meaningful

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	<b>Three Months Ended June 30,</b>				<b>Six Months Ended June 30,</b>			
	<b>2010</b>		<b>2009</b>		<b>2010</b>		<b>2009</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
<b>Market Data:</b>								
<b>Average Worldwide Rig Count:(1)</b>								
United States	1,666	36	1,004	26	1,577	34	1,176	28
Canada	156	3	79	2	280	6	186	5
Non-North America	2,846	61	2,769	72	2,798	60	2,789	67
<b>Total</b>	<b>4,668</b>	<b>100</b>	<b>3,852</b>	<b>100</b>	<b>4,655</b>	<b>100</b>	<b>4,151</b>	<b>100</b>
Onshore	4,073	87	3,257	85	4,062	87	3,555	86
Offshore	595	13	595	15	593	13	596	14
<b>Total</b>	<b>4,668</b>	<b>100</b>	<b>3,852</b>	<b>100</b>	<b>4,655</b>	<b>100</b>	<b>4,151</b>	<b>100</b>
<b>Average Commodity Prices:</b>								
Crude Oil (\$/Bbl)(2)	\$ 78.05		\$ 59.79		\$ 78.46		\$ 51.68	
Natural Gas (\$/mcf)(3)	4.35		3.81		4.67		4.13	

(1) Source: M-I SWACO (2009 revised effective January 2010).

(2) Average daily West Texas Intermediate ( WTI ) spot closing prices, as quoted by NYMEX.

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

**M-I SWACO****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 49 percent of the revenue base, and to exploration and production spending for land-based projects outside of North America, which contributes approximately 31 percent of the segment's revenues. The remaining 20 percent of M-I SWACO's revenues are derived from customer spending for North American land-based projects. Offshore drilling programs, which accounted for 13 percent of the worldwide rig count in the first half of 2010, are generally more revenue intensive than land-based projects due to the complex nature of the related drilling environment. For the second quarter of 2010, M-I SWACO's revenues totaled \$1.16 billion, an increase of 14 percent from the comparable 2009 period. The majority of the revenue growth was reported in the Western Hemisphere reflecting the affect of a substantial improvement in land-based drilling activity and demand for drilling fluids and waste management services. To a lesser extent, the year-over-year revenue increase was also driven by higher customer demand in the Former Soviet Union ( FSU ) and North Sea regions. M-I SWACO reported revenues of \$2.27 billion for the six-month period, four percent above the amounts reported in the first half of 2009. Substantially all of the revenue expansion was

reported in North America, influenced by higher demand for drilling solutions, production chemicals and waste management services for land-based projects.

*Operating Income*

Operating income for the M-I SWACO segment was \$132.6 million for the second quarter of 2010, translating into operating margins of 11.5 percent. Operating margins were slightly below prior-year levels due principally to the effect of increased charges reported in the current quarter. On an absolute dollar basis, operating income was \$11.3 million above the 2009 level, impacted by higher revenue volumes and product mix factors. Operating income rose \$16.3 million from the comparable prior-year period, after excluding

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\$8.1 million of charges associated primarily with the revaluation of certain Venezuelan U.S. dollar equivalent receivables in the June 2010 quarter and \$3.0 million of severance-related charges in the June 2009 quarter. For the six months ended June 30, 2010, M-I SWACO operating income was \$253.0 million, or 11.2 percent of revenues. After excluding \$19.1 million in costs incurred related to the Venezuelan government's currency changes and \$1.8 million business combination transaction-related expense in 2010 and \$22.3 million in charges associated with cost reduction efforts in 2009, operating income declined \$17.3 million from the prior-year level to 12.1 percent of revenue, influenced by lower overall pricing and increased variable-related operating expenses.

***Smith Oilfield******Revenues***

The Smith Oilfield segment provides three-cone and diamond drill bits, tubulars, borehole enlargement tools, drill motors, directional drilling, measurement-while-drilling, and logging-while-drilling services, as well as completions, coiled tubing, cased-hole wireline and drilling related services. The Smith Oilfield segment has a high level of North American exposure with 59 percent of revenues concentrated in those markets, driven in part, by the significance of increased unconventional drilling projects in the U.S. land-based market and the complexity of drilling programs, which drive demand for a wider range of product offerings. The Smith Oilfield segment reported revenues of \$650.2 million for the three months ended June 30, 2010, 25 percent above the second quarter of 2009. While the majority of the quarter-over-quarter increase was reported in North America driven by higher land-based exploration and production activity, significant growth was reported in all geographic regions and across most of the segment's product offerings. For the six-month period, the Smith Oilfield segment revenues totaled \$1.22 billion, two percent above the amounts reported in the comparable prior-year period. The revenue comparison was influenced primarily by lower U.S. product and service pricing from levels experienced in first quarter 2009 as well as reduced tubular product sales.

***Operating Income***

Operating income for the Smith Oilfield segment was \$81.0 million, or 12.5 percent of revenues, for the three months ended June 30, 2010. Operating margins rose 3.4 percentage points from the prior-year period reflecting the growth in fixed-cost rental and service offering revenue and the non-recurrence of \$8.6 million in employee severance-related charges reported in the second quarter of 2009. After excluding employee severance charges incurred in the prior-year quarter, operating income was \$24.8 million above the June 2009 quarter attributable to the increase in business volumes. For the six months ended June 30, 2010, the Smith Oilfield segment operating income was \$137.5 million, reflecting operating margins of 11.2 percent. Compared to the prior six-month period, the margin decline reflects a shift in the overall business mix and increased pricing pressure in the U.S. market from first quarter 2009 levels. After excluding the \$21.0 million in charges related to cost reduction efforts in 2009, operating income declined \$36.8 million from the comparable prior-year level influenced by the shift in the overall business mix and increased pricing pressure in the U.S. market.

***Distribution******Revenues***

The Distribution segment markets pipe, valves, fittings and 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 96 percent of current year revenues generated in those markets. Moreover, approximately 24 percent of the segment'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 impacted by crude oil and natural gas prices. For the second quarter of 2010, Distribution segment revenues were \$490.3 million, which represents an increase of 19 percent over the comparable 2009

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period. The expansion in revenue was concentrated in the U.S. market and attributable primarily to an improvement in customer spending for maintenance, repair and operating ( MRO ) supplies in the energy sector operations and increased demand for line pipe. The Distribution segment reported revenues of \$942.1 million for the six months ended June 30, 2010, a decline of four percent from the comparable prior-year period. Business volume growth within the energy sector operations for MRO supplies was partially masked by lower demand for line pipe products on a year-to-date basis in the energy and industrial customer base.

*Operating Income*

Operating income for the Distribution segment was \$13.6 million for the three months ended June 30, 2010, \$23.4 million above the prior-year level primarily reflecting the impact of the growth in revenue levels. After excluding \$1.3 million in charges related to cost-reduction initiatives incurred in the June 2009 quarter, operating results were \$22.1 million above the prior-year period reflecting the growth in business volumes and reduced line pipe costs. For the first half of 2010, operating income rose \$12.6 million above the amount reported in the 2010 period. After considering charges related to 2009 cost reduction efforts, operating income increased \$10.7 million from the comparable prior-year period on a revenue decline reflecting higher pricing, partially offset by an increase in variable-based operating expenditures to support the increase in business volumes.

*General Corporate**Operating Expenses*

Operating expenses for general corporate totaled \$35.7 million for the three months ended June 30, 2010, an increase of \$9.9 million over the prior-year period. The year-over-year comparison was influenced primarily by the net impact of charges and a gain reported in the 2010 quarter. During the second quarter of 2010, the Company incurred \$23.0 million of expenses associated with the proposed Merger and a \$4.5 million charge associated with the revaluation of certain Venezuelan U.S. dollar equivalent receivables, partially offset by a \$20.8 million gain recognized in connection with the @Balance transaction. For the six months ended June 30, 2010, operating expenses totaled \$92.5 million, an increase of \$39.5 million from the first half of 2009. The increase is principally attributable to the net impact of charges and a gain reported in the current year, which include \$38.4 million expenses associated with the proposed Merger, \$15.8 million related to the revaluation of its Venezuelan Bolivar Fuertes denominated net asset position and certain U.S. dollar based billings, and a \$20.8 million gain recognized in connection with the @Balance transaction. After excluding net charges from both periods, operating expenses increased \$8.6 million from the first half of 2009, attributable primarily to higher expenses associated with the Company's recent debt placements and incentive compensation programs.

**Table of Contents***Consolidated Results*

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

	<b>Three Months Ended June 30,</b>				<b>Six Months Ended June 30,</b>			
	<b>2010</b>		<b>2009</b>		<b>2010</b>		<b>2009</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
Revenues	\$ 2,296,063	100	\$ 1,944,289	100	\$ 4,433,874	100	\$ 4,355,768	100
Gross profit	658,669	29	529,030	27	1,249,849	28	1,221,332	28
Selling, general and administrative expenses	467,216	20	395,726	20	933,517	21	846,350	19
Operating income	191,453	9	133,304	7	316,332	7	374,982	9
Interest expense	36,917	2	42,803	2	74,639	2	70,327	2
Interest income	(890)		(729)		(1,568)		(1,087)	
Income before income taxes	155,426	7	91,230	5	243,261	5	305,742	7
Income tax provision	50,229	2	27,957	2	91,468	2	98,275	2
Noncontrolling interests in net income of subsidiaries	40,123	2	38,887	2	75,178	2	86,146	2
Net income attributable to Smith	\$ 65,074	3	\$ 24,386	1	\$ 76,615	1	\$ 121,321	3

Consolidated revenues were \$2.30 billion for the three months ended June 30, 2010, an increase of 18 percent from the level reported in the comparable 2009 period. Over three-quarters of the year-over-year growth in revenue was reported in the North American land market, influenced by continued improvement in customer demand for the Company's drilling and completion offerings and MRO supplies. Revenues outside of North America rose eight percent from the second quarter of 2009 due to increased customer spending in the Europe, Africa and Latin America regions. For the first half of 2010, consolidated revenues totaled \$4.43 billion, or two percent above the amount reported in the comparable 2009 period. The impact of the higher land based drilling in North America and increased customer activity in Europe, Africa and Latin America regions was partially offset by reduced customer purchases of tubular goods. The revenue comparison also reflects the impact of a decline in drilling activity in the offshore sector and market-driven pricing contraction for the Company's products and services subsequent to the first quarter of 2009 in response to the sharp fall in activity levels in the United States.

Gross profit rose \$129.6 million, or 25 percent, from the prior-year period to \$658.7 million for the second quarter of 2010. The gross profit expansion is attributable to the period-to-period increase in revenues across all business segments. Consolidated gross profit margins were 28.7 percent in the second quarter of 2010, which is 150 basis



points above the prior-year level. The gross margin improvement reflects the affect of higher oilfield rental and service volumes as well as lower line pipe product costs within the Distribution segment. Gross profit for the six-month period ended June 30, 2010 was \$1.25 billion, an increase of \$28.5 million, or two percent, from the prior-year level. The half-year comparison reflects the impact of lower pricing due to competitive pressures in the U.S. market and the extension or award of a number of long-term contracts in early 2009 which did not fully impact reported results until the second quarter of 2009.

Selling, general and administrative expenses totaled \$467.2 million for the three months ended June 30, 2010, an 18 percent increase over the amounts reported in the prior-year quarter. The reported growth in operating expenses is attributable primarily to the reported revenue increase, continued investment in infrastructure to support growth and, to a lesser extent, net charges recognized in the comparable periods. During the second quarter of 2010, the Company recorded \$23.7 million in business combination transaction-related expenses and an \$11.9 million charge associated with the revaluation of certain Venezuelan U.S. dollar equivalent receivables, partially offset by a \$20.8 million gain recognized in connection with the @Balance transaction. The comparable prior-year quarter included \$13.0 million in employee severance-related costs.

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Selling, general and administrative expenses totaled \$933.5 million for the six-month period ended June 30, 2010, which is 10 percent above amounts reported in the first half of 2009. The year-over-year increase in operating expenses was driven principally by the business expansion reported the second quarter of 2010, net charges recognized in the comparable periods and continued investment in the Company's global infrastructure.

Net interest expense, which represents interest expense less interest income, equaled \$36.0 million in the second quarter of 2010. The \$6.0 million year-over-year reported decline in net interest expense reflects a reduction in outstanding debt levels. Net interest expense increased \$3.8 million from the first six months of 2009 to \$74.6 million for the first half of 2010, attributable to higher interest rates associated with the refinancing of short-term indebtedness with a fixed-rate debt issuance during March of 2009 and was partially offset by reduced debt levels.

The effective tax rate approximated 32 percent and 38 percent for the three-month and six-month periods ended June 30, 2010, respectively. The Company's 2010 second quarter and year-to-date results include \$7.6 million and \$30.6 million of losses related to devaluation of the Venezuelan local currency denominated net asset position and certain business combination transaction-related expenses for which no tax benefit was recognized. On a combined basis, the effect of these items accounted for the majority of the year-over-year increases in the effective tax rates. After excluding non-deductible charges reported in 2010, the effective tax rates for both periods were lower than the U.S. statutory rate due to the impact of M-I SWACO's U.S. partnership earnings for which the noncontrolling interest partner is directly responsible for its related income taxes. The Company properly consolidates the pretax income related to the noncontrolling partner's share of U.S. partnership earnings but excludes the related tax provision.

Noncontrolling interests in net income of subsidiaries reflects the portion of the results of majority-owned operations which are applicable to the noncontrolling interest partners. Expense related to noncontrolling interests totaled \$40.1 million for the June 2010 quarter, \$1.2 million above the amount reported in the prior-year period primarily associated with an increase in profitability levels in the M-I SWACO joint venture. Noncontrolling interests declined \$11.0 million from amounts reported in the first half of 2009 due principally to a reduction in the first quarter 2010 profitability levels in the M-I SWACO joint venture.

## **Liquidity and Capital Resources**

### ***General***

Cash and cash equivalents equaled \$497.7 million as of June 30, 2010, a decrease \$490.7 million during the first six months of 2010. During the first half of 2010, the Company generated \$222.1 million of cash flows from operations, which compares to \$651.3 million generated in the prior-year period. The reduction in cash flows generated from operations was driven by increased investment in working capital, primarily accounts receivable, and the lower year-on-year profitability levels.

Cash flows used in investing activities for the six-month period ended June 30, 2010 totaled \$270.3 million, and relates principally to investments in property, plant and equipment and the acquisition of the remaining 65-percent interest in @Balance. When compared to the first six months of 2009, cash flows used in investing activities for the first half of 2010 rose \$190.1 million with approximately two-thirds of the increase attributable to acquisition and disposition transactions completed in the comparable periods. To a lesser extent, the growth in exploration and production activity in 2010 resulted in higher capital spending year-over-year.

The Company has increased its expected capital investment for property, plant and equipment for fiscal 2010 in response to a continuing favorable industry environment, estimating spending to range from \$420 million to \$450 million. The allocation of additional funds by the Company for capital expenditures throughout the year is likely and would be implemented in accordance with the terms of the Merger Agreement.

Cash flows used in financing activities totaled \$432.4 million for the six months ended June 30, 2010, \$79.5 million below the prior-year period. During the first half of 2010, the Company used a portion of the cash received in the November 2009 equity offering to repay outstanding borrowings under various loan agreements and fund \$59.6 million of common stock dividends.

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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 June 30, 2010, the Company had no amounts drawn or letters of credit issued under various U.S. revolving credit facilities, resulting in \$1.4 billion of current capacity available for operating or investing needs. Subsequent to June 30, 2010, the Company's \$375.0 million revolving credit facility expired and was not replaced. The Company also has revolving credit facilities in place outside of the United States, which are generally used to finance local operating needs. At June 30, 2010, the Company had available borrowing capacity of \$138 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 and is subject to the restrictions imposed by the Merger Agreement. As of June 30, 2010, the Company was within the covenant compliance thresholds under its various loan agreements, as amended, providing the ability to access available borrowing capacity. Management believes internally generated cash flow combined with capacity available under existing credit facilities 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 and businesses complementary to the Company's operations, subject to the restrictions imposed by the Merger Agreement. In addition to potential external acquisition candidates, if the Merger is not consummated, either we or our M-I SWACO joint venture partner, Schlumberger, can offer to sell to the other party its entire ownership interest in the joint venture in exchange for a cash purchase price specified by the offering partner. If the initiating partner's offer to sell is not accepted, such party is obligated to purchase the other party's interest at the same valuation per interest. If we agree to purchase Schlumberger's joint venture interest, whether pursuant to these provisions or otherwise, we would need to fund the transaction. Our funding could include issuing equity, resulting in dilution to our existing stockholders, obtaining additional debt, which may require waivers of applicable debt covenants, or obtaining other financing, as well as using available cash to fund the purchase. This financing and/or use of cash could impact our ability to fund working capital requirements, make capital expenditures and investments or fund other general corporate requirements, and could limit our ability to make future acquisitions. Should we instead not purchase Schlumberger's interest, we would no longer have an interest in the joint venture.

The Company makes regular quarterly distributions under a dividend program. The current annual payout under the program of approximately \$120 million is expected to be funded with future 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, subject to the restrictions imposed by the Merger Agreement, which permits regular quarterly dividends in an amount up to \$0.12 per share, 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 maintains a share repurchase 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 June 30, 2010, the Company had 15.2 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 share repurchase program has been suspended during the pendency of the Merger in order to comply with the restrictions imposed by the Merger Agreement.

**Commitments and Contingencies**

*Litigation*

Subsequent to the announcement of the Merger, five putative class action lawsuits were commenced on behalf of stockholders of the Company against the Company and its directors, and in certain cases against

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Schlumberger and one of its affiliates, challenging the Merger. Four of the lawsuits were filed in the District Court of Harris County, Texas, and have been consolidated into a single action in the 164th District Court of Harris County, Texas (the Texas Action ), and one lawsuit is pending in the Delaware Court of Chancery (the Delaware Action, and collectively with the Texas Action, the Actions ). The parties in the Actions have agreed to an expedited discovery schedule and to the coordination of pleadings and discovery in advance of any preliminary injunction hearing, which will be heard only in the Texas Action. On April 19, 2010, the court in the Delaware Action approved the parties agreement concerning the coordination of the Actions and agreed to otherwise stay the Delaware proceedings through any preliminary injunction hearing in Texas. Plaintiffs in the Actions have served a consolidated amended petition for breach of fiduciary duty and a verified amended class action complaint, respectively. The amended pleadings are substantively similar and allege that the Company s directors breached their fiduciary duties by, among other things, causing the Company to enter into the Merger Agreement at an allegedly inadequate and unfair price, agreeing to transaction terms that improperly inhibit alternative transactions and failing to provide material information to the Company s stockholders in the preliminary proxy statement filed in connection with the Merger. Specifically, the pleadings allege that the preliminary proxy statement omits material information relating to, among other things: the analyses performed by, and the information relied upon by, UBS; any strategic alternatives to the Merger considered by UBS; UBS s involvement in the negotiations between the Company and Schlumberger; the fee to be paid to UBS in connection with the Merger; and any negotiations or plans concerning the employment of Smith management after consummation of the Merger. The pleadings also allege that the Company and Schlumberger aided and abetted the directors breaches of fiduciary duties. The pleadings seek, among other things, an injunction barring defendants from consummating the proposed transaction, declaratory relief and attorneys fees.

On May 28, 2010, a purported Company stockholder filed an individual lawsuit in the United States District Court for the Southern District of Texas, Houston Division, against the Company and its directors, alleging that the Company had disseminated a false and materially misleading preliminary proxy statement in connection with the Merger in violation of Sections 14(a) and 20(a) of the Securities Exchange Act of 1934 and the rules promulgated thereunder. The lawsuit alleges that the preliminary proxy statement omits and/or misrepresents material information relating to, among other things: negotiations, if any, with other potential acquirers of the Company; any market check conducted by the Company in connection with the Merger; any strategic alternatives considered by the Company s directors in connection with the Merger; whether the Merger consideration includes any compensation for the synergies to be achieved in the Merger; the financial information and forecasts provided by the Company s directors to UBS in connection with its fairness opinion; the discounted cash flow, comparable transaction and selected companies analyses performed by UBS; and business ties between any of the Company s directors and Schlumberger. The complaint seeks, among other things, injunctive relief, compensatory damages and reasonable costs and expenses incurred in the action, including counsel fees and expert fees.

The Company believes that the lawsuits in which it is named are without merit and intends to defend these lawsuits vigorously.

On April 20, 2010, a fire and explosion occurred onboard the semisubmersible drilling rig *Deepwater Horizon*, owned by Transocean Ltd. and under contract to a subsidiary of BP plc. Pursuant to a contract between M-I SWACO and BP for the provision of certain services by M-I SWACO under the direction of BP, five employees of M-I SWACO were aboard the *Deepwater Horizon* at the time of the incident and unfortunately two of them were killed (the other three were uninjured). A number of legal actions, certain of which name an M-I SWACO entity as a defendant, have been filed in connection with the *Deepwater Horizon* incident, and additional legal actions may be filed in the future. Smith is currently investigating the incident and the liabilities that could potentially arise therefrom, and is assessing the availability of contractual indemnities and insurance coverage. However, based on information currently known, the amount of any potential loss attributable to M-I SWACO with respect to potential liabilities related to the incident would not be material.

The Company is also a defendant in various other 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.

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### *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 with respect to certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which \$20.3 million of related liabilities are reflected in the accompanying consolidated condensed balance sheet, the Company was contingently liable for approximately \$245 million of standby letters of credit and bid, performance and surety bonds at June 30, 2010. Management does not expect any material amounts to be drawn on these instruments.

### *Insurance*

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

### *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. 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.

## **Critical Accounting Policies and Estimates**

The discussion and analysis of financial condition and results of operations are based upon the Company's consolidated condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company 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 ongoing 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. In its 2009 Annual Report on Form 10-K, the Company has described the critical accounting policies that require management's most significant judgments and estimates. There have been no material changes in these critical accounting policies.

## **Recent Accounting Pronouncements**

From time to time, new accounting standards are issued by the Financial Accounting Standards Board ( FASB ). On January 1, 2010, the Company adopted a new accounting standard, which amends previous guidance on the consolidation of variable interest entities ( VIE ). The standard modifies how an enterprise determines the primary beneficiary that would consolidate the VIE from a quantitative risks and rewards calculation to a qualitative approach. Such assessment is required to be performed on a continuous basis and is influenced by, among other things, an enterprise's ability to direct the most significant activities that influence the VIE's operating performance. The adoption of this accounting standard did not have a material impact on the Company's consolidated condensed financial statements.



In October 2009, the FASB issued an update to existing guidance with respect to revenue recognition for arrangements with multiple deliverables. This update will allow allocation of consideration received for qualified separate deliverables based on estimated selling prices for both delivered and undelivered items when vendor-specific or third-party evidence is not available. Additionally, disclosure of the nature of multiple element arrangements, the general timing of their delivery, and significant factors and estimates used to

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determine estimated selling prices are required. The Company is currently evaluating this update, which will be adopted for new revenue arrangements entered into or materially modified beginning January 1, 2011.

### **Item 3. *Quantitative and Qualitative Disclosures about Market Risk***

The Company is exposed to market risk primarily associated with 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. During the reporting period, no events or transactions have occurred which would materially change the information disclosed in the Company's 2009 Annual Report on Form 10-K.

### **Item 4. *Controls and Procedures***

*Evaluation of disclosure controls and procedures.* Our management, with the participation of our principal executive and financial officers, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act )) as of June 30, 2010. Based upon that evaluation, our principal executive and financial officers concluded that as of June 30, 2010, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms, and (2) accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

*Changes in internal control over financial reporting.* There has been no change in the Company's internal control over financial reporting during the quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1. *Legal Proceedings***

Subsequent to the announcement of the Merger, five putative class action lawsuits were commenced on behalf of stockholders of the Company against the Company and its directors, and in certain cases against Schlumberger and one of its affiliates, challenging the Merger. Four of the lawsuits were filed in the District Court of Harris County, Texas, and have been consolidated into a single action in the 164th District Court of Harris County, Texas (the Texas Action ), and one lawsuit is pending in the Delaware Court of Chancery (the Delaware Action, and collectively with the Texas Action, the Actions ). The parties in the Actions have agreed to an expedited discovery schedule and to the coordination of pleadings and discovery in advance of any preliminary injunction hearing, which will be heard only in the Texas Action. On April 19, 2010, the court in the Delaware Action approved the parties' agreement concerning the coordination of the Actions and agreed to otherwise stay the Delaware proceedings through any preliminary injunction hearing in Texas. Plaintiffs in the Actions have served a consolidated amended petition for breach of fiduciary duty and a verified amended class action complaint, respectively. The amended pleadings are substantively similar and allege that the Company's directors breached their fiduciary duties by, among other things, causing the Company to enter into the Merger Agreement at an allegedly inadequate and unfair price, agreeing to transaction terms that improperly inhibit alternative transactions and failing to provide material information to the Company's stockholders in the preliminary proxy statement filed in connection with the Merger. Specifically, the pleadings allege that the preliminary proxy statement omits material information relating to, among other things: the analyses performed by, and the information relied upon by, UBS; any strategic alternatives to the Merger considered by UBS; UBS's involvement in the negotiations between the Company and Schlumberger; the fee to be paid to UBS in connection

with the Merger; and any negotiations or plans concerning the employment of Smith management after consummation of the Merger. The pleadings also allege that the Company and Schlumberger aided and abetted the directors' breaches of fiduciary duties. The

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pleadings seek, among other things, an injunction barring defendants from consummating the proposed transaction, declaratory relief and attorneys' fees.

On May 28, 2010, a purported Company stockholder filed an individual lawsuit in the United States District Court for the Southern District of Texas, Houston Division, against the Company and its directors, alleging that the Company had disseminated a false and materially misleading preliminary proxy statement in connection with the Merger in violation of Sections 14(a) and 20(a) of the Securities Exchange Act of 1934 and the rules promulgated thereunder. The lawsuit alleges that the preliminary proxy statement omits and/or misrepresents material information relating to, among other things: negotiations, if any, with other potential acquirers of the Company; any market check conducted by the Company in connection with the Merger; any strategic alternatives considered by the Company's directors in connection with the Merger; whether the Merger consideration includes any compensation for the synergies to be achieved in the Merger; the financial information and forecasts provided by the Company's directors to UBS in connection with its fairness opinion; the discounted cash flow, comparable transaction and selected companies analyses performed by UBS; and business ties between any of the Company's directors and Schlumberger. The complaint seeks, among other things, injunctive relief, compensatory damages and reasonable costs and expenses incurred in the action, including counsel fees and expert fees.

The Company believes that the lawsuits in which it is named are without merit and intends to defend these lawsuits vigorously.

On April 20, 2010, a fire and explosion occurred onboard the semisubmersible drilling rig *Deepwater Horizon*, owned by Transocean Ltd. and under contract to a subsidiary of BP plc. Pursuant to a contract between M-I SWACO and BP for the provision of certain services by M-I SWACO under the direction of BP, five employees of M-I SWACO were aboard the *Deepwater Horizon* at the time of the incident and unfortunately two of them were killed (the other three were uninjured). A number of legal actions, certain of which name an M-I SWACO entity as a defendant, have been filed in connection with the *Deepwater Horizon* incident, and additional legal actions may be filed in the future. Smith is currently investigating the incident and the liabilities that could potentially arise therefrom, and is assessing the availability of contractual indemnities and insurance coverage. However, based on information currently known, the amount of any potential loss attributable to M-I SWACO with respect to potential liabilities related to the incident would not be material.

The Company is also a defendant in various other 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.

### **Item 1A. Risk Factors**

The risk factors discussed below update the Risk Factors previously disclosed in Item 1A to Part I of our Form 10-K for the year ended December 31, 2009.

#### **Risks Related To Our Business**

***The significant deterioration in the global business environment and related factors could adversely impact our financial condition and results of operations.***

The deterioration in the global business environment has led to a significant reduction in commodity prices from average levels reported in 2008, which has contributed to lower cash flow generation for oil and natural gas exploration and production companies. In addition, the reduction in the availability and increased cost of financing which began in the second half of 2008 had a significant impact on a number of our customers. These factors, if

continued or worsened, could contribute to a sustained or further decline in our customers' spending levels. As a result, we must manage our costs, including our workforce levels, to match the decline. A continued reduction in the level of future investment or our inability to reduce our costs sufficiently to match the material slowdown in drilling activity could have a material adverse effect on our results of operations, financial condition and cash flows.

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Moreover, if the business environment experiences a significant deterioration from current levels, we may be required to record goodwill and/or other intangible asset impairment losses, which could have a material adverse effect on our results of operations and financial condition and our compliance with applicable debt covenants.

***The financial and credit market environment may limit our ability to expand our business through acquisitions and to fund necessary expenditures.***

The global financial and credit market environment has increased the cost of financing and at times has limited its availability. Any inability to access the credit and capital markets could limit our ability to make significant business acquisitions and pursue business opportunities. If the Merger is not consummated, either we or our M-I SWACO joint venture partner, Schlumberger, can offer to sell to the other party its entire ownership interest in the joint venture in exchange for a cash purchase price specified by the offering partner. If the initiating partner's offer to sell is not accepted, such party is obligated to purchase the other party's interest at the same valuation per interest. If we agree to purchase Schlumberger's joint venture interest, whether pursuant to these provisions or otherwise, we would need to fund the transaction. Our funding could include issuing equity, resulting in dilution to our existing stockholders, obtaining additional debt, which may require waivers of applicable debt covenants, or obtaining other financing, as well as using available cash to fund the purchase. This financing and/or use of cash could impact our ability to fund working capital requirements, make capital expenditures and investments or fund other general corporate requirements, and could limit our ability to make future acquisitions. Should we instead not purchase Schlumberger's interest, we would no longer have an interest in the joint venture. The failure to pursue significant acquisition opportunities, or the consequences of seeking waivers, issuing equity or obtaining other financing, could have a material adverse effect on our future results of operations, financial condition and cash flows.

***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. The current state of world economies could lead to further weakness in exploration and production spending levels, further reducing demand for our products and services and adversely impacting future results. 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 of 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;

seasonal weather conditions that temporarily curtail drilling operations; and

laws and regulations related to environmental or energy security matters, including those addressing alternative energy sources and the risks of global climate change.

Changes in any of these factors could adversely impact our financial condition, results of operations or cash flows.

*A significant portion of our revenue is derived in markets outside of North America.*

We are a multinational oilfield service company and generate the majority of our oilfield-related 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 operations in

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such countries and as a result 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 affecting oil and natural gas exploration and development activities;

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 in the countries in which we operate; 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 and to commercialize performance-driven new technology. 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.

***Regulatory compliance costs and liabilities could adversely impact our earnings and cash available for operations.***

We are exposed to a variety of federal, state, local and international laws and regulations relating to matters such as the use of hazardous materials, health and safety, labor and employment, import/export control, currency exchange, bribery, corruption and taxation, and the environment, including laws and regulations governing air emissions, wastewater discharges and waste management. 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. For example, the adoption of more stringent laws and regulations that curtailed either directly or indirectly the level of oil and natural gas exploration and development activities could adversely affect our operations by limiting demand for our products and services.

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

Over the past years, the industry in which we operate 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 the risk of monetary judgments that, in certain circumstances, are subject to being enhanced and are often brought in venues that have proved to be favorable to plaintiffs. If we are served with any intellectual property claims that we are unsuccessful in defending, it could adversely impact our results of operations, financial condition and cash flows.



***Our business operations in countries outside the United States are subject to a number of U.S. federal laws and regulations, including restrictions imposed by the Foreign Corrupt Practices Act as well as trade sanctions administered by the Office of Foreign Assets Control and the Commerce Department.***

Our business operations in countries outside the United States are subject to a number of U.S. federal laws and regulations, including restrictions imposed by the Foreign Corrupt Practices Act ( FCPA ) as well as trade sanctions administered by the Office of Foreign Assets Control ( OFAC ) and the Commerce Department. The FCPA is intended to prohibit bribery of foreign officials or parties and requires public

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companies in the United States to keep books and records that accurately and fairly reflect those companies transactions. OFAC and the Commerce Department administer and enforce economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign states, organizations and individuals. If we fail to comply with these laws and regulations, we could be exposed to claims for damages, financial penalties, reputational harm, and incarceration of our employees or restrictions on our operations. We have received an administrative subpoena with respect to our historical business practices in Iran and Sudan. We are conducting a review of our business activities involving Iran and Sudan, and are actively pursuing the termination of all business activities in Iran and Sudan. While the nature and scope of issues that may emerge from this review are yet to be determined, there is a risk that we could identify violations of U.S. sanctions laws, which if pursued by regulatory authorities, could result in administrative or criminal penalties which in certain circumstances could adversely impact our results of operations, financial condition and cash flows.

***The offshore oil and gas operations of our business could be adversely impacted by the Deepwater Horizon drilling rig accident and resulting oil spill.***

On April 20, 2010, a fire and explosion occurred onboard the semisubmersible drilling rig *Deepwater Horizon*, owned by Transocean Ltd. and under contract to a subsidiary of BP plc. In response to this incident, the Minerals Management Service of the U.S. Department of the Interior, or MMS, issued a notice on May 30, 2010 implementing a six-month moratorium on certain drilling activities in the U.S. Gulf of Mexico. The notice also stated that the MMS will not consider during the six-month moratorium period drilling permits for new wells and related activities for specified water depths. In addition, wells covered by the moratorium that were then being drilled were required to halt drilling and take steps to secure the well. On June 22, 2010, the U.S. District Court for the Eastern District of Louisiana issued a preliminary injunction prohibiting the enforcement of the moratorium, which the Department of the Interior has appealed to the Fifth Circuit Court of Appeals. On July 8, 2010, the Court of Appeals denied the government's request that the district court's order be stayed while the appeal is pending. On July 12, 2010, the Secretary of the Department of the Interior directed the Bureau of Ocean Energy Management, Regulation and Enforcement, or BOEMRE (formerly named the MMS), to issue a suspension until November 30, 2010 of most deepwater drilling activities for specified drilling configurations and technologies, rather than a moratorium based on water depths. The BOEMRE is expected to issue new safety and environmental guidelines or regulations for drilling in the U.S. Gulf of Mexico and may take other steps that could increase the costs of exploration and production, reduce the area of operations and result in permitting delays.

The Company's revenue attributable to the U.S. Gulf of Mexico represented approximately six percent of its consolidated revenue for the year ended December 31, 2009. The majority of these revenues related to the high-performance services and products deployed in deepwater operations.

At this time, Smith can not predict what further impact the *Deepwater Horizon* incident may have on the regulation of offshore oil and gas exploration and development activity, the cost or availability of insurance coverage to cover the risks of such operations, or what actions may be taken by customers of Smith or other industry participants in response to the incident. Increased costs for the operations of Smith's customers in the U.S. Gulf of Mexico, along with permitting delays, could affect the economics of currently planned activity in the area and demand for their services and may result over the long term in a shift in activity away from the United States. A prolonged suspension of drilling activity in the U.S. Gulf of Mexico and resulting new regulations could materially adversely affect the Company's financial condition, results of operations or cash flows.

***Our business may be affected by market or regulatory responses to climate change.***

Climate change and greenhouse gas emissions are the subject of a significant attention within and outside the United States. Future environmental regulatory developments (such as restrictions, caps, taxes, or other controls) could

adversely influence the cost of and demand for oil and natural gas. A reduction in demand for these commodities may result in a decline in exploration and production spending by our customers, which in turn could adversely impact demand and pricing for our products and services. Additionally, restrictions on emissions or other climate change related mandates could result in significant increases in the cost of our

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goods and services. There is no assurance that in response to escalating expenses, we could increase our prices to customers sufficiently to mitigate the financial impact of such cost expansion. These factors, individually or together, or other unforeseen impacts of climate change regulation could have a material adverse effect on our results of operations, financial condition and cash flows.

### **Risks Related to the Pending Merger with Schlumberger**

***The exchange ratio for the Merger is fixed and will not be adjusted in the event of any change in either our or Schlumberger's stock price.***

Upon the closing of the Merger, each share of our common stock will be converted into the right to receive 0.6966 shares of Schlumberger common stock, with cash paid in lieu of fractional shares. This exchange ratio was fixed in the Merger Agreement and will not be adjusted for changes in the market price of either our common stock or Schlumberger common stock. Changes in the price of Schlumberger common stock prior to the merger will affect the market value that a stockholder may be entitled to receive on the date of the Merger. Stock price changes may result from a variety of factors (many of which are beyond our or Schlumberger's control), including the following factors:

changes in our and Schlumberger's respective business, operations and prospects;

changes in market assessments of the business, operations and prospects of either company;

market assessments of the likelihood that the Merger will be completed, including related considerations regarding regulatory approvals of the Merger;

interest rates, general market, industry and economic conditions and other factors generally affecting the price of our and Schlumberger's common stock; and

federal, state and local legislation, governmental regulation and legal developments in the businesses in which we and Schlumberger operate.

The price of Schlumberger common stock at the closing of the Merger may vary from its price on the date the Merger Agreement was executed, on the date of this report, and on the date of our annual meeting to vote on the Merger. As a result, the market value represented by the exchange ratio will also vary.

***Because the date that the Merger is completed will be later than the date of our annual meeting, at the time of our annual meeting, a stockholder will not know the exact market value of the Schlumberger common stock that will be received upon completion of the Merger.***

If the price of Schlumberger common stock declines between the date of our annual meeting and the effective time of the Merger, including for any of the reasons described above, a stockholder will receive shares of Schlumberger common stock that have a market value upon completion of the Merger that is less than the market value calculated pursuant to the exchange ratio upon the date of our annual meeting. Therefore, while the number of shares of Schlumberger common stock to be issued in the Merger is fixed, a stockholder cannot be sure of the market value of the Schlumberger common stock to be received upon completion of the Merger or the market value of Schlumberger common stock at any time after the completion of the Merger.

***Our ability to complete the Merger is subject to stockholder approval, certain closing conditions and the receipt of consents and approvals from government entities which may impose conditions that could adversely affect us or cause the Merger to be abandoned.***

The Merger Agreement contains certain closing conditions including approval of the Merger by Smith stockholders, the absence of injunctions or other legal restrictions and that no material adverse effect shall have occurred to either company. In addition, we will be unable to complete the merger until approvals are received from various governmental entities. Regulatory agencies may impose certain requirements or obligations as conditions for their approval. The Merger Agreement may require us and/or Schlumberger to accept conditions from these regulators that could adversely impact the combined company. We can provide

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no assurance that we will satisfy the various closing conditions and that the necessary approvals will be obtained or that any required conditions will not materially adversely affect the combined company following the Merger. In addition, we can provide no assurance that these conditions will not result in the abandonment or delay of the Merger.

### ***Failure to complete the Merger could negatively impact us.***

If the Merger is not completed, our ongoing businesses and the market price of our common stock may be adversely affected and we will be subject to several risks, including being required, under certain circumstances, to pay Schlumberger a termination fee of \$340 million; having to pay certain costs relating to the Merger, and diverting the focus of management from pursuing other opportunities that could be beneficial to us, in each case, without realizing any of the benefits of having the Merger completed.

### ***The pendency of the Merger could adversely affect us.***

In connection with the pending Merger, some of our customers may delay or defer purchasing decisions, which could negatively impact our revenues, earnings and cash flows regardless of whether the Merger is completed. Additionally, we have agreed in the Merger Agreement to refrain from taking certain actions with respect to our business and financial affairs during the pendency of the Merger, which restrictions could be in place for an extended period of time if completion of the Merger is delayed and could adversely impact our financial condition, results of operations or cash flows.

### ***The combined company could incur substantial expenses related to the integration of the Company and Schlumberger.***

We expect that the combined company will incur substantial expenses in connection with integrating our business, policies, procedures, operations, technologies and systems with those of Schlumberger. There are a large number of systems that must be integrated, including information management, purchasing, accounting and finance, sales, billing, payroll and benefits, fixed asset and lease administration systems and regulatory compliance. There are a number of factors beyond the control of either party that could affect the total amount or the timing of all of the expected integration expenses. Moreover, many of the expenses that will be incurred, by their nature, are difficult to estimate accurately at the present time. These expenses could, particularly in the near term, exceed the savings that Schlumberger expects to achieve from the elimination of duplicative expenses and the realization of economies of scale and cost savings and revenue enhancements related to the integration of the businesses following the completion of the Merger. These integration expenses may result in the combined company taking significant charges against earnings following the completion of the Merger.

### ***Following the Merger, the combined company may be unable to successfully integrate our business and Schlumberger's business and realize the anticipated benefits of the Merger.***

The Merger involves the combination of two companies which currently operate as independent public companies. The combined company will be required to devote management attention and resources to integrating its business practices and operations. Potential difficulties the combined company may encounter in the integration process include the following:

the inability to successfully integrate our business into Schlumberger's business in a manner that permits the combined company to achieve the cost savings and operating synergies anticipated to result from the Merger, which would result in the anticipated benefits of the Merger not being realized partly or wholly in the time frame currently anticipated or at all;

lost sales and customers as a result of certain customers of either of the two companies deciding not to do business with the combined company, or deciding to decrease their amount of business in order to reduce their reliance on a single company;

integrating personnel from the two companies while maintaining focus on providing consistent, high quality products and customer service;

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potential unknown liabilities and unforeseen increased expenses, delays or regulatory conditions associated with the Merger; and

performance shortfalls at one or both of the two companies as a result of the diversion of management's attention caused by completing the Merger and integrating the companies' operations.

In addition, we and Schlumberger have operated and, until the completion of the Merger, will continue to operate, independently. It is possible that the integration process could result in the diversion of each company's management attention, the disruption or interruption of, or the loss of momentum in, each company's ongoing businesses or inconsistencies in standards, controls, procedures and policies, any of which could adversely affect our ability to maintain relationships with customers and employees or our ability to achieve the anticipated benefits of the Merger, or could reduce the earnings or otherwise adversely affect the business and financial results of the combined company.

***We may be unable to retain key employees during the pendency of the Merger.***

In connection with the pending Merger, our current and prospective employees may experience uncertainty about their future roles with the combined company following the Merger, which may materially adversely affect our ability to attract and retain key personnel during the pendency of the Merger. Key employees may depart because of issues relating to the uncertainty and difficulty of integration or a desire not to remain with the combined company following the Merger. Accordingly, no assurance can be given that we will be able to retain key employees to the same extent that we have been able to in the past.

***Multiple lawsuits have been filed against us challenging the Merger, and an adverse ruling in any such lawsuit may prevent the Merger from being completed.***

Subsequent to the announcement of the Merger, five putative class actions were commenced on behalf of our stockholders against us and our directors, and in certain cases against Schlumberger and one of its affiliates, challenging the Merger. One of the conditions to the closing of the Merger is that no law, order, injunction, judgment, decree, ruling or other similar requirement shall be in effect that prohibits the completion of the Merger. Accordingly, if any of the plaintiffs is successful in obtaining an injunction prohibiting the completion of the Merger, then such injunction may prevent the Merger from becoming effective, or from becoming effective within the expected timeframe.

***The required regulatory approvals may not be obtained or may contain materially burdensome conditions that could have an adverse effect on Schlumberger.***

Completion of the Merger is conditioned upon the receipt of certain governmental approvals, including the approval of the Merger by the antitrust regulators in certain specified jurisdictions. Although we and Schlumberger have agreed in the Merger Agreement to use our reasonable best efforts to obtain the requisite governmental approvals, there can be no assurance that these approvals will be obtained. In addition, the governmental authorities from which these approvals are required may impose conditions on the completion of the Merger or require changes to the terms of the Merger. Under the terms of the Merger Agreement, Schlumberger is required to agree to take all actions demanded by an antitrust regulator in order to resolve any objections to the Merger (including divestitures, hold-separate restrictions or other restrictions) if doing so would not exceed a specified threshold, which is referred to as the detriment limit. The detriment limit would be exceeded if the required divestitures or hold-separate restrictions affect assets other than (1) the W-H Energy Services business and corresponding Schlumberger operations and (2) other assets accounting for Schlumberger or Smith revenues of not more than \$190 million in 2009, excluding from such calculation any W-H Energy Services operations and our Wilson business unit. If Schlumberger agrees to undertake divestitures or comply



with operating restrictions in order to obtain any approvals required to complete the Merger, Schlumberger may be less able to realize anticipated benefits of the Merger, and the business and results of operations of the combined company after the Merger may be adversely affected.

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

The Company's Board of Directors has approved a share repurchase program that allows for the purchase of up to 20 million shares of the Company's common stock, subject to regulatory issues, market considerations and other relevant factors. During the second quarter of 2010, the Company did not repurchase any shares of common stock under the program. The number of shares that may be purchased under the program as of June 30, 2010 is 15,158,913. Prior to January 1, 2010, the Company has repurchased 4.8 million shares at an average cost of \$43.61 per share under the program. The acquired shares have been added to the Company's treasury stock holdings. Certain participants in the long-term incentive plans surrender shares of common stock in order to satisfy tax-withholding obligations. These shares are not considered acquisitions under the Company's share repurchase program. The share repurchase program has been suspended during the pendency of the Merger in order to comply with the restrictions imposed by the Merger Agreement.

**Item 3. *Defaults upon Senior Securities***

None.

**Item 4. *Removed and Reserved***

**Item 5. *Other Information***

The 2010 Annual Meeting of Stockholders (the 2010 Annual Meeting) of the Company has been scheduled for August 24, 2010.

As previously announced, pursuant to Rule 14a-5(f) and Rule 14a-8(e)(2) under the Exchange Act, the deadline for receipt of stockholder proposals for inclusion in the Company's proxy statement and form of proxy for the 2010 Annual Meeting in accordance with Rule 14a-8 under the Exchange Act was set at July 19, 2010. In order for a proposal to be considered timely, it must have been received in writing by the Company on or prior to the applicable date at the Company's principal executive offices, located at 1310 Rankin Road, Houston, Texas 77073, Attn: Secretary and General Counsel. In addition, in accordance with the advance notice requirements set forth in the Company's Amended and Restated Bylaws (the Bylaws), in order for a stockholder proposal made outside of Rule 14a-8 to be considered timely within the meaning of the Bylaws and Rule 14a-4(c) under the Exchange Act, such proposal must have been received by the Company at the address set forth above on or before July 26, 2010.

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**Item 6. Exhibits**

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

- 2.1 Agreement and Plan of Merger, dated as of February 21, 2010, by and among Schlumberger Limited (Schlumberger N.V.), Turnberry Merger Sub Inc., and Smith International, Inc. Filed as Exhibit 2.1 to the Company's report on Form 8-K filed on February 22, 2010 and incorporated herein by reference.
- 4.1 Amendment No. 4, dated as of June 8, 2010, to the Rights Agreement, dated as of June 8, 2000, between Smith International, Inc. and Computershare Trust Company, N.A. as rights agent. Filed as Exhibit 4.1 to the Company's report on Form 8-K filed on June 9, 2010 and incorporated herein by reference.
- 31.1\* Certification of Chief Executive Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Chief Financial Officer pursuant to Rule 13a-14 or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\*\* Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101\*\* The following materials from Smith International, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Condensed Statements of Operations, (ii) Consolidated Condensed Balance Sheets, (iii) Consolidated Condensed Statement of Cash Flows, (iv) Consolidated Condensed Statements of Stockholders' Equity and Comprehensive Income and (v) Notes to Consolidated Condensed Financial Statements, tagged as blocks of text.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SMITH INTERNATIONAL, INC.  
Registrant

/s/ John Yearwood  
John Yearwood  
Chief Executive Officer,  
President and Chief Operating Officer

Date: August 6, 2010

/s/ William Restrepo  
William Restrepo  
Senior Vice President,  
Chief Financial Officer and Treasurer

Date: August 6, 2010

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**EXHIBIT INDEX**

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