SMITH INTERNATIONAL INC
Form 10-K
March 15, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

(MARK ONE)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2003

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

COMMISSION FILE NUMBER 1-8514

SMITH INTERNATIONAL, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	95-3822631
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)
411 NORTH SAM HOUSTON PARKWAY, SUITE 600 HOUSTON, TEXAS	77060
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	(ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (281) 443-3370

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:

COMMON STOCK, $1.00 PAR VALUE	NEW YORK STOCK EXCHANGE, INC. PACIFIC EXCHANGE, INC.
(TITLE OF EACH CLASS)	(NAME OF EACH EXCHANGE ON WHICH REGISTERED)

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: NONE

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 [X] No [ ]

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).
Yes [X] No [ ].

The aggregate market value of the voting stock held by non-affiliates on June 30, 2003 was $3,669,886,810 (99,888,046 shares at the closing price on the New York Stock Exchange of $36.74). On June 30, 2003, 102,460,806 shares of common stock were outstanding. For this purpose all shares held by officers and directors and their respective affiliates are considered to be held by affiliates, but neither the Registrant nor such persons concede that they are affiliates of the Registrant.

There were 103,969,738 shares of common stock outstanding on March 8, 2004.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement related to the Registrant's 2004 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K.

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PART I

ITEM 1. BUSINESS

GENERAL

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

The Company was incorporated in the state of California in January 1937 and reincorporated under Delaware law in May 1983. The Company's executive offices are headquartered at 411 North Sam Houston Parkway, Suite 600, Houston, Texas 77060 and its telephone number is (281) 443-3370. The Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act of 1934 are made available free of charge on the Company's Internet website at www.smith.com as soon as reasonably practicable after the Company has electronically filed such material with, or furnished it to, the Securities and Exchange Commission.

The Company's operations are aggregated into two reportable segments: Oilfield Products and Services and Distribution. The Oilfield Products and Services segment consists of: M-I SWACO, which provides drilling and completion fluid systems and services, solids-control and separation equipment, waste-management services and oilfield production chemicals; Smith Technologies, which manufactures and sells three-cone drill bits, diamond drill bits and turbine products; and Smith Services, which manufactures and markets products and services used for drilling, workover, well completion and well re-entry operations. The Distribution segment consists of one business unit, Wilson, which markets pipe, valves and fittings as well as mill, safety and other maintenance products to energy and industrial markets.

Financial information regarding reportable segments and international operations appears in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 15 of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K. Information related to business combinations appears in Note 3 of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K.

BUSINESS OPERATIONS

OILFIELD PRODUCTS AND SERVICES SEGMENT

M-I SWACO

Fluid Products and Services. The Company is a leading worldwide provider of drilling, reservoir drill-in and completion fluid systems, products and engineering services to end users engaged in drilling oil and natural gas wells. Drilling fluids are used to cool and lubricate the bit during drilling operations, contain formation pressures, suspend and remove rock cuttings from the hole and maintain the stability of the wellbore. Engineering services are provided to ensure that the fluid products are applied effectively to optimize drilling operations. These services include recommending products and services during the well planning phase; monitoring drilling fluid properties; recommending adjustments during the drilling phase; and analyzing/benchmarking well results after completion of the project to improve the efficiencies of future wells.

M-I SWACO offers water-base, oil-base and synthetic-base drilling fluid systems. Water-base drilling fluids are the world's most widely utilized systems, having application in both land and offshore environments. Typically, these systems comprise an engineered blend of weighting materials used to contain formation pressures, and a broad range of chemical additives, designed to yield the specific drilling performance characteristics required for a given drilling project. Oil-base drilling fluids, which primarily are used to drill water-sensitive shales, reduce torque and drag and are widely used in areas where stuck pipe is likely to occur. In certain drilling areas of the world, oil-base systems exhibit comparably higher penetration rates when compared to water-base systems, significantly reducing time on location and overall drilling costs. Synthetic-base drilling fluids are used in drilling environments where oil-base fluids are environmentally prohibited and provide the performance benefits of oil-base systems. Synthetic-base systems are particularly advantageous in the deepwater environment. M-I SWACO also provides a comprehensive line of reservoir drill-in fluids which combine the high performance properties of a premium drilling fluid with minimal damaging characteristics of a brine completion fluid.

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

Fluid Competition. The major competitors in the worldwide drilling fluids market, which approximated $3.5 billion in 2003, are Baroid Drilling Fluids (a division of Halliburton Company ("Halliburton")) and INTEQ (a division of Baker Hughes, Inc. ("Baker Hughes")). While M-I SWACO and these companies supply a majority of the market, the drilling fluids industry is highly competitive, with a significant number of smaller, locally based competitors. The major competitors in the worldwide completion fluids market, which approximated $0.5 billion in 2003, are Baroid Completion Fluids (a division of Halliburton), Tetra Technologies, Inc., BJ Services Company and Ambar, Inc.

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

SWACO Products and Services. M-I SWACO provides services, equipment and engineering for solids control, pressure control and waste management to the worldwide drilling market.

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

Operators employ M-I SWACO-manufactured pressure-control equipment to drill safely and economically in sour-gas and high-pressure zones. Well killing and high-pressure control drilling chokes, together with related operating consoles, are used in the drilling process during well kicks and well clean-up and testing operations. Degassers and mud gas separators are designed to remove and safely vent entrained gases, including toxic gases such as hydrogen sulfide and corrosive oxygen, from the drilling mud. This equipment reduces the risk of dangerous and costly blowouts caused by recirculating mud that contains natural gas. Key products in M-I SWACO's pressure control product line include the MUD D-GASSER(R) and SUPER CHOKE(TM), both of which hold strong market positions as do the SUPER MUD GAS SEPARATOR(TM) and the SUPER AUTOCHOKE(TM). The latter products represent key advancements in hands-free well pressure control and underbalanced drilling operations.

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

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

Oilfield Production Chemicals. M-I SWACO provides a complete line of oilfield specialty chemicals and related technical services through its Oilfield Production Chemical division, acquired in January 2003. Oilfield production chemicals are used to enhance the flow of hydrocarbons from the wellbore by eliminating paraffin, scale and other byproducts encountered during the production process. Oilfield production chemicals are also used to protect piping and other equipment associated with the production, transportation and processing of oil and gas.

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

Smith Technologies

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

Smith Technologies designs, manufactures and markets three-cone drill bits for the petroleum industry, ranging in size from 3 1/2 to 28 inches in diameter. These three-cone bits comprise two major components - the body and the cones, which contain different types of pointed structures referred to as "cutting structures" or "teeth." The cutting structures are either an integral part of the steel cone with a hardmetal-applied surface (referred to as "milled tooth") or made of an inserted material (referred to as "insert"), which is usually tungsten carbide. The Company also produces three-cone drill bits in which the tungsten carbide insert is coated with polycrystalline diamond. In certain formations, bits produced with diamond-enhanced inserts last longer and increase penetration rates, which substantially decreases overall drilling costs. Smith Technologies is the leading provider of drill bits utilizing diamond-enhanced insert technology.

In addition, Smith Technologies designs, manufactures and markets diamond drill bits. Diamond bits consist of a single body made of either a matrix powder alloy or steel. The cutting structures of diamond bits consist of either polycrystalline diamond cutters, which are brazed on the bit, or natural or synthetic diamonds, which are impregnated in the bit. These bits range in size from 2 3/4 to 26 inches in diameter.

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

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

Competition. Besides the Company, Hughes Christensen (a division of Baker Hughes), Security DBS (a division of Halliburton) and ReedHycalog (a division of Grant Prideco, Inc.) are the three major competitors in the drill bit business. While Smith Technologies and these companies supply the majority of the worldwide drill bit market, which approximated $1.3 billion in 2003, they compete with more than 20 companies. Generally, competition for sales of drill bits is based on a number of factors, including performance, quality, reliability, service, price, technological advances and breadth of products. The Company believes its quality, reliability and technological advances, such as diamond-enhanced inserts, provide its products with a competitive advantage.

Smith Services

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

Smith Services' Drilling Systems business provides a broad range of downhole impact tools for drilling applications as well as numerous other specialized downhole drilling products and services. Smith Services sells and rents impact drilling tools such as the HYDRA-JAR(R) tool and the ACCELERATOR(R) tool, which are used to free stuck drill strings during the drilling process. Additionally, drilling performance tools such as the HYDRA-THRUST(R) tool, used in the drilling process to maintain constant weight on the drill bit, and Drilling on Gauge subs used for maintaining hole gauge and quality of the wellbore, are examples of Smith Services continuous commitment to developing new technology. Smith Services also offers tubular drill string components, such as drill collars, subs, stabilizers, kellys and HEVI-WATE(TM) drill pipe, and provides related inspection services, including drill string repair and rebuild services. These components and their placement in the drill string are supported by engineering and field technical services in order to optimize bottom hole management techniques. Through state-of-the-art software, Smith Services aids the customer in maximizing the life of drill string components. Rotating drilling heads for flow control in underbalanced drilling applications and automatic connection torque monitoring and control systems are also designed and manufactured by Smith Services. Smith Services also manufactures and markets hole openers and underreamers which are designed to create larger hole diameters in certain sections of the wellbore. The Company's patented RHINO(R) Reamer, REAMASTER(R) and simultaneous drilling and hole enlargement system are three examples of products that aid the customer in realizing lower drilling costs through technology. Through the use of the simultaneous drilling and hole enlargement system above the drill bit, the operator may drill the main bore with the bit and enlarge the diameter of the hole above the drill bit in the same run.

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

Smith Services provides Wellbore Departure Systems and Multilateral Junctions through the manufacture of proprietary casing exit tools which are installed by highly trained technicians. These systems, which include the patented TRACKMASTER(R)WHIPSTOCK SYSTEM, PACK-STOCK(R), ANCHOR-STOCK(R) and the MX(R) Multilateral Junction, allow the operator to divert around obstructions in the main wellbore or reach multiple production zones from the main wellbore (known as multilateral completions). In addition, Smith Services' DRILLAHEAD SYSTEM combined with the XITOR(R), GEOTRACK(TM) and One-trip mills, which mill the casing exit and continue to drill several hundred feet of formation, provide for a "no trip" system which saves the customer time and reduces their overall drilling costs. The Company also provides mechanical, hydraulic and explosive pipe-cutting services to remove casing during well or platform abandonment.

Smith Services' Completion Systems business specializes in providing fit-for-purpose liner hanger, liner cementing equipment, isolation packers, retrievable and permanent packers, packer products and multilateral completion equipment. Liner hangers allow strings of casing to be suspended within the wellbore without having to extend the string all the way to the surface and are also used to isolate production zones and formations. Most directional and multilateral wells include one or more hangers due to the difficult casing programs and need for zonal isolation. Using Smith Services' POCKET SLIP(TM) liner hanger system, long heavy liners can be suspended with minimal casing distortion and maximum flow-by area. Packers are mechanically or hydraulically actuated devices which lock into place at specified depths in the well and provide a seal between zones through expanding-element systems. The devices therefore create isolated zones within the wellbore to permit either specific formation production or allow for certain operations, such as cementing or acidizing, to take place without damaging the reservoir.

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

DISTRIBUTION SEGMENT

Wilson

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

Approximately two-thirds of Wilson's 2003 revenues were generated in the energy sector, which includes exploration and production companies and companies with operations in the petroleum industry's pipeline sector. The remainder related to sales in the downstream and industrial market, including refineries, petrochemical and power generation plants and other energy-focused operations.

Competition. Wilson's competitors in its energy segment operations include National-Oilwell, Redman Pipe and Supply Company and a significant number of smaller, locally based operations. Wilson's competitors in the downstream and industrial market include McJunkin Corporation, WW Grainger and Hagemeyer NV. The distribution market that Wilson participates in is highly competitive. Generally, competition involves numerous factors, including price, experience, customer service and equipment availability.

NON-U.S. OPERATIONS

Sales to oil and gas exploration and production markets outside the United States are a key strategic focus of Smith's management. The Company markets its products and services through subsidiaries, joint ventures and sales agents located in virtually all petroleum-producing areas of the world, including Canada, Europe/Africa, the Middle East, Latin America and the Far East. Approximately 56 percent, 53 percent and 48 percent of the Company's revenues in 2003, 2002 and 2001, respectively, were derived from equipment or services sold or provided outside the United States. The Company's Distribution operations constitute a significant portion of the consolidated revenue base and are concentrated in North America which serves to distort the geographic revenue mix of the Company's Oilfield segment operations. Excluding the impact of the Distribution operations, 65 percent, 64 percent and 59 percent of the Company's revenues were generated in non-U.S. markets in 2003, 2002 and 2001, respectively.

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

SALES AND DISTRIBUTION

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

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

MANUFACTURING

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

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

RAW MATERIALS

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

The Company purchases a variety of raw materials for its Smith Technologies and Smith Services units, including alloy and stainless steel bars, tungsten carbide inserts and forgings. Generally, the Company is not dependent on any single source of supply for any of its raw materials or purchased components, and believes that numerous alternative supply sources are available for all such materials. The Company produces polycrystalline diamond materials in Provo, Utah and Scurelle, Italy for utilization in various Company products as well as direct customer sales. The Company believes that it enjoys a competitive advantage in the manufacture of diamond drill bits because it is the only diamond drill bit producer with substantial polycrystalline diamond manufacturing capabilities.

PRODUCT DEVELOPMENT, ENGINEERING AND PATENTS

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

The Company also maintains a drill bit database which records the performance of drill bits over the last 18 years, including those manufactured by competitors. This database gives the Company the ability to monitor, among other things, drill bit failures and performance improvements related to product development. Management believes this proprietary database gives the Company a competitive advantage in the drill bit business.

The Company has historically invested significant resources in research and engineering in order to provide customers with broader product lines and technologically-advanced products and services. The Company's expenditures for research and engineering activities are attributable to the Company's Oilfield Products and Services segment and totaled $55.6 million in 2003, $50.6 million in 2002 and $50.8 million in 2001. In 2003, research and engineering expenditures approximated 2.1 percent of the Company's Oilfield Products and Services segment revenues.

Although the Company has over 1,600 issued and pending patents and regards its patents and patent applications as important in the operation of its business, it does not believe that any significant portion of its business is materially dependent upon any single patent.

EMPLOYEES

At December 31, 2003, the Company had 11,971 full time employees throughout the world. Most of the Company's employees in the United States are not covered by collective bargaining agreements except in certain U.S. mining operations of M-I SWACO and several distribution locations of Wilson. The Company considers its labor relations to be satisfactory.

RISK FACTORS

This document and other filings with the Securities and Exchange Commission contain "forward-looking statements", as defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements discuss the Company's outlook, financial projections, business strategies as well as various other matters.

Our forward-looking statements are based on assumptions that we believe to be reasonable but that may not prove to be accurate. All of the Company's forward-looking information is, therefore, subject to risks and uncertainties that could cause actual results to differ materially from the results expected. Although it is not possible to identify all factors, these risks and uncertainties include the risk factors discussed below.

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 and price expectations. In addition to oil and natural gas prices, the following factors impact exploration and development activity and may lead to significant changes in worldwide activity levels:

- Overall level of global economic growth and activity;
- Actual and perceived changes in the supply and demand for oil and natural gas;
- Political stability of oil-producing countries;
- Finding and development costs of operations; and
- Decline and depletion rates for oil and natural gas wells.

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

We are a multinational oilfield service company and have operations in certain countries that are inherently subject to risks of war, local economic conditions, political disruption, civil disturbance and policies that may:

- Disrupt oil and gas exploration and production activities and our operations;
- Restrict the movement of funds and other assets;
- Lead to U.S. government or international sanctions; and
- Limit access to markets.

The occurrence of any of these events could adversely impact our financial condition or results of operations.

ITEM 2. PROPERTIES

The principal facilities and properties utilized by the Company at December 31, 2003 are shown in the table below. Generally, the facilities and properties are owned by the Company.

Location	Principal Products Processed or Manufactured
Oilfield Products and Services Segment:	
Houston, Texas....................	Tubulars, surface and downhole tools, remedial products, liner hangers, diamond drill bits, drilling and fishing jars and fishing tool equipment
Ponca City, Oklahoma...............	Three-cone drill bits
Florence, Kentucky.................	Separator units, mill units, parts, screens and motor
Aberdeen, Scotland.................	Downhole tools and remedial products
Greybull, Wyoming..................	Bentonite mine and processing
Tulsa, Oklahoma....................	Oilfield and industrial screening products
Saline di Volterra, Italy..........	Three-cone drill bits
Edinburgh, Scotland................	Wire cloth and oilfield screening products
Aberdeen, Scotland.................	Downhole tools
Karmoy, Norway.....................	Barite and bentonite processing
Greystone, Nevada..................	Barite mine and processing
Battle Mountain, Nevada............	Barite processing
Provo, Utah........................	Synthetic diamond materials
Nisku, Canada......................	Tubulars and drill collars
Zelmou, Morocco....................	Barite mine
Zavalla, Texas.....................	Drilling fluid chemical products
Nivellas, Belgium..................	Separator units, mill units, parts, screens and motor
Scurelle, Italy....................	Diamond drill bits and synthetic diamond materials
Amelia, Louisiana..................	Barite processing
Spruce Grove, Canada...............	Drilling fluid processing
Berra, Italy.......................	Solids control equipment
Salzweld, Germany..................	Drilling fluid processing
Galveston, Texas...................	Barite processing
Macon, Georgia.....................	Separator units and screens
Aberdeen, Scotland.................	Barite and bentonite processing
Foss/Aberfeldy, Scotland...........	Barite mine and processing
Mountain Springs, Nevada...........	Barite mine
Distribution Segment:	
Houston, Texas.....................	Pipe, valves and fittings

The Company considers its mines and manufacturing and processing facilities to be in good condition and adequately maintained.

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

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 4A. OFFICERS OF THE REGISTRANT

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

NAME, AGE AND POSITIONS	PRINCIPAL CURRENT OCCUPATION AND OTHER SIGNIFICAN
Doug Rock (57)...................... Chairman of the Board, Chief Executive Officer, President and Chief Operating Officer	Chairman of the Board since February 1991, elected Chief Ex served as President and Chief Operating Officer since D positions since joining the Company in June 1974, serve Drilco Division beginning April 1982 and was named Pres Tool Division in July 1985.
Loren K. Carroll (60)............... Executive Vice President of the Company; President and and Chief Executive Officer of M-I SWACO	President and Chief Executive Officer of M-I SWACO since Ma President since October 1992 and member of the Board of Joined Company in December 1984 as Vice President and C in that capacity until March 1989. Rejoined the Company President and Chief Financial Officer.
Neal S. Sutton (58)................. Senior Vice President--Administration, General Counsel and Secretary	Senior Vice President--Administration, General Counsel and Joined Company as Vice President, Secretary and General named Vice President-Administration in March 1992.
Margaret K. Dorman (40)............. Senior Vice President, Chief Financial Officer and Treasurer	Senior Vice President, Chief Financial Officer and Treasur Company as Director of Financial Reporting in December Controller and Assistant Treasurer in February 1998.
Roger A. Brown (58)................. President, Smith Technologies	President, Smith Technologies since July 1998. Joined Compa Technology in April 1995.
John J. Kennedy (51)................ President and Chief Executive Officer, Wilson	President and Chief Executive Officer, Wilson since June 19 Manager in November 1986, named Treasury Director resp Operations in November 1987 and served as Treasurer be President, Chief Accounting Officer and Treasurer in Ma President, Chief Financial Officer and Treasurer in Apr
Richard A. Werner (62).............. President, Smith Services	President, Smith Services since May 1994. Joined Company a Manager-Downhole Tools and Services in May 1991 and nam Manager-Drilco/Servco in March 1993. Served as Vice Pre Services beginning December 1993.
David R. Cobb (38).................. Vice President and Controller	Vice President and Controller since July 2002. Joined Compa October 2001. Assistant Treasurer, Kent Electronics Co September 2001.

Earl M. Springer (53).............. Vice President, Business Development	Vice President, Business Development since February 199 Manager of M-I SWACO in November 1990 and named Senior SWACO in September 1993. Served as Manager of Technolog 1994 and named Manager of Business Development in July

Geri D. Wilde (53).................. Vice President, Taxes and Assistant Treasurer	Vice President, Taxes since February 1998. Joined Company a of M-I SWACO in December 1986 and named Director of Taxe April 1997.

(b) All officers of the Company are elected annually by the Board of Directors at the meeting held immediately following the annual meeting of stockholders. They hold office until their successors are elected and qualified.

There are no family relationships between the officers of the Company.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED SECURITY HOLDER MATTERS

The common stock of the Company is traded on the New York Stock Exchange and the Pacific Stock Exchange. The following are the high and low sale prices for the Company's common stock as reported on the New York Stock Exchange Composite Tape for the periods indicated, and adjusted for the two-for-one stock split effective July 8, 2002.

	COMMON STOCK	
	HIGH	LOW
2002		
First Quarter	$ 34.94	$ 23.19
Second Quarter	38.72	30.23
Third Quarter	36.24	25.79
Fourth Quarter	35.95	26.55
2003		
First Quarter	36.48	29.85
Second Quarter	41.55	34.47
Third Quarter	39.30	33.96
Fourth Quarter	42.52	35.86

On March 8, 2004, the Company had 2,139 common stock holders of record and the last reported closing price on the New York Stock Exchange Composite Tape was $51.50.

The Company has not paid dividends on its common stock since the first quarter of 1986. The determination of the amount of future cash dividends to be declared and paid on the common stock, if any, will depend upon the Company's financial condition, earnings and cash flow from operations, the level of its capital expenditures, its future business prospects and other factors that the Board of Directors deems relevant.

ITEM 6. SELECTED FINANCIAL DATA

	FOR THE YEARS ENDED DECEMBE		
	2003	2002	2001
	(In thousands, except per sha		
STATEMENT OF OPERATIONS DATA:			
Revenues..............................	$ 3,594,828	$ 3,170,080	$ 3,551,209
Gross profit..........................	1,075,931	918,302	1,045,804
Operating income......................	328,747	256,148	371,510
Income before cumulative effect of change in accounting principle.......	124,634	93,189	152,145
Earnings per share before cumulative effect of change in accounting principle - diluted basis(a).........	1.24	0.93	1.51
BALANCE SHEET DATA:			
Total assets..........................	$ 3,097,047	$ 2,749,545	$ 2,735,828
Long-term debt........................	488,548	441,967	538,842
Total stockholders' equity.............	1,235,776	1,063,535	949,159

The Notes to Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-K should be read in order to understand factors such as changes in the method of accounting for goodwill, business combinations completed during 2003, 2002 and 2001, and unusual items which may affect the comparability of the information shown above.

(a) All fiscal years prior to 2002 have been restated for the impact of a two-for-one stock split, which was effective July 8, 2002.

(b) In July 1999, the Company completed a transaction with Schlumberger Limited related to the combination of certain M-I SWACO and Dowell drilling fluid operations under a joint venture arrangement. Schlumberger contributed its non-U.S. drilling fluid operations and paid cash consideration of $280.0 million to the Company in exchange for a 40 percent minority ownership interest in the combined operations. The Company recognized a non-recurring gain of $81.4 million in connection with this transaction.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

The following "Management's Discussion and Analysis of Financial Condition and Results of Operations" is provided to assist readers in understanding the Company's financial performance during the periods presented and significant trends which may impact the future performance of the Company. This discussion should be read in conjunction with the Consolidated Financial Statements of the Company and the related notes thereto included elsewhere in this Form 10-K.

MANAGEMENT OVERVIEW

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

Management believes the increasing complexity of drilling programs has resulted in a shift in exploration and production spending toward value-added, technology-based products, which reduce operators' overall drilling costs. The Company continues to focus on investing in the development of technology-based products that considerably improve the drilling process through increased efficiency and rates of penetration and reduced formation damage. Management believes the overall savings realized by the use of the Company's premium products compensate for the higher costs of these products over their non-premium counterparts.

The Company's operations are largely driven by the level of exploration and production ("E&P") spending in major energy-producing regions around the world and the depth and complexity of these projects. Although E&P spending is significantly influenced by the market price of oil and natural gas, it may also be affected by supply and demand fundamentals, finding and development costs, decline and depletion rates, political actions and uncertainties, environmental concerns, the financial condition of independent E&P companies and the overall level of global economic growth and activity. In addition, approximately 10 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 85 percent of the current rig count focused on natural gas finding and development activities. Conversely, drilling in areas outside of North America is more dependent on crude oil fundamentals, which influence over three-quarters of international drilling activity. Historically, business in markets outside of North America has proved to be less volatile as the high cost E&P programs in these regions are generally undertaken by major oil companies, consortiums and national oil companies as part of a longer-term strategic development plan. Although over half of the Company's consolidated revenues were generated in North America during 2003, Smith's profitability was largely dependent upon business levels in markets outside of North America. The Distribution segment, which accounts for approximately one-quarter of consolidated revenues and primarily supports a North American customer base, serves to distort the geographic revenue mix of the Company's Oilfield segment operations. Excluding the impact of the Distribution operations, 59 percent of the Company's 2003 revenues were generated in markets outside of North America.

MARKET AND INDUSTRY ACTIVITY AND OUTLOOK

The 2003 average worldwide rig count grew 19 percent above the prior year level, primarily associated with a strong land-based North American drilling recovery. The Company anticipates a modest increase in E&P spending in 2004, which is somewhat dependent upon commodity prices remaining at or near the average level reported in 2003. The incremental spending is expected to be largely concentrated in markets outside North America, as E&P companies develop higher-reserve projects to address production declines associated with historical underinvestment in their upstream operations. Although there are several factors which could influence forecasted spending, the Company's business is highly dependent on the general economic environment in the United States and other major world economies, which ultimately impact energy consumption and the resulting demand for our products and services. Any deterioration in the global economic environment could adversely impact worldwide drilling activity and the future financial results of the Company.

FORWARD-LOOKING STATEMENTS

This discussion contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 concerning, among other things, the Company's 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 "believe," "anticipate," "forecast," "expect," "estimate," "project" and similar terms. The statements are based on certain assumptions and analyses made by the Company that it believes are appropriate under the circumstances. Such statements are subject to general economic and business conditions, industry conditions, changes in laws or regulations and other risk factors outlined elsewhere in this Form 10-K, 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 vary.

RESULTS OF OPERATIONS

Segment Discussion

The Company markets its products and services throughout the world through four business units which are aggregated into two reportable segments. The Oilfield Products and Services segment consists of three business units: M-I

SWACO, Smith Technologies and Smith Services. The Distribution segment includes the Wilson business unit. The revenue discussion below has been summarized by business unit in order to provide additional information in analyzing the Company's operations.

	FOR THE YEARS ENDED DECEMBER			
	2003		2002	
	AMOUNT	PERCENT	AMOUNT	PERCENT
FINANCIAL DATA: (dollars in thousands)				
Revenues:				
M-I SWACO............................	$ 1,865,851	52	$ 1,558,672	49
Smith Technologies...................	403,261	11	324,735	10
Smith Services.......................	409,162	11	399,502	13
Oilfield Products and Services......	2,678,274	74	2,282,909	72
Wilson...............................	916,554	26	887,171	28
Total............................	$ 3,594,828	100	$ 3,170,080	100
Geographic Revenues:				
United States:				
Oilfield Products and Services......	$ 925,148	26	$ 813,946	26
Distribution.......................	667,095	18	678,764	21
Total United States..............	1,592,243	44	1,492,710	47
Canada:				
Oilfield Products and Services......	171,653	5	117,014	4
Distribution.......................	191,221	5	169,626	5
Total Canada.....................	362,874	10	286,640	9
Non-North America:				
Oilfield Products and Services......	1,581,483	44	1,351,949	43
Distribution.......................	58,228	2	38,781	1
Total Non-North America..........	1,639,711	46	1,390,730	44
Total Revenue................	$ 3,594,828	100	$ 3,170,080	100
Operating Income:				
Oilfield Products and Services........	$ 343,486	13	$ 266,692	12
Distribution.........................	(7,897)	-	(4,026)	-
General Corporate....................	(6,842)	*	(6,518)	*
Total............................	$ 328,747	9	$ 256,148	8
MARKET DATA:				
Average Worldwide Rig Count: (1)				
United States........................	1,216	47	946	43
Canada...............................	339	13	255	12
Non-North America....................	1,050	40	990	45
Total............................	2,605	100	2,191	100

Average Commodity Prices:

Crude Oil ($/Bbl)(2)..................	$ 31.06	$ 26.08
Natural Gas ($/mcf)(3)................	5.29	3.10

(1) Source: M-I SWACO.
(2) Average West Texas Intermediate ("WTI") spot closing prices.
(3) Average weekly composite spot U.S. wellhead prices.
*not meaningful

Oilfield Products and Services Segment

Revenues

M-I SWACO primarily provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry. Additionally, these operations provide oilfield production chemicals and manufacture and market equipment and services used for solids-control, particle separation, pressure control, rig instrumentation and waste-management. M-I SWACO is significantly influenced by spending in markets outside of North America, which contributes approximately two-thirds of the unit's revenues, and by its exposure to the U.S. offshore market, which constitutes approximately 13 percent of the revenue base. U.S. offshore drilling programs, which account for approximately five percent of the worldwide rig count, are generally more revenue-intensive than land-based projects due to the complex nature of the related drilling environment. M-I SWACO's revenues totaled $1.9 billion for the year ended December 31, 2003, an increase of 20 percent above the prior year period. Excluding the effect of acquired operations, revenues rose 14 percent above 2002 levels impacted by increased sales volumes in markets outside of North America. On a geographic basis, increased E&P spending and new contract awards in Latin America, the Former Soviet Union ("FSU") and West Africa influenced the higher reported revenues. The year-over-year base revenue growth was also impacted by the significant increase in the number of North American land-based drilling programs and, to a lesser extent, a favorable customer mix in the U.S. offshore market. For the year ended December 31, 2002, M-I SWACO reported revenues of $1.6 billion, a decline of four percent from 2001 revenue levels. Excluding the impact of acquired operations, revenues were ten percent below the prior period and compared to an 18 percent decline in the average worldwide rig count. The majority of the base revenue decline was attributable to the lower number of land-based drilling programs in the Western Hemisphere markets, primarily the United States, Argentina and Venezuela. Lower sales of synthetic drilling fluids, related to a 22 percent reduction in the average number of U.S. offshore drilling projects, accounted for the remainder of the year-to-year variance.

Smith Technologies designs, manufactures and sells three-cone drill bits, diamond drill bits and turbines for use in the oil and gas industry. Due to the nature of its product offerings, revenues for these operations correlate more closely to the rig count than any of the Company's other businesses. Smith Technologies reported revenues of $403.3 million for the year ended December 31, 2003, an increase of 24 percent over the prior year. Excluding incremental revenues from businesses acquired in the latter half of 2002, base revenues were approximately 19 percent above the prior year and approximated the increase in the worldwide rig count. The year-to-year base revenue growth was generated in North America, reflecting the higher level of land-based drilling activity and, to a lesser extent, the impact of new product introductions. For the year ended December 31, 2002, Smith Technologies' revenues totaled $324.7 million. Revenues for the Smith Technologies unit were 18 percent below the prior year and mirrored the decline in worldwide activity levels. The majority of the revenue variance resulted from lower unit sales of three-cone bits, reflecting the 28 percent reduction in U.S. drilling activity. Reduced activity levels in certain Latin American markets, specifically Colombia, Argentina and Venezuela, accounted for the remainder of the year-to-year variance.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, work-over, well completion and well re-entry. Revenues for Smith Services are evenly distributed between North America and the international markets and are heavily influenced by the complexity of drilling projects, which drive demand for a wider range of its product offerings. For the year ended December 31, 2003, Smith Services reported revenues of $409.2 million, a two percent increase from the prior year. The year-to-year revenue comparison was impacted by a 50 percent reduction in U.S. drill pipe product sales, which are not highly correlated to drilling activity. Excluding the impact of drill pipe sales, revenues increased seven percent above the prior year, primarily attributable to higher E&P spending in North America and certain Middle East markets. On a product basis, the majority of the core revenue growth was driven by higher demand for remedial product and service lines, including new product introductions. For the year ended December 31, 2002, Smith Services reported revenues of $399.5 million. Revenues were comparable with amounts reported in 2001, as incremental revenues from acquired operations offset a 13 percent decline in base business volumes. The base revenue reduction primarily reflects the effect of a 27 percent decline in North American activity levels, which impacted demand for drilling-related products and services, including tubulars and inspection services.

Operating Income

Operating income for the Oilfield Products and Services segment was $343.5 million, or 12.8 percent of revenues, for the year ended December 31, 2003. Segment operating margins increased one percentage point above the prior year level reflecting a combination of gross margin expansion and, to a lesser extent, reduced operating expenses as a percentage of revenues. The gross margins were influenced by a favorable shift in the revenue mix towards higher-margin products and, to a lesser extent, improved expense coverage resulting from the impact of increased sales volumes on the segment's manufacturing and service infrastructure. For the year ended December 31, 2002, Oilfield operating income was $266.7 million, a 25 percent decline from the prior year period. Operating margins for the segment were 11.7 percent, approximately three percentage points below the prior year's level. The year-to-year decrease in segment operating income relates to decreased gross profit, primarily associated with lower sales volumes. To a lesser extent, decreased demand for higher-margin products, specifically drill bits and premium drilling fluids which accounted for over three quarters of the revenue decline, contributed to the gross profit reduction. Segment operating expenses were comparable with the prior year, as the effect of lower employee profit-sharing requirements and the elimination of goodwill amortization was offset by incremental expenses associated with acquired operations and higher costs incurred under medical and casualty insurance programs.

Distribution Segment

Revenues

Wilson 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 over 90 percent of Wilson's 2003 revenues generated in those markets. Moreover, approximately one-third of Wilson's revenues relate to sales to the downstream energy sector, including petrochemical plants and refineries, whose spending is largely influenced by the general state of the U.S. economic environment. Additionally, certain customers in this sector utilize petroleum products as a base material and, accordingly, are adversely impacted by increases in crude oil and natural gas prices. Wilson reported revenues of $916.6 million for the year ended December 31, 2003, three percent above the prior year. The year-over-year revenue increase was reported in the energy sector operations driven by the higher level of North American drilling and completion activity. Lower industrial sales volumes, primarily related to reduced maintenance and repair spending in the refining, petrochemical and power generation customer base impacted the reported revenue variance. For the year ended December 31, 2002, Wilson's revenues totaled $887.2 million, a 21 percent decline from the prior year period. Over 70 percent of the revenue variance was reported in the energy sector operations related to a combination of lower North American drilling and completion activity and reduced Canadian tubular product sales due to increased competition from steel mills. Lower spending for major maintenance programs and projects by customers in the U.S. industrial and petrochemical markets contributed to the remainder of the segment's revenue variance.

Operating Income

Operating income for the Distribution segment declined $3.9 million from the 2002 level, impacted by a $4.6 million charge recorded in the fourth quarter of 2003. Approximately $3.8 million of this amount was an inventory-related charge, while the remainder provided for estimated losses associated with the bankruptcy of a large industrial customer. Excluding this charge, Distribution operating results increased $0.7 million over the amount reported in 2002, equating to incremental operating income of approximately two percent of revenues. The incrementals were below those historically reported in the segment, impacted by the higher mix of project and export orders, which typically generate lower comparable margins. For the year ended December 31, 2002, Distribution segment operating income declined $26.9 million from the amounts reported in 2001, equating to decremental operating margins of 11 percent. The decrementals reflect the significant reduction in gross profit associated with the reported revenue decline, partially offset by lower variable-based operating expenses.

Other

The Distribution segment goodwill balance, which approximated $37.8 million as of December 31, 2003, is subject to an annual impairment test. This evaluation is largely influenced by future cash flow projections, and, therefore, requires management to make judgments about future operating results and working capital requirements. As noted above, Wilson's financial performance has been impacted by the lower level of business volumes experienced in its downstream and industrial sector. Changes in cash flow assumptions or other factors which negatively impact the estimated fair value of the Distribution business would influence the evaluation and might result in the determination that a portion of the goodwill is impaired when the analysis is performed during the first quarter of 2004.

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):

	FOR THE YEARS ENDED DECEMBER 31			
	2003		2002	
	AMOUNT	PERCENT	AMOUNT	PERCENT
Revenues	$ 3,594,828	100	$ 3,170,080	100
Gross profit	1,075,931	30	918,302	29
Operating expenses	747,184	21	662,154	21
Operating income	328,747	9	256,148	8
Interest expense	40,964	1	40,928	1
Interest income	(1,973)	-	(2,579)	-
Income before income taxes, minority interests and cumulative effect of change in accounting principle	289,756	8	217,799	7
Income tax provision	93,334	3	66,632	2
Minority interests	71,788	2	57,978	2
Income before cumulative effect of change in accounting principle	124,634	3	93,189	3
Cumulative effect of change in accounting principle, net of tax and minority interests	(1,154)	-	-	-
Net income	$ 123,480	3	$ 93,189	3

2003 versus 2002

Consolidated revenues were $3.6 billion for the year ended December 31, 2003, 13 percent above the prior year's level. The majority of the revenue growth was reported in the Company's Oilfield operations, impacted by increased worldwide drilling activity and, to a lesser extent, revenues from acquired operations. Excluding incremental revenues from acquired operations, base business revenues grew 10 percent over the prior year as demand for the Company's products and services was impacted by increased North American drilling activity as well as customer spending and new contract awards in markets outside the United States and Canada.

Gross profit was $1.1 billion, 17 percent above the prior year period. The increase in gross profit reflects higher sales volumes associated with the increased worldwide activity levels. Gross profit margins for the year were 30 percent of revenues, one percentage point above the gross profit margins reported in the prior year. The gross margin improvement was primarily impacted by an increased proportion of Oilfield segment sales, which traditionally generate higher gross profit margins than the Distribution segment. To a lesser extent, a favorable shift in the product mix towards higher-margin products, including drill bits and premium drilling fluids, contributed to the margin expansion.

Operating expenses, consisting of selling, general and administrative expenses, increased $85.0 million from the amount reported in 2002. The majority of the year-to-year increase was attributable to higher variable costs directly associated with the improved business volumes, as well as increased investment in people and infrastructure to support the expanding base business. To a lesser extent, the operating expense variance was impacted by incremental expenses associated with acquired operations. As a percentage of revenues, operating expenses were comparable with the prior year.

Net interest expense, which represents interest expense less interest income, equaled $39.0 million in 2003. Net interest expense was relatively consistent with the prior year amount as average debt levels were comparable between the periods.

The effective tax rate approximated 32 percent, which was above the 31 percent effective rate reported in the prior year, but below the U.S. statutory rate. The effective tax rate was lower than the U.S. statutory rate due to the impact of M-I SWACO's U.S. partnership earnings for which the minority partner is directly responsible for its related income taxes. The Company properly consolidates the pre-tax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision. The effective tax rate increased one percentage point from the prior year due to a shift in the geographic mix of pre-tax income toward higher rate jurisdictions and, to a lesser extent, a lower proportion of M-I SWACO's U.S. partnership earnings.

Minority interests reflect the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interests totaled $71.8 million in 2003, a $13.8 million increase from the prior year. The increase predominantly reflects the higher profitability of the M-I SWACO joint venture during 2003.

The cumulative effect of change in accounting principle included for 2003 represents the impact of the adoption of Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations."

2002 versus 2001

Consolidated revenues were $3.2 billion for the year ended December 31, 2002, 11 percent below the prior year's level. The majority of the revenue reduction was reported in the Company's Distribution operations, which are concentrated in North America and were impacted by the significant decline in corresponding activity levels. The revenue variance was also influenced by the impact of revenues from acquired operations and, to a lesser extent, the contribution of certain Oilfield segment operations to an unconsolidated joint venture in the fourth quarter of 2001. Excluding the net impact of acquired and divested operations, base revenues declined 15 percent from the prior year, as demand for the Company's products and services was impacted by a 26 percent reduction in Western Hemisphere drilling activity. Base revenue growth in the Eastern Hemisphere markets, attributable to increased activity levels and new contract awards, served to partially offset the overall revenue decline.

Gross profit was $918.3 million, 12 percent below the prior year period. The decrease in gross profit reflects lower sales volumes associated with the reduction in worldwide activity levels and, to a lesser extent, decreased demand for higher-margin Oilfield segment products. Gross profit margins for the year were 29 percent of revenues, comparable with the prior year period. An increased proportion of Oilfield segment revenues in 2002, which generate higher gross profit margins than the Distribution operations, served to mask the margin deterioration reported in the Oilfield segment.

Operating expenses, consisting of selling, general and administrative expenses decreased $12.1 million from the amount reported in 2001. The operating expense decline was attributable to cost reduction efforts initiated in response to the decrease in Western Hemisphere activity levels, lower employee profit-sharing requirements and the elimination of goodwill amortization in accordance with SFAS No. 142. Incremental expenses from acquired operations and the increased cost of medical and casualty insurance programs served to partially offset the overall expense decline. As a percentage of revenues, operating expenses increased two percentage points, reflecting lower fixed cost coverage related to the overall sales and administrative functions in both of the Company's operating segments.

Net interest expense, which represents interest expense less interest income, decreased $4.1 million from 2001. The minimal increase in average debt levels, primarily related to financing acquisitions in the fourth quarter of the prior year, was more than offset by the impact of reduced short-term interest rates on the Company's variable rate debt.

The effective tax rate approximated 31 percent, which was below both the 32 percent effective rate reported in the prior year and the U.S. statutory rate. The effective tax rate was lower than the U.S. statutory rate due to the impact of M-I SWACO's U.S. partnership earnings for which the minority partner is directly responsible for its related income taxes. The Company properly consolidates the pre-tax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision. The effective tax rate declined one percentage point from the prior year due to the elimination of goodwill amortization, a portion of which was not tax deductible, and a favorable shift in the geographic mix of pre-tax income toward lower rate jurisdictions.

Minority interests reflect the portion of the results of majority-owned operations which are applicable to the minority interest partners. Minority interests totaled $58.0 million in 2002, a $12.5 million reduction from 2001. The decrease reflects the lower profitability of the M-I SWACO joint venture, partially offset by the impact of acquiring a majority interest in United Engineering Services LLC in the fourth quarter of 2001.

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LIQUIDITY AND CAPITAL RESOURCES

General

At December 31, 2003, cash and cash equivalents equaled $51.3 million. During 2003, the Company's operations generated $142.6 million of cash flows as compared to the $323.5 million generated by the Company's operations in the prior year. The significant recovery of worldwide drilling activity has driven higher working capital investment, particularly accounts receivable and inventories, in contrast to the prior year when declining business levels contributed to positive cash flow from working capital accounts.

In 2003, cash flows used in investing activities totaled $177.8 million, consisting of amounts required to fund acquisitions and, to a lesser extent, capital expenditures. Acquisition funding, which primarily related to the purchase of the oilfield production chemical operations of Dynea International, resulted in cash outflows of $101.8 million in 2003. The Company also invested $76.0 million in property, plant and equipment, net of cash proceeds arising from certain asset disposals. Projected net capital expenditures for 2004 are expected to approximate $95.0 million, as higher drilling activity and an expanding business base impact the level of investment in manufacturing and rental tool equipment. Capital spending in 2004 is expected to primarily consist of spending for routine additions of property and equipment to support the Company's operations and maintenance of the Company's capital equipment base.

The combination of excess cash balances held at the beginning of the year and cash flows from operations exceeded cash required to fund investing activities resulting in repayments of $16.9 million in outstanding indebtedness. Cash flows used in financing activities totaled $1.9 million for 2003 as debt repayments were largely offset by cash proceeds associated with the exercise of employee stock options.

The Company's primary internal source of liquidity is cash flow generated from operations. Cash flow generated by 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. The Company has various revolving credit facilities in the United States. As of December 31, 2003, the Company had $315.8 million of capacity available under these facilities for future operating or investing needs. The Company also has revolving credit facilities in place outside of the United States, which are generally used to finance local operating needs. At year-end, the Company had available borrowing capacity of $82.7 million under the non-U.S. borrowing facilities.

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

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

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

The Company believes that it has sufficient existing manufacturing capacity to meet current demand for its products and services. Additionally, inflation has not had a material effect on the Company in recent years and is expected to have a modest impact on the operations in the foreseeable future. The Company has generally been able to offset most of the effects of inflation through productivity gains, cost reductions and price increases.

Contractual Obligations, Commitments and Contingencies

Contractual Obligations

The following table summarizes the Company's debt maturities and future minimum payments under non-cancelable operating leases having initial terms in excess of one year as of December 31, 2003 (in thousands):

		Amount of Commitment Expiration		
	Total	Less than 1 year	1-3 years	3-5 years
Debt maturities..................	$ 578,295	$ 89,747	$ 112,292	$ 156
Operating lease commitments......	148,924	35,231	47,682	24
Total...........................	$ 727,219	$ 124,978	$ 159,974	$ 181

Amounts related to commitments under capital lease agreements, as well as pension and other postretirement obligations, were immaterial for the periods presented.

Standby Letters of Credit and Guarantees

In the normal course of business with customers, vendors and others, the Company is contingently liable for its performance under standby letters of credit and bid, performance and surety bonds. Certain of these outstanding instruments guarantee payment of notes issued to former shareholders of an acquired entity as well as to insurance companies which reinsure certain liability coverages of the Company's insurance captive. Excluding the impact of these instruments, for which the $31.6 million of related liabilities are reflected in the accompanying consolidated balance sheets, the Company is contingently liable for approximately $41.6 million of standby letters of credit and bid, performance and surety bonds at December 31, 2003. Management does not expect any material amounts to be drawn on these instruments.

The Company has also provided loan guarantees related to certain joint ventures accounted for under the equity method of accounting. As the net assets and cash flows of these entities are available to satisfy obligations as they become due, management believes the likelihood is remote that the Company will be required to perform under these guarantees. The Company's estimated maximum exposure under these loan guarantees approximated $17.2 million as of December 31, 2003.

Insurance

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

Litigation

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

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 connection with most business acquisitions, the Company obtains contractual indemnifications from the seller related to environmental matters. These indemnifications generally provide for the reimbursement of environmental clean-up costs incurred by the Company for events occurring or circumstances existing prior to the purchase date, whether the event or circumstance was known or unknown at that time. A substantial portion of the Company's total environmental exposure is associated with its M-I SWACO operations, which are subject to various indemnifications from former owners.

As of December 31, 2003, the Company's environmental reserve approximated $10.0 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at December 31, 2003, the Company does not believe that these differences will have a material impact on the Company's financial position or results of operations, subject to the indemnifications in place. During the first quarter of 2003, the Company initiated legal action against M-I SWACO's former owners to address issues associated with certain provisions of the environmental indemnification provided. This matter is expected to go to trial during the fourth quarter of 2004. In the event that i) M-I SWACO's former owners and other parties to indemnification agreements with the Company do not fulfill their obligations, and ii) costs incurred to remediate the identified properties reach estimated maximum exposure limits, the Company would be required to establish additional environmental reserves of up to $25.0 million, impacting earnings and cash flows in future periods.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

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

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

Goodwill. The Company has acquired a number of operations during the past decade, which has resulted in the recording of a material amount of goodwill. Under SFAS No. 142, "Goodwill and Other Intangible Assets," the Company is required to perform an annual goodwill impairment evaluation, which is largely influenced by future cash flow projections. Estimating future cash flows of the Company's operations requires management to make judgments about future operating results and working capital requirements. Although the majority of the goodwill relates to the Company's Oilfield operations, $37.8 million of goodwill has been recorded which relates to Distribution transactions. Wilson's financial performance has been impacted by the lower level of business volumes experienced in its downstream and industrial sector. Changes in cash flow assumptions or other factors which negatively impact the fair value of the Distribution business would influence the evaluation and might result in the determination that a portion of the goodwill is impaired when the analysis is performed during the first quarter of 2004.

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

Income taxes. Deferred tax assets and liabilities are recognized for differences between the book basis and tax basis of the net assets of the Company. In providing for deferred taxes, management considers current tax regulations, estimates of future taxable income and available tax planning strategies. In certain cases, management has established reserves to reduce deferred tax assets to estimated realizable value. If tax regulations, operating results or the ability to implement tax planning strategies vary, adjustments to the carrying value of deferred tax assets and liabilities may be required.

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

RECENT ACCOUNTING PRONOUNCEMENTS

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board ("FASB") which are adopted by the Company as of the specified effective date. Unless otherwise discussed, management believes the impact of recently issued standards, which are not yet effective, will not have a material impact on the Company's consolidated financial statements upon adoption.

ITEM 7A. QUALITATIVE AND QUANTITATIVE MARKET RISK DISCLOSURES

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

The Company's exposure to interest rate changes is managed through the use of a combination of fixed and floating rate debt and by entering into interest rate contracts, from time to time, on a portion of its long-term borrowings. The Company had no interest rate contracts outstanding as of December 31, 2003 and 2002. At December 31, 2003, 22 percent of the Company's long-term debt carried a variable interest rate. Management believes that significant interest rate changes will not have a material near-term impact on the Company's future earnings or cash flows.

The Company's exposure to changes in foreign exchange rates is managed primarily through the use of forward exchange contracts. These contracts increase or decrease in value as foreign exchange rates change, to protect the value of the underlying transactions denominated in foreign currencies. All currency contracts are components of the Company's hedging program and are entered into for the sole purpose of hedging an existing or anticipated currency exposure. The gains and losses on these contracts offset changes in the value of the related exposures. The terms of these contracts generally do not exceed two years. As of December 31, 2003, the notional amounts of fair value hedge contracts and cash flow hedge contracts outstanding were $45.5 million and $9.2 million, respectively, and the fair value exceeded the notional amount of these contracts by $1.9 million. As of December 31, 2002, the notional amounts of fair value hedge contracts and cash flow hedge contracts outstanding were $43.4 million and $31.4 million, respectively, and the fair value exceeded the notional amount of these contracts by $3.6 million. In some areas, where hedging is not cost effective, the Company addresses foreign currency exposure utilizing working capital management.

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Below is a copy of the report previously issued by Arthur Andersen LLP, the Company's former independent public accountants, related to the Company's consolidated financial statements for the years ended December 31, 2001 and 2000. Arthur Andersen ceased operations in 2002 and is unable to issue an updated report. Certain financial statements covered by this report have not been included in the accompanying financial statements.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To Smith International, Inc.:

We have audited the accompanying consolidated balance sheets of Smith International, Inc. (a Delaware corporation) and subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of operations, stockholders' equity and comprehensive income and cash flows for each of the three years in the period ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Smith International, Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

ARTHUR ANDERSEN LLP

Houston, Texas
January 29, 2002

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated balance sheets of Smith International, Inc. and subsidiaries (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for the years then ended. Our audits also included the 2003 and 2002 financial statement schedules listed in Part IV, Item 15(a)(2). These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. The consolidated financial statements and financial statement schedule of the Company as of December 31, 2001 and for the year then ended, prior to the revisions discussed below, were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated January 29, 2002.

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

In our opinion, the 2003 and 2002 consolidated financial statements present fairly, in all material respects, the financial position of Smith International, Inc. and subsidiaries as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such 2003 and 2002 financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Notes 1 and 2 to the financial statements, the Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations" in 2003 and SFAS No. 142, "Goodwill and Other Intangible Assets" in 2002.

As discussed above, the consolidated financial statements and financial statement schedule of the Company as of December 31, 2001 and for the year then ended were audited by other auditors who have ceased operations. Those financial statements have been revised to i) give effect to a two-for-one stock split during 2002 (Notes 1, 4, 11 and 14), ii) include the transitional disclosures required by SFAS No. 142 (Notes 1 and 7), and iii) include expanded disclosures relating to the Company's supplemental executive retirement plan (Note 12). We audited the adjustments, transitional disclosures and expanded disclosures described above. Our procedures included a) agreeing previously reported weighted average shares outstanding, stock option, net income and goodwill amounts to the previously issued financial statements, b) agreeing the transitional adjustments and expanded disclosure amounts to the Company's underlying records obtained from management, and c) testing the mathematical accuracy of the applicable 2001 amounts. In our opinion, such adjustments and disclosures for 2001 are appropriate and have been properly applied. However, we were not engaged to audit, review or apply any procedures to the 2001 consolidated financial statements and financial statement schedule of the Company other than with respect to such adjustments and disclosures, and accordingly, we do not express an opinion or any other form of assurance on the 2001 consolidated financial statements and financial statement schedule taken as a whole.

DELOITTE & TOUCHE LLP

Houston, Texas
March 11, 2004

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

	DEC
	2003
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$ 51,286
Receivables, net (Note 1)	801,819
Inventories, net	739,627
Deferred tax assets, net	31,238
Prepaid expenses and other	55,826
Total current assets	1,679,796
PROPERTY, PLANT AND EQUIPMENT, NET	534,871
GOODWILL, NET	690,593
OTHER ASSETS	191,787
TOTAL ASSETS	$ 3,097,047
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Short-term borrowings and current portion of long-term debt	$ 89,747
Accounts payable	310,754

Accrued payroll costs	73,723
Income taxes payable	69,301
Other	87,399
Total current liabilities	630,924
LONG-TERM DEBT	488,548
DEFERRED TAX LIABILITIES	80,065
OTHER LONG-TERM LIABILITIES	74,066
MINORITY INTERESTS	587,668
COMMITMENTS AND CONTINGENCIES (Note 16)	
STOCKHOLDERS' EQUITY:	
Preferred stock, $1 par value; 5,000 shares authorized; no shares issued or outstanding in 2003 or 2002	-
Common stock, $1 par value; 150,000 shares authorized; 102,720 shares issued in 2003 (101,546 shares issued in 2002)	102,720
Additional paid-in capital	371,438
Retained earnings	779,123
Accumulated other comprehensive income	11,625
Less - Treasury securities, at cost; 2,384 common shares in 2003 and 2002	(29,130
Total stockholders' equity	1,235,776
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 3,097,047

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

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

	FOR THE YEARS ENDED DECEMB	
	2003	2002
Revenues	$ 3,594,828	$ 3,170,080
Costs and expenses:		
Costs of revenues	2,518,897	2,251,778
Selling expenses	586,163	520,509
General and administrative expenses	161,021	141,645
Goodwill amortization	-	-
Total costs and expenses	3,266,081	2,913,932
Operating income	328,747	256,148

Interest expense	40,964	40,928
Interest income	(1,973)	(2,579)
Income before income taxes, minority interests and cumulative effect of change in accounting principle	289,756	217,799
Income tax provision	93,334	66,632
Minority interests	71,788	57,978
Income before cumulative effect of change in accounting principle	124,634	93,189
Cumulative effect of change in accounting principle, net of tax and minority interests	(1,154)	-
Net income	$ 123,480	$ 93,189
Basic:		
Earnings per share before cumulative effect of change in accounting principle	$ 1.25	$ 0.94
Cumulative effect of change in accounting principle, net of tax and minority interests	(0.01)	-
Earnings per share	$ 1.24	$ 0.94
Diluted:		
Earnings per share before cumulative effect of change in accounting principle	$ 1.24	$ 0.93
Cumulative effect of change in accounting principle, net of tax and minority interests	(0.01)	-
Earnings per share	$ 1.23	$ 0.93
Weighted average shares outstanding:		
Basic	99,815	98,984
Diluted	100,903	100,091

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

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

	FOR THE Y
	2003
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income	$ 123,480
Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:	

Cumulative effect of change in accounting principle................	1,154
Depreciation and amortization......................................	101,709
Minority interests...	71,788
Deferred income tax provision (benefit)............................	8,154
Provision for losses on receivables................................	3,835
Increase (decrease) in LIFO inventory reserves.....................	231
Gain on disposal of property, plant and equipment..................	(8,463)
Foreign currency translation losses (gains)........................	1,516
Changes in operating assets and liabilities:	
Receivables..	(161,205)
Inventories.........................	