ENTRX CORP
Form 10-Q
November 12, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from __________ to __________

Commission File Number 0-2000

Entrx Corporation
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 95-2368719 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 800 Nicollet Mall, Suite 2690, Minneapolis, MN (Address of Principal Executive Office) | 55402 (Zip Code) |

Registrant's telephone number, including area code (612) 333-0614

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

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

| | | | |
|---|---|---|---|
| Large accelerated filer | ¨ | Accelerated filer | ¨ |
| Non-accelerated filer | ¨ | Smaller reporting Company | x |

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

As of November 9, 2010, the registrant had 7,491,211 shares outstanding of its Common Stock, $.10 par value.

ENTRX CORPORATION AND SUBSIDIARIES

TABLE OF CONTENTS



References to “we”, “us”, “our”, “the registrant” and “the Company” in this quarterly report on Form 10-Q shall mean or refer Entrx Corporation and its consolidated subsidiary, Metalclad Insulation Corporation, unless the context in which those words are used would indicate a different meaning.

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

ENTRX CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | September 30, 2010 (unaudited) | December 31, 2009 (audited) |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 1,469,314 | $ 2,070,710 |
| Restricted cash | 317,000 | - |
| Available-for-sale securities | 7,000 | 7,000 |
| Accounts receivable, less allowance for doubtful accounts of $80,000 as of September 30, 2010 and December 31, 2009 | 4,532,057 | 3,888,261 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | 895,500 | 1,174,085 |
| Inventories | 71,050 | 34,620 |
| Prepaid expenses and other current assets | 157,513 | 327,802 |
| Insurance claims receivable | 6,500,000 | 8,000,000 |
| Other receivables | 14,818 | 83,620 |
| Total current assets | 13,964,252 | 15,586,098 |
| | | |
| Property, plant and equipment, net | 201,909 | 195,069 |
| Insurance claims receivable | 39,500,000 | 44,000,000 |
| Other assets | 227,703 | 62,431 |
| | $ 53,893,864 | $ 59,843,598 |
| | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt | $ 67,582 | $ 106,152 |
| Accounts payable | 704,393 | 496,004 |
| Accrued expenses | 1,106,821 | 1,221,047 |
| Reserve for asbestos liability claims | 6,500,000 | 8,000,000 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 81,827 | 111,312 |
| Total current liabilities | 8,460,623 | 9,934,515 |
| | | |
| Long-term debt, less current portion | 22,529 | 31,620 |
| Reserve for asbestos liability claims | 39,500,000 | 44,000,000 |
| Total liabilities | 47,983,152 | 53,966,135 |
| | | |
| Commitments and contingencies | | |
| | | |
| Shareholders' equity: | | |
| Preferred stock, par value $1; 5,000,000 shares authorized; none issued | - | - |
| Common stock, par value $0.10; 80,000,000 shares authorized; 7,491,211 and 7,416,211 issued and outstanding at September 30, 2010 and December 31, 2009, respectively | 794,601 | 787,101 |
| Additional paid-in capital | 69,045,026 | 69,023,276 |

| | | |
|---|---|---|
| Accumulated deficit | (63,928,915) | (63,932,914) |
| Total shareholders' equity | 5,910,712 | 5,877,463 |
| | $ 53,893,864 | $ 59,843,598 |

See Notes to Consolidated Financial Statements

ENTRX CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (Loss)
(Unaudited)

| | Three Months Ended September 30, 2010 | Three Months Ended September 30, 2009 | Nine Months Ended September 30, 2010 | Nine Months Ended September 30, 2009 |
|---|---|---|---|---|
| Contract revenues | $ 4,033,268 | $ 3,830,412 | $ 13,279,918 | $ 14,320,248 |
| Contract costs and expenses | 3,455,469 | 3,107,740 | 11,134,738 | 11,955,251 |
| Gross margin | 577,799 | 722,672 | 2,145,180 | 2,364,997 |
| Operating expenses: | | | | |
| Selling, general and administrative | 674,867 | 735,927 | 2,164,556 | 2,437,470 |
| Gain on disposal of property, plant and equipment | - | (2,800) | (18,398) | (2,800) |
| Total operating expenses | 674,867 | 733,127 | 2,146,158 | 2,434,670 |
| Operating loss | (97,068) | (10,455) | (978) | (69,673) |
| Interest income | 3,106 | 5,013 | 7,785 | 14,546 |
| Interest expense | (1,340) | (1,756) | (3,379) | (5,946) |
| Gain on sale of marketable securities | - | 121,799 | - | 121,799 |
| Impairment charge on available-for-sale securities | - | - | - | (94,283) |
| Other income | - | - | 571 | - |
| Net income (loss) | (95,302) | 114,601 | 3,999 | (33,557) |
| Other comprehensive income (loss) | | | | |
| Unrealized gains on available-for-sale securities | - | 84,061 | - | 14,875 |
| Reclassification adjustment for unrealized losses on available-for-sale securities recognized in net income | - | (100,795) | - | (6,512) |
| Comprehensive income (loss) | $ (95,302) | $ 97,867 | $ 3,999 | $ (25,194) |
| Weighted average number of common shares — basic and diluted | 7,491,211 | 7,416,211 | 7,455,497 | 7,570,202 |
| Net income (loss) per share of common stock — basic and diluted | $ (0.01) | $ 0.02 | $ 0.00 | $ (0.00) |

See Notes to Consolidated Financial Statements

ENTRX CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2010 | 2009 |
| | (unaudited) | |
| Cash flows from operating activities: | | |
| Net income (loss) | $ 3,999 | $ (33,557) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 122,999 | 161,667 |
| Gain on disposal of property, plant and equipment | (18,398) | (2,800) |
| Gain on sales of available-for-sale securities | - | (121,799) |
| Impairment charge on investments | - | 94,283 |
| Common stock issued for services | 29,250 | 17,500 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (643,796) | 3,013,816 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | 278,585 | (15,282) |
| Inventories | (36,430) | (53,958) |
| Prepaid expenses and other current assets | 170,289 | (103,441) |
| Other receivables | 68,802 | 22,237 |
| Other assets | (165,272) | (15,811) |
| Accounts payable and accrued expenses | 94,163 | (1,318,173) |
| Billings in excess of costs and estimated earnings on uncompleted contracts | (29,485) | (29,227) |
| Net cash (used in) provided by operating activities | (125,294) | 1,615,455 |
| | | |
| Cash flows from investing activities: | | |
| Restricted cash | (317,000) | - |
| Proceeds from sale of property and equipment | 24,157 | 2,800 |
| Sales of available-for-sale securities | - | 316,782 |
| Capital expenditures | (95,543) | (40,202) |
| Net cash (used in) provided by investing activities | (388,386) | 279,380 |
| | | |
| Cash flows from financing activities: | | |
| Payments on long-term debt | (87,716) | (120,931) |
| Repurchases of common stock | - | (108,478) |
| Net cash used in financing activities | (87,716) | (229,409) |
| | | |
| (Decrease) Increase in cash and cash equivalents | (601,396) | 1,665,426 |
| Cash and cash equivalents at beginning of period | 2,070,710 | 2,078,666 |
| Cash and cash equivalents at end of period | $ 1,469,314 | $ 3,744,092 |
| | | |
| Non-cash investing and financing activities: | | |
| Acquisition of property, plant and equipment in exchange for notes payable | $ 40,980 | $ - |

See Notes to Consolidated Financial Statements

3

ENTRX CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Nine Months Ended September 30, 2010 and 2009
(Unaudited)

1. The accompanying unaudited consolidated financial statements of Entrx Corporation and its subsidiaries (the "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America. In the opinion of management all adjustments, consisting of normal recurring items, necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. These consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

2. The income per share amounts for the three and nine months ended September 30, 2010 and 2009, were computed by dividing the net income by the weighted average shares outstanding during the applicable period. Dilutive common equivalent shares have not been included in the computation of diluted income per share because their inclusion would be anti-dilutive.

For the nine months ended September 30, 2010 all stock options and warrants were anti-dilutive because their respective exercise prices were greater than the average market price of the common stock. All stock options and warrants were anti-dilutive for the three months ended September 30, 2010 and for the three and nine months ended September 30, 2009 due to the Company’s net loss during these periods.

3. On May 4, 2009, the Company’s shareholders approved two proposals to amend Entrx’s Restated and Amended Certificate of Incorporation. The first amendment effected a reverse 1-for-500 share stock split of Entrx’s common stock. The second amendment effected a subsequent forward 500-for-1 share stock split of Entrx’s common stock. The proposals had the effect of reducing the then number of the Company’s shareholders from an estimated 2,350 to between 800 and 900, and the then number of shareholders of record from approximately 520 to approximately 53, by cashing out fractional shares after the reverse stock split. The shareholdings of a person owning 500 shares or more of Entrx in any one account were unaffected, while the shares held by persons owning less than 500 shares of Entrx in any one account were bought out at the price of $0.35 per share. The amendments were effective with regards to shareholders of record at the close of business on May 15, 2009. There were 309,936 shares of common stock cashed-out related to the reverse and forward splits and therefore the amount of cash paid to the cashed-out shareholders was approximately $108,000.

4. In April 2010, the Company obtained from a bank an irrevocable standby letter of credit in the amount of $317,000 for the benefit of an indemnity company in connection with a performance bond issued related to a contract for a customer of the Company. The letter of credit expires on April 30, 2011, but automatically renews for additional one year periods unless 60 days prior to the expiration date the bank notifies the indemnity company that the bank elects to not consider the letter of credit renewed for any such additional period. In obtaining the letter of credit, the Company purchased a $317,000 one-year certificate of deposit and pledged it as collateral to the issuer of the letter of credit.

5. Investments held by the Company are classified as available-for-sale securities. Available-for-sale securities are reported at fair value with all unrealized gains or losses included in other comprehensive income (loss). The fair value of the securities was determined by quoted market prices of the underlying security (Level 1 inputs under the three-level fair-value hierarchy established under Fair Value Measurements and Disclosures, ASC 820-10-35-40.) For

purposes of determining gross realized gains (losses), the cost of available-for-sale securities is based on specific identification.

On an ongoing basis, the Company evaluates its investments in available-for-sale securities to determine if a decline in fair value is other-than-temporary such that the change should be reflected in the Company's financial statements. When a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established. Considering the severity and duration of the declines in fair value and the financial condition and near-term prospects of our investments, we recognized an other than temporary impairment charge of $94,283 on our investment in Catalytic Solutions, Inc. during the nine month period ended September 30, 2009. During the three month period ended September 30, 2009, the Company sold substantially all of its remaining investments, resulting in a realized gain of $121,799

6. Inventories, which consist principally of insulation products and related materials, are stated at the lower of cost (determined on the first-in, first-out method) or market.

7. Accrued expenses consist of the following:

| | September 30, 2010 | December 31, 2009 |
|---|---|---|
| Wages, bonuses and payroll taxes | $ 272,418 | $ 233,293 |
| Union dues | 224,393 | 262,124 |
| Accounting and legal fees | 42,200 | 110,351 |
| Insurance | 23,666 | 61,470 |
| Insurance settlement reserve | 375,000 | 375,000 |
| Taxes | 18,719 | 25,884 |
| Other | 150,425 | 152,925 |
| | $ 1,106,821 | $ 1,221,047 |

8. As more fully described in our Annual Report on Form 10-K for the year ended December 31, 2009, the Company has granted stock options over the years to employees and directors under various stockholder approved stock option plans. At September 30, 2010, options to purchase 1,060,000 shares of the Company's common stock were outstanding. No stock options have been granted since January 2005. Stock options expiring during the first nine months of 2010 and 2009 were 80,000 and 283,400, respectively.

During the nine months ended September 30, 2010, the Company authorized the issuance of an aggregate of 75,000 shares of its common stock to the five members of the Company's Board of Directors contingent upon the receipt from those directors of certain documentation. The shares issued to the members of the Board of Directors had an aggregate market value of $29,250 based upon the market price at the time of such authorization. The shares were issued by the transfer agent on July 20, 2010 after receipt of the required documentation.

9. Sales to significant customers were as follows:

| | Three Months Ended September 30, 2010 | | Three Months Ended September 30, 2009 | |
|---|---|---|---|---|
| | Revenue | % of Total Revenue | Revenue | % of Total Revenue |
| McCarthy Building Companies, Inc. | $ 650,000 | 16.1% | (1) | (1) |
| Mercer Demo & Surplus, Inc. | $ 417,000 | 10.4% | (1) | (1) |
| Jacobs Field Services North America, Inc. | $ 406,000 | 10.1% | (1) | (1) |
| BP West Coast Products LLC | (1) | (1) | $ 611,000 | 16.0% |
| Southern California Edison | (1) | (1) | $ 477,000 | 12.5% |

| | Nine Months Ended September 30, 2010 | | Nine Months Ended September 30, 2009 | |
|---|---|---|---|---|
| | Revenue | % of Total Revenue | Revenue | % of Total Revenue |
| NRG Energy | $ 1,626,000 | 12.2% | $ 1,864,000 | 13.0% |
| Mercer Demo & Surplus, Inc. | $ 1,356,000 | 10.2% | (1) | (1) |
| Jacobs Field Services North America, Inc. | $ 1,339,000 | 10.1% | (1) | (1) |

| | | | |
|---|---|---|---|
| BP West Coast Products LLC | (1) | (1) | $ 2,331,000 | 16.3% |

(1) Sales to this customer were less than 10% of total revenue during the reported period.

Significant accounts receivable were as follows:

| | September 30, 2010 | | December 31, 2009 | |
|---|---|---|---|---|
| | Accounts Receivable | % of Total Accounts Receivable | Accounts Receivable | % of Total Accounts Receivable |
| Mercer Demo & Surplus, Inc. | $ 762,000 | 16.5% | (1) | (1) |
| McCarthy Building Companies, Inc. | $ 546,000 | 11.8% | (1) | (1) |
| Southern California Edison | (1) | (1) | $ 1,271,000 | 32.0% |

(1) Accounts receivable from this customer were less than 10% of total accounts receivable for the reported period.

Since many of the projects we undertake are relatively large, it is normal that various customers will represent a significant portion of our sales and/or accounts receivable in a given period. It is also the nature of the Company's business that a significant customer in one year may not be a significant customer in a succeeding year.

10. In June 2009, the FASB issued authoritative guidance modifying how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The guidance clarifies that the determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. The guidance requires an ongoing reassessment of whether a company is the primary beneficiary of a variable interest entity. The guidance also requires additional disclosures about a company's involvement in variable interest entities and any significant changes in risk exposure due to that involvement. The guidance is effective for fiscal years beginning after November 15, 2009. The adoption of this authoritative guidance did not have a material effect on our financial condition, results of operations or cash flows.

11. There were 100 new asbestos-related cases initiated naming us (primarily our subsidiary, Metalclad Insulation Corporation) as a defendant in the first nine months of 2010, compared to 150 in the first nine months of 2009. As of December 31, 2009, there were 239 cases pending and as of September 30, 2010 there were 202 cases pending. These claims are currently defended and covered by insurance.

Under current accounting rules we are required to estimate our liability for existing and future asbestos-related claims. This requires that we estimate the number of claims we believe will be brought in the future. We previously based our estimates on the downward trend of cases brought from 725 cases brought in 2001, to 199 cases brought in 2005. This downward trend leveled off somewhat from 2006 through 2009. In addition, we have experienced increases in our costs to defend and resolve claims during this period. As a result, we have found it necessary to increase our projections of our liabilities for cases which are pending and for new cases which may be initiated in the future with respect to each of our 2006, 2008 and 2009 financial statements. We believe that the leveling off of cases brought in 2005 through 2009 is largely due to an aggressive campaign waged by plaintiffs' lawyers in an attempt to identify new plaintiffs, and that as the pool of plaintiffs decreases that it is probable that the downward trend experienced prior to 2006 will resume, although such resumption cannot be assured.

From 2001 and through 2009, the annual average indemnity paid on each of over 3,000 resolved cases has fluctuated significantly, between a low of $14,504 in 2006 and a high of $54,946 in 2008, with an overall average over that period of approximately $21,130. During this period, although there has been no discernible upward or downward trend in indemnity payments, our most recent indemnity payment experience in 2009 and 2010 of approximately $24,000 per resolved claim has been slightly less favorable than the $21,130 projected.

We believe that the sympathies of juries, the aggressiveness of the plaintiffs' bar and the declining base of potential defendants as the result of business failures, have tended to increase payments on resolved cases. This tendency, we believe, has been mitigated by the declining pool of claimants resulting from death, and the likelihood that the most meritorious claims have been ferreted out by plaintiffs' attorneys. We expect that the newer cases being brought will not be as meritorious and have as high a potential for damages as cases which were brought earlier. We have no reason to believe, therefore, that the average future indemnity payments will increase materially in the future.

In addition, direct defense costs per resolved claim increased from a low of $8,514 in 2003 to a high of $44,490 in 2008. The weighted average defense cost per resolved claim from 2005 through 2009 was $20,988. We believe that these defense costs increased as a result of a change in legal counsel in 2004, and the more aggressive defense posture taken by new legal counsel since that change. We intend to monitor the defense costs in 2010 and will adjust our estimates if events occur which would cause us to believe that those estimates need revision. We are currently projecting those costs to be approximately $21,000 per claim.

Although defense costs are included in our insurance coverage, we expended $28,000 and $84,000 in the three and nine months ended September 30, 2010, respectively, and $20,000 and $85,000 in the three and nine months ended September 30, 2009, respectively, to administer the asbestos claims and defend the ACE Lawsuit discussed below. These amounts were primarily fees paid to attorneys to monitor the activities of the insurers, and their selected defense counsel, and to look after our rights under the various insurance policies.

As of December 31, 2009, we re-evaluated our estimates to take into account our experience in 2009. Primarily as a result of the increase in the number of new cases commenced during 2009 which exceeded our previous estimates, we projected that there would be 986 asbestos-related injury claims made against the Company after December 31, 2009. The 986 projected claims, in addition to the 239 claims existing as of December 31, 2009, totals 1,225 current and future claims. Multiplying the average indemnity per resolved claim over the past nine full calendar years of $21,130, times 1,225, we projected the probable future indemnity to be paid on those claims after December 31, 2009 to be equal to approximately $26,000,000. In addition, multiplying an estimated cost of defense per resolved claim of approximately $21,000 times 1,225, we projected the probable future defense costs to equal approximately $26,000,000. Accordingly, our total estimated future asbestos-related liability at December 31, 2009 was $52,000,000.

As of December 31, 2009 we projected that approximately 158 new asbestos-related claims would be commenced and approximately 179 cases will be resolved in 2010, resulting in an estimated 218 cases pending at December 31, 2010. Since we projected that an aggregate of 986 new cases would be commenced after December 31, 2009, and that 158 of these cases would be commenced in 2010, we estimated that an aggregate of 828 new cases will be commenced after December 31, 2010. Accordingly, we projected the cases pending and projected to be commenced in the future at December 31, 2010, would be 1,046 cases. The sum of the approximate average indemnity paid per resolved claim from 2001 through 2009 plus the approximate defense costs incurred per resolved claim from 2005 through 2009, equals $42,130. Multiplying 1,046 claims times $42,130 we estimate our liability for current and future asbestos-related claims at December 31, 2010 to be approximately $44,000,000. This amounts to an $8,000,000 reduction from the $52,000,000 liability we estimated as of December 31, 2009, or a $2,000,000 reduction per quarter in 2010.

We intend to re-evaluate our estimate of future liability for asbestos claims at the end of each fiscal year, or whenever actual results are materially different from our estimates, integrating our actual experience in that fiscal year with that of prior fiscal years since 2001. Our estimate does not take into consideration the potential effects of economic inflation on either the average indemnity payment or the projected direct legal expenses.

There are numerous insurance carriers which have issued a number of policies to us over a period extending from approximately 1967 through approximately 1985 that still provide coverage for asbestos-related injury claims. After approximately 1985 the policies were issued with provisions which purport to exclude coverage for asbestos related claims. The terms of our insurance policies are complex, and coverage for many types of claims is limited as to the nature of the claim and the amount of coverage available. It is clear, however, under California law, where the substantial majority of the asbestos-related injury claims are litigated, that all of those policies cover any asbestos-related injury occurring during the 1967 through 1985 period when these policies were in force.

We have determined that the minimum probable insurance coverage available to satisfy asbestos-related injury claims exceeds our estimated future liability for such claims of $46,000,000 and $52,000,000 as of September 30, 2010 and December 31, 2009, respectively. This determination assumes that the general trend of reducing asbestos-related injury claims experienced prior to 2006 will resume and that the average indemnity and direct legal costs of each resolved claim will not materially increase. The determination also assumes that the insurance companies remain solvent and live up to what we believe is their obligation to continue to cover our exposure with regards to these claims. Accordingly, we have included $46,000,000 and $52,000,000 of such insurance coverage receivable as an asset on our September 30, 2010 and December 31, 2009 balance sheets, respectively. Several affiliated insurance companies have brought a declaratory relief action against our subsidiary, Metalclad, as well as a number of other insurers, to resolve certain coverage issues, as discussed below. Regardless of our best estimates of liability for current and future asbestos-related claims, the liability for these claims could be higher or lower than estimated by amounts which are not predictable. We, of course, cannot give any assurance that our liability for such claims will not ultimately exceed our available insurance coverage. We will update our estimates of insurance coverage in future filings with the Securities and Exchange Commission, as events occur which would cause us to believe that those estimates need revision, based upon the subsequent claim experience, using the methodology we have employed.



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On February 23, 2005 ACE Property & Casualty Company ("ACE"), Central National Insurance Company of Omaha ("Central National") and Industrial Underwriters Insurance Company ("Industrial"), which are all related entities, filed a declaratory relief lawsuit (“the ACE Lawsuit”) against Metalclad Insulation Corporation (“Metalclad”) and a number of Metalclad's other liability insurers, in the Superior Court of the State of California, County of Los Angeles. ACE, Central National and Industrial issued umbrella and excess policies to Metalclad, which has sought and obtained from the plaintiffs both defense and indemnity under these policies for the asbestos lawsuits brought against Metalclad during the last four to five years. The ACE Lawsuit seeks declarations regarding a variety of coverage issues, but is centrally focused on issues involving whether historical and currently pending asbestos lawsuits brought against Metalclad are subject to either an "aggregate" limits of liability or separate "per occurrence" limits of liability. Whether any particular asbestos lawsuit is properly classified as being subject to an aggregate limit of liability depends upon whether or not the suit falls within the "products" or "completed operations" hazards found in most of the liability policies issued to Metalclad. Resolution of these classification issues will determine if, as ACE and Central National allege, their policies are nearing exhaustion of their aggregate limits and whether or not other Metalclad insurers who previously asserted they no longer owed any coverage obligations to Metalclad because of the claimed exhaustion of their aggregate limits, in fact, owe Metalclad additional coverage obligations. The ACE Lawsuit does not seek any monetary recovery from Metalclad. The ACE Lawsuit is principally about coverage responsibility among the several insurers, as well as total coverage. Regardless of the outcome of this litigation, Entrx does not believe that the ACE Lawsuit will result in materially diminishing Entrx’s insurance coverage for asbestos-related claims. Nonetheless, we anticipate that we will incur attorney’s fees and other associated litigation costs in defending the lawsuit and any counter claims made against us by any other insurers, and in prosecuting any claims we may seek to have adjudicated regarding our insurance coverage.

The ACE Lawsuit also seeks to determine the effect of a June 2004 settlement agreement between the Company and Allstate Insurance Company on the insurance obligations of various other insurers of Metalclad, and the effect of the “asbestos exclusion” in the Allstate policy. Under the settlement agreement the Company received $2,500,000 from Allstate in consideration of releasing Allstate from a potential liability under a $5,000,000 limits insurance policy. The ACE Lawsuit may result in our incurring costs in connection with obligations we may have to indemnify Allstate under that settlement agreement. Allstate, in a cross-complaint filed against Metalclad Insulation Corporation in October, 2005, asked the court to determine the Company’s obligation to assume and pay for the defense of Allstate in the ACE Lawsuit under the Company’s indemnification obligations in the settlement agreement. The Company does not believe that it has any legal obligation to assume or pay for such defense. If Allstate is required to provide indemnity for Entrx’s asbestos-related lawsuits, it is likely that Entrx would have to indemnify Allstate for asbestos-related claims that it defends up to $2,500,000 in the aggregate. If Allstate is not required to provide indemnity, Entrx would have no liability to Allstate. Entrx has accrued $375,000 as a potential loss in connection with the Allstate matter.

12. An audit of Metalclad Insulation Corporation’s billing history, with respect to one of its principal customers, was conducted in the quarter ending June 30, 2010, by an independent auditing firm engaged by that customer. As a result of the audit, the auditing firm reported on July 26, 2010 that during 2008 and 2009, Metalclad overcharged the customer by approximately $400,000. The issues identified by the auditing firm related to how overtime should be billed and what hourly rates were to be charged for certain categories of union labor. All work was performed by Metalclad for that customer under a Master Services Agreement (the Agreement) entered into in 2000 and subsequently amended or extended on eleven occasions. We reviewed the auditing firm’s report and the Agreement, as amended, and we do not agree with the auditing firm’s interpretation of the Agreement on the identified issues. We performed our own analysis of the billing and on August 16, 2010 submitted a response to the findings contained in the audit report. Our analysis showed that, on an aggregate basis, the customer was correctly billed. We have not yet received a response to our analysis from the customer or independent auditing firm. While we do not believe that the customer was overcharged, it is possible that we may have to repay some or all of the amounts claimed as an overcharge, the amount of which may be material. No amounts have been accrued in our financial statements as of

September 30, 2010.

13. Supplemental disclosures of cash flow information:

Cash paid for interest was $3,000 and $6,000 for the nine months ended September 30, 2010 and 2009, respectively.

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

All statements, other than statements of historical fact, included in this Form 10-Q, including without limitation the statements under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Description of Business" are, or may be deemed to be, "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934. Such forward-looking statements involve assumptions, known and unknown risks, uncertainties, and other factors which may cause the actual results, performance or achievements of Entrx Corporation (the "Company") to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements contained in this Form 10-Q. Such potential risks and uncertainties include, without limitation; estimates of future revenues; the outcome of existing litigation; competitive pricing and other pressures from other businesses in the Company's markets; the accuracy of the Company's estimate of future liability for asbestos-related injury claims; the adequacy of insurance, including the adequacy of insurance to cover current and future asbestos-related injury claims; the imposition of laws or regulations relating to asbestos related injury claims; economic conditions generally and in the Company's primary markets; availability of capital; the adequacy of the Company's cash and cash equivalents; the cost of labor; the accuracy of the Company's cost analysis for fixed price contracts; the appropriateness of the Company's billing practices; and other risk factors detailed herein and in other of the Company's filings with the Securities and Exchange Commission. The forward-looking statements are made as of the date of this Form 10-Q and the Company assumes no obligation to update the forward-looking statements or to update the reasons actual results could differ from those projected in such forward-looking statements. Therefore, readers are cautioned not to place undue reliance on these forward-looking statements. You can identify these forward-looking statements by forward-looking words such as "may," "assume," "expect," "project," "anticipate," "believe," "intend," "estimate," "cor similar words.

General. The Company provides insulation installation and removal services, including asbestos abatement services, primarily on the West Coast. We also enter into contracts to repair and maintain existing insulation systems. These maintenance contracts are generally awarded on a year to year basis, but are often renewed from year to year. We also provide and erect scaffolding both with respect to our installation, removal and maintenance services, and for others. Through our wholly-owned subsidiary Metalclad Insulation Corporation, we provide these services to a wide range of industrial, commercial and public agency clients. Insulation installation services include the installation of high- and low-temperature insulation on pipe, ducts, furnaces, boilers, and other types of industrial equipment and commercial applications. Insulation removal services involve the removal of old insulation prior to the installation of new insulation or system demolition, including the removal and disposal of asbestos-containing products. We fabricate specialty items for the insulation industry, and sell insulation material and accessories incidental to our services business to our customers as well as to other contractors. A diverse list of clientele includes refineries, utilities, chemical plants, manufacturing facilities, commercial properties, office buildings and various governmental facilities.

Results of Operations: Three and Nine Months Ended September 30, 2010 and 2009

Revenue

Revenue for the three months ended September 30, 2010 was $4,033,000, an increase of 5.3% as compared to $3,830,000 for the three months ended September 30, 2009. Revenue for the nine months ended September 30, 2010 was $13,280,000, a decrease of 7.3% as compared to $14,320,000 for the nine months ended September 30,

2009. Revenues increased during the three months ended September 30, 2010 as compared with the three months ended September 30, 2009 primarily as result of a large firestopping contract during the three months ended September 30, 2010 that did not occur in the same period during the prior year, partially offset by a decrease in revenues from commercial projects. Revenues decreased during the nine months ended September 30, 2010 as compared with the nine months ended September 30, 2009 primarily as result of a decline in the commercial insulation and asbestos market due to what we believe to be macro-economic factors. Several large commercial projects secured prior to the economic downturn were completed during the first nine months of 2009 and were not replaced with similar size projects in the first nine months of 2010. Additionally, a major industrial new construction insulation project and several large scaffolding projects were completed in the nine months ended September 30, 2009, and similar sized projects were not secured in the nine months ended September 30, 2010.

Approximately 29% and 39% of the revenues for the three and nine months ended September 30, 2010, respectively, were from insulation maintenance contracts, which often continue from year to year. Most of the contracts are priced on a time and materials basis and, therefore, the amount of revenue on any given maintenance contract can fluctuate from period to period based upon the amount of maintenance the customer requests during that period. We believe that cost reduction measures taken by some of our customers during a period of general economic downturn may have accounted for lower revenues from maintenance contracts during the first nine months of 2010, as compared to the same period in 2009. This compares with 52% and 51% of our revenues being derived from insulation maintenance contracts in the three and nine months ended September 30, 2009, respectively. Approximately 48% and 43% of revenues in the three and nine months ended September 30, 2010, respectively, were derived from insulation installation and removal projects, which are not normally continuing, but can go on for a year or more. This compares with 42% and 36% of revenues of our revenues being derived from insulation installation and removal projects in the three and nine months ended September 30, 2009, respectively. These percentages are approximate because some installation and removal projects involve maintenance arrangements, and vice versa. Approximately 5% and 8% of the revenues for the three and nine months ended September 30, 2010, respectively, were from scaffolding contracts, which often continue from year to year. This compares with 6% and 10% of our revenues being derived from scaffolding contracts in the three and nine months ended September 30, 2009, respectively. Approximately 17% and 9% of the revenues for the three and nine months ended September 30, 2010, respectively, were from firestopping contracts, which are not normally continuing. This compares with 3% and 2% of our revenues being derived from firestopping contracts in the three and nine months ended September 30, 2009, respectively. The Company bids on hundreds of projects during any given year. These projects range in value from a few hundred dollars to several million dollars, and the projects can last from a few hours up to over a year in duration. The Company cannot predict what projects will be coming up for bid in any particular period, or whether it will be the winning bidder. Accordingly, the Company is unable to determine if the revenue trends, or the allocation between maintenance contracts and installation and removal contracts, will continue. We anticipate that our revenues in 2010 will be slightly less than those in 2009.

Cost of Revenue and Gross Margin

Total cost of revenue for the three months ended September 30, 2010 was $3,455,000 as compared to $3,108,000 for the three months ended September 30, 2009, an increase of 11.2%. Cost of revenue was $11,135,000 for the nine months ended September 30, 2010, as compared to $11,955,000 for the nine months ended September 30, 2009, a decrease of 6.9%. The gross margin as a percentage of revenue was approximately 14.3% for the three months ended September 30, 2010 compared to 18.9% for the three months ended September 30, 2009 primarily due to the Company pricing its bids aggressively during the three months ended September 30, 2010 due to the general macro-economic environment. The gross margin as a percentage of revenue was approximately 16.2% for the nine months ended September 30, 2010 compared to 16.5% for the nine months ended September 30, 2009. The gross margin as a percentage of revenue was positively impacted by a change in estimate of the Company's estimated workers compensation liability of approximately $56,000 in the three and nine months ended September 30, 2009. While the gross margin percentage varies from job to job, insulation maintenance contracts generally have a lower gross margin percentage than insulation installation and removal contracts. The increase in the cost of revenues for the three months ended September 30, 2010 as compared to the three months ended September 30, 2009 was primarily due to increased work evidenced by the higher revenues as discussed above. The decrease in the cost of revenues for the nine months ended September 30, 2010 as compared to the nine months ended September 30, 2009 was primarily due to reduced work evidenced by the lower revenues as discussed above.

Selling, General and Administrative

Selling, general and administrative expenses were $675,000 for the three months ended September 30, 2010 as compared to $736,000 for the three months ended September 30, 2009, a decrease of 8.3%. Selling, general and administrative expenses for the nine months ended September 30, 2010 were $2,165,000 as compared to $2,437,000 for the comparable period ended September 30, 2009, a decrease of 11.2%. The decrease for the three months ended September 30, 2010 as compared to the three months ended September 30, 2009 was primarily due to a decrease in labor expense of $26,000 and a decrease in entertainment expenses of $46,000. The decrease for the nine months ended September 30, 2010 as compared to the nine months ended September 30, 2009 were primarily due to decreases in labor expenses of $87,000, bad debt expense of $63,000, shareholder reporting expenses of $45,000, legal expenses of $22,000 and entertainment expenses of $44,000. The decrease in labor expense for the nine months ended September 30, 2010 as compared to the nine months ended September 30, 2009 was partially due to payroll taxes incurred on bonuses paid in the first half of 2009 that were not incurred in the first half of 2010 and partially due to headcount reductions.

Gain on Disposal of Property, Plant and Equipment

Gain on the disposal of property plant and equipment was $0 and $3,000 for the three months ended September 30, 2010 and 2009, respectively. Gain on the disposal of property plant and equipment was $18,000 and $3,000 for the nine months ended September 30, 2010 and 2009, respectively.

Interest Income and Expense

Interest expense for the three months ended September 30, 2010 was $1,000 as compared with interest expense of $2,000 for the three months ended September 30, 2009. Interest expense for the nine months ended September 30, 2010 was $3,000 as compared with interest expense of $6,000 for the nine months ended September 30, 2009. Interest income for the three months ended September 30, 2010 was $3,000 as compared with interest income of $5,000 for the three months ended September 30, 2009. Interest income for the nine months ended September 30, 2010 was $8,000 as compared with interest income of $15,000 for the nine months ended September 30, 2009.

Gain on Sale of Marketable Securities

We recognized a gain on sale of marketable securities of $122,000 for the three and nine months ended September 30, 2009. The Company recognized a gain of $121,000 on the sale of all of its 39,415 shares of Clearwire Corporation and a gain of $1,000 on the sale of all of its 19,056 shares of VioQuest Pharmaceuticals, Inc.

Impairment Charge on Available-for-Sale Securities

The Company recognized an impairment charge of $94,000 on its investment in Catalytic Solutions, Inc. in the nine months ended September 30, 2009.

Net Income (Loss)

We had a net loss of $95,000 for the three months ended September 30, 2010 as compared to a net income of $115,000 for the three months ended September 30, 2009. We had net income of $4,000 for the nine months ended September 30, 2010 as compared to a net loss of $34,000 for the nine months ended September 30, 2009.

Liquidity and Capital Resources

As of September 30, 2010, we had $1,469,000 in cash and cash equivalents, $317,000 in restricted cash and $7,000 in available-for-sale securities. The Company had working capital of $5,504,000 as of September 30, 2010. We own 384,084 shares of Catalytic Solutions, Inc. common stock (AIM: CTSU), which are treated as available-for-sale securities.

Cash used in operations was $125,000 for the nine months ended September 30, 2010 compared with cash provided by operations of $1,615,000 for the nine months ended September 30, 2009. For the nine months ended September 30, 2010 the negative cash flow from operations was primarily the result of an increase in accounts receivable of $644,000 and other assets of $165,000. This negative cash flow was partially offset by a decrease in costs and estimated earnings in excess of billings on uncompleted contracts of $279,000, a decrease in prepaid expenses and other current assets of $170,000 and non-cash expenses for depreciation and amortization of $123,000. For the nine months ended September 30, 2009 the positive cash flow from operations was primarily the result of a decrease in accounts receivable of $3,014,000. This positive cash flow was partially offset by a decrease in accounts payable and accrued expenses of $1,318,000.

Net investing activities used $388,000 and provided $279,000 of cash in the nine months ended September 30, 2010 and 2009, respectively. During the nine months ended September 30, 2010, we used cash of $317,000 to secure a letter of credit in connection with a performance bond related to a contract with a customer of the Company. For the nine months ended September 30, 2010 and 2009, we used cash of $96,000 and $40,000, respectively, for capital expenditures, primarily at our subsidiary, Metalclad Insulation Corporation. Proceeds from sale of property and equipment provided $24,000 in the nine months ended September 30, 2010.

Cash used in financing activities totaled $88,000 for the nine months ended September 30, 2010 compared with cash used in financing activities of $229,000 for the comparable period in 2009. Payments on long-term borrowings used $88,000 and $121,000 of cash in the nine months ended September 30, 2010 and 2009, respectively. In the nine months ended September 30, 2009, the Company used $108,000 to repurchase common stock related to the reverse/forward stock split approved by the shareholders.

We obtain substantially all of our field employees from pools of workers supplied by local trade unions. These employees are generally engaged on an hourly basis. The number of hourly employees employed by us at any one time fluctuates depending upon the number and size of projects that we have under construction at any particular time. It has been our experience that hourly employees are generally available for our projects, and we have continuously employed a significant number of hourly employees on various projects over an extended period of time.

Metalclad Insulation Corporation currently is a party to seven collective bargaining agreements, representing workers engaged in insulation, asbestos/lead abatement, scaffolding and firestopping activities, including, primarily, agreements with Locals 5 and 16 of the International Association of Heat and Frost Insulators and Allied Workers union; Local 1506 of the United Brotherhood of Carpenters and Joiners of America; Locals 300 and 67 of the Laborers International Union of North America; and District Council 16 of the United Association. All union contracts expire at various times from June 2011 through December 2012. We consider our relations with our hourly employees and the unions representing them to be good, and have not experienced any recent strikes or work stoppages.

As of September 30, 2010, Metalclad Insulation Corporation employed approximately 100 hourly employees, then constituting approximately 85% of our hourly workforce, engaged in insulation and asbestos/lead abatement, supplied by Local 5 of the International Association of Heat and Frost Insulators and Allied Workers union. Our agreement with this union local expires in June 2011 and contains a “no strike, no work-stoppage” provision. Approximately 15 additional hourly employees were engaged by Metalclad Insulation Corporation as of September 30, 2010 in other activities, including scaffolding construction and firestopping installation.

The number of asbestos-related cases which have been initiated naming us (primarily our subsidiary, Metalclad Insulation Corporation) as a defendant have fluctuated from 199 in 2005, to 232 in 2006, to 163 in 2007, to 187 in 2008, and to 188 in 2009. There were 100 new claims made in the first nine months of 2010, compared to 150 in the first nine months of 2009. At December 31, 2005, 2006, 2007 and 2008, there were, respectively, approximately 507, 404, 222 and 271 cases pending. As of December 31, 2009, there were 239 cases pending and as of September 30, 2010 there were 202 cases pending. These claims are currently defended and covered by insurance.

Under current accounting rules we are required to estimate our liability for existing and future asbestos-related claims. This requires that we estimate the number of claims we believe will be brought in the future. We previously based our estimates on the downward trend of cases brought from 725 cases brought in 2001, to 199 cases brought in 2005. This downward trend leveled off somewhat from 2006 through 2009. In addition, we have experienced increases in our costs to defend and resolve claims during this period. As a result, we have found it necessary to increase our projections of our liabilities for cases which are pending and for new cases which may be initiated in the future, with respect to each of our 2006, 2008 and 2009 financial statements. We believe that the leveling off of cases brought in 2005 through 2009 is largely due to an aggressive campaign waged by plaintiffs’ lawyers in an attempt to identify new plaintiffs, and that as the pool of plaintiffs decreases that it is probable that the downward trend experienced prior to 2006 will resume, although such resumption cannot be assured.

From 2001 and through 2009, the annual average indemnity paid on each of over 3,000 resolved cases has fluctuated significantly, between a low of $14,504 in 2006 and a high of $54,946 in 2008, with an overall average over that period of approximately $21,130. During this period, although there has been no discernible upward or downward trend in indemnity payments, our most recent indemnity payment experience in 2009 and 2010 of approximately $24,000 per resolved claim has been slightly less favorable than the $21,130 projected.

We believe that the sympathies of juries, the aggressiveness of the plaintiffs' bar and the declining base of potential defendants as the result of business failures, have tended to increase payments on resolved cases. This tendency, we believe, has been mitigated by the declining pool of claimants resulting from death, and the likelihood that the most meritorious claims have been ferreted out by plaintiffs' attorneys. We expect that the newer cases being brought will not be as meritorious and have as high a potential for damages as cases which were brought earlier. We have no reason to believe, therefore, that the average future indemnity payments will increase materially in the future.

In addition, direct defense costs per resolved claim increased from a low of $8,514 in 2003 to a high of $44,490 in 2008. The weighted average defense cost per resolved claim from 2005 through 2009 was $20,988. We believe that these defense costs increased as a result of a change in legal counsel in 2004, and the more aggressive defense posture taken by new legal counsel since that change. We intend to monitor the defense costs in 2010 and will adjust our estimates if events occur which would cause us to believe that those estimates need revision. We are currently projecting those costs to be approximately $21,000 per claim.

Although defense costs are included in our insurance coverage, we expended $188,000, $215,000, $296,000, $128,000 and $96,000 in 2005, 2006, 2007, 2008 and 2009, respectively, and $84,000 and $85,000 in the nine months ended September 30, 2010 and 2009, respectively, to administer the asbestos claims and defend the ACE Lawsuit discussed below. These amounts were primarily fees paid to attorneys to monitor the activities of the insurers, and their selected defense counsel, and to look after our rights under the various insurance policies.

As of December 31, 2009, we re-evaluated our estimates to take into account our experience in 2009. Primarily as a result of the increase in the number of new cases commenced during 2009 which exceeded our previous estimates, we projected that there would be 986 asbestos-related injury claims made against the Company after December 31, 2009. The 986 projected claims, in addition to the 239 claims existing as of December 31, 2009, totals 1,225 current and future claims. Multiplying the average indemnity per resolved claim over the past nine full calendar years of $21,130, times 1,225, we projected the probable future indemnity to be paid on those claims after December 31, 2009 to be equal to approximately $26,000,000. In addition, multiplying an estimated cost of defense per resolved claim of approximately $21,000 times 1,225, we projected the probable future defense costs to equal approximately $26,000,000. Accordingly, our total estimated future asbestos-related liability at December 31, 2009 was $52,000,000.

As of December 31, 2009 we projected that approximately 158 new asbestos-related claims would be commenced and approximately 179 cases will be resolved in 2010, resulting in an estimated 218 cases pending at December 31, 2010. Since we projected that an aggregate of 986 new cases would be commenced after December 31, 2009, and that 158 of these cases would be commenced in 2010, we estimated that an aggregate of 828 new cases will be commenced after December 31, 2010. Accordingly, we projected the cases pending and projected to be commenced in the future at December 31, 2010, would be 1,046 cases. The sum of the approximate average indemnity paid per resolved claim from 2001 through 2009, plus the approximate defense costs incurred per resolved claim from 2005 through 2009, equals $42,130. Multiplying 1,046 claims times $42,130, we estimate our liability for current and future asbestos-related claims at December 31, 2010 to be approximately $44,000,000. This amounts to an $8,000,000 reduction from the $52,000,000 liability we estimated as of December 31, 2009, or a $2,000,000 reduction per quarter in 2010.

We intend to re-evaluate our estimate of future liability for asbestos claims at the end of each fiscal year, or whenever actual results are materially different from our estimates, integrating our actual experience in that fiscal year with that of prior fiscal years since 2001. Our estimate does not take into consideration the potential effects of economic inflation on either the average indemnity payment or the projected direct legal expenses.

There are numerous insurance carriers which have issued a number of policies to us over a period extending from approximately 1967 through approximately 1985 that still provide coverage for asbestos-related injury claims. After approximately 1985 the policies were issued with provisions which purport to exclude coverage for asbestos related claims. The terms of our insurance policies are complex, and coverage for many types of claims is limited as to the nature of the claim and the amount of coverage available. It is clear, however, under California law, where the substantial majority of the asbestos-related injury claims are litigated, that all of those policies cover any asbestos-related injury occurring during the 1967 through 1985 period when these policies were in force.

We have determined that the minimum probable insurance coverage available to satisfy asbestos-related injury claims exceeds our estimated future liability for such claims of $46,000,000 and $52,000,000 as of September 30, 2010 and December 31, 2009, respectively. This determination assumes that the general trend of reducing asbestos-related injury claims experienced prior to 2006 will resume and that the average indemnity and direct legal costs of each resolved claim will not materially increase. The determination also assumes that the insurance companies remain solvent and live up to what we believe is their obligation to continue to cover our exposure with regards to these claims. Accordingly, we have included $46,000,000 and $52,000,000 of such insurance coverage receivable as an asset on our September 30, 2010 and December 31, 2009 balance sheets, respectively. Several affiliated insurance companies have brought a declaratory relief action against our subsidiary, Metalclad, as well as a number of other insurers, to resolve certain coverage issues, as discussed below. Regardless of our best estimates of liability for current and future asbestos-related claims, the liability for these claims could be higher or lower than estimated by amounts which are not predictable. We, of course, cannot give any assurance that our liability for such claims will not ultimately exceed our available insurance coverage. We will update our estimates of insurance coverage in future filings with the Securities and Exchange Commission, as events occur which would cause us to believe that those estimates need revision, based upon the subsequent claim experience, using the methodology we have employed.

On February 23, 2005 ACE Property & Casualty Company ("ACE"), Central National Insurance Company of Omaha ("Central National") and Industrial Underwriters Insurance Company ("Industrial"), which are all related entities, filed a declaratory relief lawsuit (“the ACE Lawsuit”) against Metalclad Insulation Corporation (“Metalclad”) and a number of Metalclad's other liability insurers, in the Superior Court of the State of California, County of Los Angeles. ACE, Central National and Industrial issued umbrella and excess policies to Metalclad, which has sought and obtained from the plaintiffs both defense and indemnity under these policies for the asbestos lawsuits brought against Metalclad during the last four to five years. The ACE Lawsuit seeks declarations regarding a variety of coverage issues, but is centrally focused on issues involving whether historical and currently pending asbestos lawsuits brought against Metalclad are subject to either an "aggregate" limits of liability or separate "per occurrence" limits of liability. Whether any particular asbestos lawsuit is properly classified as being subject to an aggregate limit of liability depends upon whether or not the suit falls within the "products" or "completed operations" hazards found in most of the liability policies issued to Metalclad. Resolution of these classification issues will determine if, as ACE and Central National allege, their policies are nearing exhaustion of their aggregate limits and whether or not other Metalclad insurers who previously asserted they no longer owed any coverage obligations to Metalclad because of the claimed exhaustion of their aggregate limits, in fact, owe Metalclad additional coverage obligations. The ACE Lawsuit does not seek any monetary recovery from Metalclad. The ACE Lawsuit is principally about coverage responsibility among the several insurers, as well as total coverage. Regardless of the outcome of this litigation, Entrx does not believe that the ACE Lawsuit will result in materially diminishing Entrx’s insurance coverage for asbestos-related claims. Nonetheless, we anticipate that we will incur attorney’s fees and other associated litigation costs in defending the lawsuit and any counter claims made against us by any other insurers, and in prosecuting any claims we may seek to have adjudicated regarding our insurance coverage.

The ACE Lawsuit also seeks to determine the effect of a June 2004 settlement agreement between the Company and Allstate Insurance Company on the insurance obligations of various other insurers of Metalclad, and the effect of the “asbestos exclusion” in the Allstate policy. Under the settlement agreement the Company received $2,500,000 from Allstate in consideration of releasing Allstate from a potential liability under a $5,000,000 limits insurance policy. The ACE Lawsuit may result in our incurring costs in connection with obligations we may have to indemnify Allstate under that settlement agreement. Allstate, in a cross-complaint filed against Metalclad Insulation Corporation in October, 2005, asked the court to determine the Company’s obligation to assume and pay for the defense of Allstate in the ACE Lawsuit under the Company’s indemnification obligations in the settlement agreement. The Company does not believe that it has any legal obligation to assume or pay for such defense. If Allstate is required to provide indemnity for Entrx’s asbestos-related lawsuits, it is likely that Entrx would have to indemnify Allstate for asbestos-related claims that it defends up to $2,500,000 in the aggregate. If Allstate is not required to provide indemnity, Entrx would have no liability to Allstate. Entrx has accrued $375,000 as a potential loss in connection with the Allstate matter.

The Company projects that cash flow generated through the operation of its subsidiary, Metalclad Insulation Corporation, and the Company’s net cash assets as of September 30, 2010 will be sufficient to meet the Company’s cash requirements for at least the next twelve months.

Significant Accounting Policies

Our significant accounting policies are described in Note 1 to the consolidated financial statements included in our annual report for the year ended December 31, 2009. The accounting policies used in preparing our interim 2010 consolidated condensed financial statements are the same as those described in our annual report.

Our critical accounting policies are those both having the most impact to the reporting of our financial condition and results, and requiring significant judgments and estimates. Our critical accounting policies include those related to (a) revenue recognition, (b) allowances for uncollectible accounts receivable, (c) judgments and estimates used in determining the amount of our asbestos liability, and (d) evaluation and estimates of our probable insurance coverage for asbestos-related claims. Revenue recognition for fixed price insulation installation and asbestos abatement contracts are accounted for by the percentage-of-completion method, wherein costs and estimated earnings are included in revenues as the work is performed. If a loss on a fixed price contract is indicated, the entire amount of the estimated loss is accrued when known. Revenue recognition on time and material contracts is recognized based upon the amount of work performed. Accounts receivable are reduced by an allowance for amounts that may become uncollectible in the future. The estimated allowance for uncollectible amounts is based primarily on our evaluation of the financial condition of the customer. Future changes in the financial condition of a customer may require an adjustment to the allowance for uncollectible accounts receivable. We have estimated the probable amount of future claims related to our asbestos liability and the probable amount of insurance coverage related to those claims. We offset proceeds received from our insurance carriers resulting from claims of personal injury allegedly related to asbestos exposure against the payment issued to the plaintiff. The cash from the insurance company goes directly to the plaintiff, so we never have access to this cash. We never have control over any of the funds the insurance company issues to the plaintiff. Once a claim is settled, payment of the claim is normally made by the insurance carrier or carriers within 30 to 60 days. Changes in any of the judgments and estimates could have a material impact on our financial condition and results of operations.

Recent Accounting Pronouncements

See footnote 10 of the financial statements.

Item 4T. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We have established disclosure controls and procedures to ensure that material information relating to the Company is made known to the officers who certify the financial statements and to other members of senior management and the Audit Committee of the Board.

We conducted an evaluation, under the supervision and with the participation of our chief executive officer and chief financial officer of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based on this evaluation our chief executive officer and chief financial officer have concluded that, as of September 30, 2010, our disclosure controls and procedures are effective.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal controls over financial reporting for the three-months ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

Asbestos-related Claims

Prior to 1975, we were engaged in the sale and installation of asbestos-related insulation materials, which has resulted in numerous claims of personal injury allegedly related to asbestos exposure. Some of these claims are now being brought by the children and close relatives of persons who have died, allegedly as a result of the direct or indirect exposure to asbestos. To date all of our asbestos-related injury claims have been paid and defended by our insurance carriers.

The number of asbestos-related cases which have been initiated naming us (primarily our subsidiary, Metalclad Insulation Corporation) as a defendant have fluctuated from 199 in 2005, to 232 in 2006, to 163 in 2007, to 187 in 2008, and to 188 in 2009. There were 100 new claims made in the first nine months of 2010, compared to 150 in the first nine months of 2009. As of December 31, 2009, there were 239 cases pending and as of September 30, 2010 there were 202 cases pending. These claims are currently defended and covered by insurance.

Set forth below is a table for the years ended December 31, 2006, 2007, 2008, 2009 and the nine months ended September 30, 2010, which sets forth for each such period the approximate number of asbestos-related cases initiated, the number of such cases resolved by dismissal or by trial, the number of such cases resolved by settlement, the total number of resolved cases, the number of initiated cases pending at the end of such period, the total indemnity paid on all resolved cases, the average indemnity paid on all settled cases and the average indemnity paid on all resolved cases:

| | 2006 | 2007 | 2008 | 2009 | Nine Months Ended September 30, 2010 |
|---|---|---|---|---|---|
| New cases initiated | 232 | 163 | 187 | 188 | 100 |
| Defense judgments and dismissals | 253 | 292(3) | 109 | 168 | 96 |
| Plaintiff judgments and settled cases | 82 | 53 | 29 | 52 | 41 |
| Total resolved cases (1) | 335 | 345(3) | 138 | 220 | 137 |
| Pending cases (1) | 404 | 222(3) | 271 | 239 | 202 |
| Total indemnity payments | $ 4,858,750 | $ 7,974,500 | $ 7,582,550(2) | $ 5,345,000 | $ 3,332,000 |
| Average indemnity paid on plaintiff judgments and settled cases | $ 59,253 | $ 150,462 | $ 261,467(2) | $ 102,788 | $ 81,268 |
| Average indemnity paid on all resolved cases | $ 14,504 | $ 23,114 | $ 54,946 | $ 24,295 | $ 24,321 |

(1) Total resolved cases includes, and the number of pending cases excludes, cases which have been settled but which have not been closed for lack of final documentation or payment.

(2) The total and average indemnity amounts paid on resolved cases in 2008 includes an award rendered on April 4, 2005, finding Metalclad Insulation Corporation liable for $1,117,000 in damages. The judgment was appealed by our insurer, and a final order and judgment of $1,659,000 was rendered in 2008.

(3) Included in the decrease from 404 cases pending at December 31, 2006 to 222 cases pending at December 31, 2007, were 53 cases which had been previously counted in error and are included in “Defense judgments and dismissals” and “Total resolved cases”, so that the actual decrease for the year ended December 31, 2007 was 129 cases.

Under current accounting rules we are required to estimate our liability for existing and future asbestos-related claims. This requires that we estimate the number of claims we believe will be brought in the future. We previously based our estimates on the downward trend of cases brought from 725 cases brought in 2001, to 199 cases brought in 2005. This downward trend leveled off somewhat from 2006 through 2009. In addition, we have experienced increases in our costs to defend and resolve claims during this period. As a result, we have found it necessary to increase our projections of our liabilities for cases which are pending and for new cases which may be initiated in the future, with respect to each of our 2006, 2008 and 2009 financial statements. We believe that the leveling off of cases brought in 2005 through 2009 is largely due to an aggressive campaign waged by plaintiffs’ lawyers in an attempt to identify new plaintiffs, and that as the pool of plaintiffs decreases that it is probable that the downward trend experienced prior to 2006 will resume, although such resumption cannot be assured.

From 2001 and through 2009, the annual average indemnity paid on each of over 3,000 resolved cases has fluctuated significantly, between a low of $14,504 in 2006 and a high of $54,946 in 2008, with an overall average over that period of approximately $21,130. During this period, although there has been no discernible upward or downward trend in indemnity payments, our most recent indemnity payment experience in 2009 and 2010 of approximately $24,000 per resolved claim has been slightly less favorable than the $21,130 projected.

We believe that the sympathies of juries, the aggressiveness of the plaintiffs’ bar and the declining base of potential defendants as the result of business failures, have tended to increase payments on resolved cases. This tendency, we believe, has been mitigated by the declining pool of claimants resulting from death, and the likelihood that the most meritorious claims have been ferreted out by plaintiffs’ attorneys. We expect that the newer cases being brought will not be as meritorious and have as high a potential for damages as cases which were brought earlier. We have no reason to believe, therefore, that the average future indemnity payments will increase materially in the future.

In addition, direct defense costs per resolved claim increased from a low of $8,514 in 2003 to a high of $44,490 in 2008. The weighted average defense cost per resolved claim from 2005 through 2009 was $20,988. We believe that these defense costs increased as a result of a change in legal counsel in 2004, and the more aggressive defense posture taken by new legal counsel since that change. We intend to monitor the defense costs in 2010 and will adjust our estimates if events occur which would cause us to believe that those estimates need revision. We are currently projecting those costs to be approximately $21,000 per claim.

Although defense costs are included in our insurance coverage, we expended $188,000, $215,000, $296,000, $128,000 and $96,000 in 2005, 2006, 2007, 2008 and 2009, respectively, and $84,000 and $85,000 in the nine months ended September 30, 2010 and 2009, respectively, to administer the asbestos claims and defend the ACE Lawsuit discussed below. These amounts were primarily fees paid to attorneys to monitor the activities of the insurers, and their selected defense counsel, and to look after our rights under the various insurance policies.

As of December 31, 2009, we re-evaluated our estimates to take into account our experience in 2009. Primarily as a result of the increase in the number of new cases commenced during 2009 which exceeded our previous estimates, we projected that there would be 986 asbestos-related injury claims made against the Company after December 31, 2009. The 986 projected claims, in addition to the 239 claims existing as of December 31, 2009, totals 1,225 current and future claims. Multiplying the average indemnity per resolved claim over the past nine full calendar years of $21,130, times 1,225, we projected the probable future indemnity to be paid on those claims after December 31, 2009 to be equal to approximately $26,000,000. In addition, multiplying an estimated cost of defense per resolved claim of approximately $21,000 times 1,225, we projected the probable future defense costs to equal approximately $26,000,000. Accordingly, our total estimated future asbestos-related liability at December 31, 2009 was $52,000,000.

As of December 31, 2009 we projected that approximately 158 new asbestos-related claims would be commenced and approximately 179 cases will be resolved in 2010, resulting in an estimated 218 cases pending at December 31, 2010. Since we projected that an aggregate of 986 new cases would be commenced after December 31, 2009, and that 158 of these cases would be commenced in 2010, we estimated that an aggregate of 828 new cases will be commenced after December 31, 2010. Accordingly, we projected the cases pending and projected to be commenced in the future at December 31, 2010, would be 1,046 cases. The sum of the approximate average indemnity paid per resolved claim from 2001 through 2009 plus the approximate defense costs incurred per resolved claim from 2005 through 2009, equals $42,130. Multiplying 1,046 claims times $42,130 we estimate our liability for current and future asbestos-related claims at December 31, 2010 to be approximately $44,000,000. This amounts to an $8,000,000 reduction from the $52,000,000 liability we estimated as of December 31, 2009, or a $2,000,000 reduction per quarter in 2010.

We intend to re-evaluate our estimate of future liability for asbestos claims at the end of each fiscal year, or whenever actual results are materially different from our estimates, integrating our actual experience in that fiscal year with that of prior fiscal years since 2001. Our estimate does not take into consideration the potential effects of economic inflation on either the average indemnity payment or the projected direct legal expenses.

There are numerous insurance carriers which have issued a number of policies to us over a period extending from approximately 1967 through approximately 1985 that still provide coverage for asbestos-related injury claims. After approximately 1985 the policies were issued with provisions which purport to exclude coverage for asbestos related claims. The terms of our insurance policies are complex, and coverage for many types of claims is limited as to the nature of the claim and the amount of coverage available. It is clear, however, under California law, where the substantial majority of the asbestos-related injury claims are litigated, that all of those policies cover any asbestos-related injury occurring during the 1967 through 1985 period when these policies were in force.

We have determined that the minimum probable insurance coverage available to satisfy asbestos-related injury claims exceeds our estimated future liability for such claims of $46,000,000 and $52,000,000 as of September 30, 2010 and December 31, 2009, respectively. This determination assumes that the general trend of reducing asbestos-related injury claims experienced prior to 2006 will resume and that the average indemnity and direct legal costs of each resolved claim will not materially increase. The determination also assumes that the insurance companies remain solvent and live up to what we believe is their obligation to continue to cover our exposure with regards to these claims. Accordingly, we have included $46,000,000 and $52,000,000 of such insurance coverage receivable as an asset on our September 30, 2010 and December 31, 2009 balance sheets, respectively. Several affiliated insurance companies have brought a declaratory relief action against our subsidiary, Metalclad, as well as a number of other insurers, to resolve certain coverage issues, as discussed below. Regardless of our best estimates of liability for current and future asbestos-related claims, the liability for these claims could be higher or lower than estimated by amounts which are not predictable. We, of course, cannot give any assurance that our liability for such claims will not ultimately exceed our available insurance coverage. We will update our estimates of insurance coverage in future filings with the Securities and Exchange Commission, as events occur which would cause us to believe that those estimates need revision, based upon the subsequent claim experience, using the methodology we have employed.

Insurance Coverage Litigation

On February 23, 2005 ACE Property & Casualty Company ("ACE"), Central National Insurance Company of Omaha ("Central National") and Industrial Underwriters Insurance Company ("Industrial"), which are all related entities, filed a declaratory relief lawsuit ("the ACE Lawsuit") against Metalclad Insulation Corporation ("Metalclad") and a number of Metalclad's other liability insurers, in the Superior Court of the State of California, County of Los Angeles. ACE, Central National and Industrial issued umbrella and excess policies to Metalclad, which has sought and obtained from the plaintiffs both defense and indemnity under these policies for the asbestos lawsuits brought against Metalclad during the last four to five years. The ACE Lawsuit seeks declarations regarding a variety of coverage issues, but is centrally focused on issues involving whether historical and currently pending asbestos lawsuits brought against Metalclad are subject to either an "aggregate" limits of liability or separate "per occurrence" limits of liability. Whether any particular asbestos lawsuit is properly classified as being subject to an aggregate limit of liability depends upon whether or not the suit falls within the "products" or "completed operations" hazards found in most of the liability policies issued to Metalclad. Resolution of these classification issues will determine if, as ACE and Central National allege, their policies are nearing exhaustion of their aggregate limits and whether or not other Metalclad insurers who previously asserted they no longer owed any coverage obligations to Metalclad because of the claimed exhaustion of their aggregate limits, in fact, owe Metalclad additional coverage obligations. The ACE Lawsuit does not seek any monetary recovery from Metalclad. The ACE Lawsuit is principally about coverage responsibility among the several insurers, as well as total coverage. Regardless of the outcome of this litigation, Entrx does not believe that the ACE Lawsuit will result in materially diminishing Entrx's insurance coverage for asbestos-related claims. Nonetheless, we anticipate that we will incur attorney's fees and other associated litigation costs in defending the lawsuit and any counter claims made against us by any other insurers, and in prosecuting any claims we may seek to have adjudicated regarding our insurance coverage.

The ACE Lawsuit also seeks to determine the effect of a June 2004 settlement agreement between the Company and Allstate Insurance Company on the insurance obligations of various other insurers of Metalclad, and the effect of the "asbestos exclusion" in the Allstate policy. Under the settlement agreement the Company received $2,500,000 from Allstate in consideration of releasing Allstate from a potential liability under a $5,000,000 limits insurance policy. The ACE Lawsuit may result in our incurring costs in connection with obligations we may have to indemnify Allstate under that settlement agreement. Allstate, in a cross-complaint filed against Metalclad Insulation Corporation in October, 2005, asked the court to determine the Company's obligation to assume and pay for the defense of Allstate in the ACE Lawsuit under the Company's indemnification obligations in the settlement agreement. The Company does not believe that it has any legal obligation to assume or pay for such defense. If Allstate is required to provide indemnity for Entrx's asbestos-related lawsuits, it is likely that Entrx would have to indemnify Allstate for asbestos-related claims that it defends up to $2,500,000 in the aggregate. If Allstate is not required to provide indemnity, Entrx would have no liability to Allstate. Entrx has accrued $375,000 as a potential loss in connection with the Allstate matter.

Item 5. Exhibits

Exhibits

| | |
|---|---|
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer. |
| 31.2 | Rule 13a-14(a) Certification of Chief Financial Officer. |
| 32 | Section 1350 Certification. |

18

SIGNATURES

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

ENTRX CORPORATION

| | | |
|---|---|---|
| Date: November 11, 2010 | By: | /s/Peter L. Hauser<br>Peter L. Hauser<br>Chief Executive Officer |
| Date: November 11, 2010 | By: | /s/Brian D. Niebur<br>Brian D. Niebur |
| | | Cloyce A. Talbott (President & Chief Executive Officer and Director) (Messrs. Siegel and Talbott, collectively, the Group A Executive Officers ); |
| | | Kenneth N. Berns (Senior Vice President and Director); and |
| | | John E. Vollmer III (Senior Vice President Corporate Development, Chief Financial Officer and Treasurer) (Messrs. Berns and Vollmer, collectively, the Group B Executive Officers ). |

Each Group A Executive Officer would be allocated one-third of the Allocated Bonus Amount and each Group B Executive Officer would be allocated one-sixth of the Allocated Bonus Amount, however, the Compensation Committee expressly retained the ability to reduce the Allocated Bonus Amount at its discretion.

## PART III

The information required by Part III is omitted from this Report because we will file a definitive proxy statement pursuant to Regulation 14A of the Securities Exchange Act of 1934 no later than 120 days after the end of the fiscal year covered by this Report and certain information included therein is incorporated herein by reference.

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

The information required by this Item is incorporated herein by reference to the Proxy Statement.

**Item 11.** ***Executive Compensation.***

The information required by this Item is incorporated herein by reference to the Proxy Statement.

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

The information required by this Item is incorporated herein by reference to the Proxy Statement.

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

The information required by this Item is incorporated herein by reference to the Proxy Statement.

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

The information required by this Item is incorporated herein by reference to the Proxy Statement.

## PART IV

**Item 15.** ***Exhibits and Financial Statement Schedule.***

(a)(1) *Financial Statements*

See Index to Consolidated Financial Statements on page F-1 of this Report.

(a)(2) *Financial Statement Schedule*

Schedule II Valuation and qualifying accounts is filed herewith on page S-1.

All other financial statement schedules have been omitted because they are not applicable or the information required therein is included elsewhere in the financial statements or notes thereto.

(a)(3) *Exhibits*

The following exhibits are filed herewith or incorporated by reference herein.

| | |
|---|---|
| 3.1 | Restated Certificate of Incorporation, as amended (filed August 9, 2004 as Exhibit 3.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference). |
| 3.2 | Amendment to Restated Certificate of Incorporation, as amended (filed August 9, 2004 as Exhibit 3.2 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference). |
| 3.3 | Amended and Restated Bylaws (filed March 19, 2002 as Exhibit 3.2 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2001 and incorporated herein by reference). |
| 4.1 | Rights Agreement dated January 2, 1997, between Patterson Energy, Inc. and Continental Stock Transfer & Trust Company (filed January 14, 1997 as Exhibit 2 to the Company s Registration Statement on Form 8-A and incorporated herein by reference). |
| 4.2 | Amendment to Rights Agreement dated as of October 23, 2001 (filed October 31, 2001 as Exhibit 3.4 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2001 and incorporated herein by reference). |
| 4.3 | Restated Certificate of Incorporation, as amended (See Exhibits 3.1 and 3.2). |
| 4.4 | Registration Rights Agreement with Bear, Stearns and Co. Inc., dated March 25, 1994, as assigned by REMY Capital Partners III, L.P.(filed March 19, 2002 as Exhibit 4.3 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2001 and incorporated herein by reference). |
| 10.1 | For additional material contracts, see Exhibits 4.1, 4.2 and 4.4. |
| 10.2 | Patterson-UTI Energy, Inc., 1993 Stock Incentive Plan, as amended (filed March 13, 1998 as Exhibit 10.1 to the Company s Registration Statement on Form S-8 (File No. 333-47917) and incorporated herein by reference).* |
| 10.3 | Patterson-UTI Energy, Inc. Non-Employee Directors Stock Option Plan, as amended (filed November 4, 1997 as Exhibit 10.1 to the Company s Registration Statement on Form S-8 (File No. 333-39471) and incorporated herein by reference).* |
| 10.4 | Amended and Restated Patterson-UTI Energy, Inc. 2001 Long-Term Incentive Plan (filed November 27, 2002 as Exhibit 4.4 to Post Effective Amendment No. 1 to the Company s Registration Statement on Form S-8 (File No. 333-60470) and incorporated herein by reference).* |
| 10.5 | |

Patterson-UTI Energy, Inc. Amended and Restated 1997 Long-Term Incentive Plan (filed July 28, 2003 as Exhibit 4.7 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003 and incorporated herein by reference).*

10.6 Amendment to the Patterson-UTI Energy, Inc. Amended and Restated 1997 Long-Term Incentive Plan (filed August 9, 2004 as Exhibit 10.7 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).*

10.7 Amended and Restated Patterson-UTI Energy, Inc. Non-Employee Director Stock Option Plan(filed July 28, 2003 as Exhibit 4.8 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003 and incorporated herein by reference).*

10.8 Amended and Restated Patterson-UTI Energy, Inc. 1996 Employee Stock Option Plan (filed July 25, 2001 as Exhibit 4.4 to Post-Effective Amendment No. 1 to the Company s Registration Statement on Form S-8 (File No. 333-60466) and incorporated herein by reference).*

10.9 Patterson-UTI Energy, Inc. 2005 Long-Term Incentive Plan, including Form of Executive Officer Restricted Stock Award Agreement, Form of Executive Officer Stock Option Agreement, Form of Non-Employee Director Restricted Stock Award Agreement and Form of Non-Employee Director Stock Option Agreement (filed June 15, 2005 as Exhibit 10.1 to the Company s Current Report on Form 8-K, and incorporated herein by reference).*

10.10 Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and Mark S. Siegel (filed August 9, 2004 as Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).*

10.11 Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and Cloyce A. Talbott (filed August 9, 2004 as Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).*

10.12 Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and A. Glenn Patterson (filed August 9, 2004 as Exhibit 10.3 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).*

10.13 Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and Kenneth N. Berns (filed August 9, 2004 as Exhibit 10.4 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).*

10.14 Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and John E. Vollmer III (filed August 9, 2004 as Exhibit 10.6 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).*

10.15 Patterson-UTI Energy, Inc. Change in Control Agreement, effective as of January 29, 2004, by and between Patterson-UTI Energy, Inc. and Mark S. Siegel (filed on February 4, 2004 as Exhibit 10.2 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).*

10.16 Employment Agreement, effective as of May 3, 2006 between Patterson-UTI Energy, Inc. and A. Glenn Patterson (filed on May 5, 2006 as Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006 and incorporated herein by reference).*

10.17 Patterson-UTI Energy, Inc. Change in Control Agreement, effective as of January 29, 2004, by and between Patterson-UTI Energy, Inc. and Cloyce A. Talbott (filed on February 4, 2004 as Exhibit 10.4 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).*

10.18 Patterson-UTI Energy, Inc. Change in Control Agreement, effective as of January 29, 2004, by and between Patterson-UTI Energy, Inc. and Kenneth N. Berns (filed on February 4, 2004 as Exhibit 10.5 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).*

10.19 Patterson-UTI Energy, Inc. Change in Control Agreement, effective as of January 29, 2004, by and between Patterson-UTI Energy, Inc. and John E. Vollmer III (filed on February 4, 2004 as Exhibit 10.7 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).*

10.20 Form of Letter Agreement regarding termination, effective as of January 29, 2004, entered into by Patterson-UTI Energy, Inc. with each of Mark S. Siegel, Kenneth N. Berns and John E. Vollmer III (filed on February 25, 2005 as Exhibit 10.23 to the Company s Annual Report on Form 10-K for the year ended December 31, 2004 and incorporated herein by reference).*

10.21 Form of Indemnification Agreement entered into by Patterson-UTI Energy, Inc. with each of Mark S. Siegel, Cloyce A. Talbott, A. Glenn Patterson, Kenneth N. Berns, Robert C. Gist, Curtis W. Huff, Terry

H. Hunt, Kenneth R. Peak, Nadine C. Smith and John E. Vollmer III (filed April 28, 2004 as Exhibit 10.11 to the Company s Annual Report on Form 10-K, as amended, for the year ended December 31, 2003 and incorporated herein by reference).*

| | |
|---|---|
| 10.22 | Credit Agreement dated as of December 17, 2004 among Patterson-UTI Energy, Inc., as the Borrower, Bank of America, N.A., as administrative agent, L/C Issuer and a Lender and the other lenders and agents party thereto (filed on December 23, 2004 as Exhibit 10.1 to the Company s Current Report on Form 8-K and incorporated herein by reference). |
| 10.23 | Commitment Increase and Joinder Agreement, dated as of August 2, 2006, by and among Patterson-UTI Energy, Inc., the guarantors party thereto, the lenders party thereto, and Bank of America, N.A. as Administrative Agent, L/C Issuer and Lender (filed August 21, 2006 as Exhibit 10.1 to the Company s Current Report on Form 8-K and incorporated herein by reference). |
| 10.24 | Letter Agreement dated February 6, 2006 between Patterson-UTI Energy, Inc. and John E. Vollmer III (filed May 1, 2006 as Exhibit 10.25 to the Company s Annual Report on Form 10-K, as amended, and incorporated herein by reference).* |
| 14.1 | Patterson-UTI Energy, Inc. Code of Business Conduct and Ethics for Senior Financial Executives (filed on February 4, 2004 as Exhibit 14.1 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference). |
| 21.1 | Subsidiaries of the Registrant. |
| 23.1 | Consent of Independent Registered Public Accounting Firm. |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

* Management Contract or Compensatory Plan identified as required by Item 15(a)(3) of Form 10-K.

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of
Patterson-UTI Energy, Inc.:

We have completed integrated audits of Patterson-UTI Energy, Inc. s consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Patterson-UTI Energy, Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management s assessment, included in Management s Report on Internal Control over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the COSO. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP
Houston, Texas
February 26, 2007

**PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

| | December 31, 2006 | December 31, 2005 |
|---|---|---|
| | (In thousands, except share data) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 13,385 | $ 136,398 |
| Accounts receivable, net of allowance for doubtful accounts of $7,484 and $2,199 at December 31, 2006 and 2005, respectively | 484,106 | 422,002 |
| Accrued Federal and state income taxes receivable | 5,448 | |
| Inventory | 43,947 | 27,907 |
| Deferred tax assets, net | 48,868 | 26,382 |
| Deposit on equipment purchase contract | 24,746 | |
| Other | 32,170 | 25,168 |
| Total current assets | 652,670 | 637,857 |
| Property and equipment, at cost, net | 1,435,804 | 1,053,845 |
| Goodwill | 99,056 | 99,056 |
| Other | 4,973 | 5,023 |
| Total assets | $ 2,192,503 | $ 1,795,781 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable: | | |
| Trade | $ 138,372 | $ 113,226 |
| Accrued revenue distributions | 15,359 | 13,379 |
| Other | 18,424 | 5,294 |
| Accrued Federal and state income taxes payable | | 11,034 |
| Accrued expenses | 145,463 | 112,476 |
| Total current liabilities | 317,618 | 255,409 |
| Borrowings under line of credit | 120,000 | |
| Deferred tax liabilities, net | 187,960 | 169,188 |
| Other | 4,459 | 4,173 |
| Total liabilities | 630,037 | 428,770 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Preferred stock, par value $.01; authorized 1,000,000 shares, no shares issued | | |
| | 1,766 | 1,759 |

| | | |
|---|---|---|
| Common stock, par value $.01; authorized 300,000,000 shares with 176,656,401 and 175,909,274 issued and 156,542,512 and 172,441,178 outstanding at December 31, 2006 and 2005, respectively | | |
| Additional paid-in capital | 681,069 | 672,151 |
| Deferred compensation | | (9,287) |
| Retained earnings | 1,346,542 | 719,113 |
| Accumulated other comprehensive income, net of tax | 8,390 | 8,565 |
| Treasury stock, at cost, 20,113,889 shares and 3,468,096 shares at December 31, 2006 and 2005, respectively | (475,301) | (25,290) |
| Total stockholders equity | 1,562,466 | 1,367,011 |
| Total liabilities and stockholders equity | $ 2,192,503 | $ 1,795,781 |

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

**PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| | (In thousands, except per share data) | | |
| Operating revenues: | | | |
| Contract drilling | $ 2,169,370 | $ 1,485,684 | $ 809,691 |
| Pressure pumping | 145,671 | 93,144 | 66,654 |
| Drilling and completion fluids | 192,358 | 122,011 | 90,557 |
| Oil and natural gas | 39,187 | 39,616 | 33,867 |
| | 2,546,586 | 1,740,455 | 1,000,769 |
| Operating costs and expenses: | | | |
| Contract drilling | 1,002,001 | 776,313 | 556,869 |
| Pressure pumping | 77,755 | 54,956 | 37,561 |
| Drilling and completion fluids | 150,372 | 98,530 | 76,503 |
| Oil and natural gas | 13,374 | 9,566 | 7,978 |
| Depreciation, depletion and impairment | 196,370 | 156,393 | 122,800 |
| Selling, general and administrative | 55,065 | 39,110 | 31,983 |
| Embezzlement costs, net of recoveries | 3,081 | 20,043 | 19,122 |
| Other operating expenses | 9,404 | 4,248 | (514) |
| | 1,507,422 | 1,159,159 | 852,302 |
| Operating income | 1,039,164 | 581,296 | 148,467 |
| Other income (expense): | | | |
| Interest income | 5,925 | 3,551 | 1,140 |
| Interest expense | (1,602) | (516) | (695) |
| Other | 347 | 428 | 235 |
| | 4,670 | 3,463 | 680 |
| Income before income taxes and cumulative effect of change in accounting principle | 1,043,834 | 584,759 | 149,147 |
| Income tax expense (benefit): | | | |
| Current | 375,373 | 194,918 | 39,952 |
| Deferred | (4,106) | 17,101 | 14,849 |
| | 371,267 | 212,019 | 54,801 |
| Income before cumulative effect of change in accounting principle | 672,567 | 372,740 | 94,346 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Cumulative effect of change in accounting principle, net of related income tax expense of $398 | | 687 | | | | |
| Net income | $ | 673,254 | $ | 372,740 | $ | 94,346 |
| Net income per common share: | | | | | | |
| Basic: | | | | | | |
| Income before cumulative effect of change in accounting principle | $ | 4.07 | $ | 2.19 | $ | 0.57 |
| Cumulative effect of change in accounting principle | $ | | $ | | $ | |
| Net income | $ | 4.08 | $ | 2.19 | $ | 0.57 |
| Diluted: | | | | | | |
| Income before cumulative effect of change in accounting principle | $ | 4.02 | $ | 2.15 | $ | 0.56 |
| Cumulative effect of change in accounting principle | $ | | $ | | $ | |
| Net income | $ | 4.02 | $ | 2.15 | $ | 0.56 |
| Weighted average number of common shares outstanding: | | | | | | |
| Basic | | 165,159 | | 170,426 | | 166,258 |
| Diluted | | 167,413 | | 173,767 | | 169,211 |

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

**PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**

| | Common Stock Number of Shares | Common Stock Amount | Additional Paid-In Capital | Deferred Compensation | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total |
|---|---|---|---|---|---|---|---|---|
| | | | (In thousands) | | | | | |
| Balance, December 31, 2003 | 82,483 | $ 825 | $ 506,018 | $ | $ 290,237 | $ 4,389 | $ (11,655) | $ 789,814 |
| Issuance of common stock for acquisition | 1,388 | 14 | 49,462 | | | | | 49,476 |
| Issuance of restricted stock | 189 | 2 | 6,640 | (6,642) | | | | |
| Amortization of deferred compensation expense | | | | 1,222 | | | | 1,222 |
| Exercise of stock options and warrants | 2,580 | 25 | 24,494 | | | | | 24,519 |
| Tax benefit related to exercise of stock options | | | 10,666 | | | | | 10,666 |
| Foreign currency translation adjustment (net of tax of $1,716) | | | | | | 2,961 | | 2,961 |
| Purchase of treasury stock | | | | | | | (1,482) | (1,482) |
| Payment of cash dividend (see Note 10) | | | | | (10,021) | | | (10,021) |
| Effect of two-for-one stock split (see Note 10) | 84,986 | 850 | | | (850) | | | |
| Net income | | | | | 94,346 | | | 94,346 |
| | 171,626 | 1,716 | 597,280 | (5,420) | 373,712 | 7,350 | (13,137) | 961,501 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2004 | | | | | | | | |
| Issuance of restricted stock | 305 | 3 | 8,040 | (8,043) | | | | |
| Amortization of deferred compensation expense | | | | 2,825 | | | | 2,825 |
| Forfeitures of restricted shares | (65) | | (1,351) | 1,351 | | | | |
| Exercise of stock options | 4,043 | 40 | 43,434 | | | | | 43,474 |
| Tax benefit related to exercise of stock options | | | 24,748 | | | | | 24,748 |
| Foreign currency translation adjustment (net of tax of $705) | | | | | | 1,215 | | 1,215 |
| Purchase of treasury stock | | | | | | | (12,153) | (12,153) |
| Payment of cash dividend (see Note 10) | | | | | (27,339) | | | (27,339) |
| Net income | | | | | 372,740 | | | 372,740 |
| Balance, December 31, 2005 | 175,909 | 1,759 | 672,151 | (9,287) | 719,113 | 8,565 | (25,290) | 1,367,011 |
| Elimination of deferred compensation due to change in accounting principle | | | (9,287) | 9,287 | | | | |
| Issuance of restricted stock | 613 | 6 | (6) | | | | | |
| Forfeitures of restricted shares | (47) | (1) | 1 | | | | | |
| Exercise of stock options | 181 | 2 | 1,944 | | | | | 1,946 |
| Tax benefit related to exercise of stock options | | | 1,087 | | | | | 1,087 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Stock based compensation, net of cumulative effect of change in accounting principle | | | 15,179 | | | | | 15,179 |
| Foreign currency translation adjustment, (net of tax of $6) | | | | | | (175) | | (175) |
| Payment of cash dividend (see Note 10) | | | | | (45,825) | | | (45,825) |
| Purchase of treasury stock | | | | | | | (450,011) | (450,011) |
| Net income | | | | | 673,254 | | | 673,254 |
| Balance, December 31, 2006 | 176,656 | $ 1,766 | $ 681,069 | $ | $ 1,346,542 | $ 8,390 | $ (475,301) | $ 1,562,466 |

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

**PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN CASH FLOWS**

| | Years Ended December 31, 2006 | 2005 | 2004 |
|---|---|---|---|
| | (In thousands) | | |
| Cash flows from operating activities: | | | |
| Net income | $ 673,254 | $ 372,740 | $ 94,346 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation, depletion and impairment | 196,370 | 156,393 | 122,800 |
| Provision for bad debts | 5,400 | 1,231 | 897 |
| Dry holes and abandonments | 4,338 | | |
| Deferred income tax expense (benefit) | (3,708) | 17,101 | 14,849 |
| Tax benefit related to exercise of stock options | | 24,748 | 10,666 |
| Stock based compensation expense | 15,179 | 2,825 | 1,222 |
| (Gain) loss on disposal of assets | 3,819 | (1,253) | (1,411) |
| Changes in operating assets and liabilities, net of business acquired: | | | |
| Accounts receivable | (67,417) | (208,248) | (50,682) |
| Federal income taxes receivable/payable | (16,231) | 7,068 | 15,734 |
| Inventory and other current assets | (47,406) | (9,402) | (13,556) |
| Accounts payable | 27,184 | 60,860 | 12,861 |
| Accrued expenses | 32,972 | 32,514 | 1,555 |
| Other liabilities | 13,416 | 3,902 | (6,090) |
| Net cash provided by operating activities | 837,170 | 460,479 | 203,191 |
| Cash flows from investing activities: | | | |
| Acquisitions, net of cash acquired | | (73,577) | (30,387) |
| Purchases of property and equipment | (597,919) | (380,094) | (174,589) |
| Proceeds from disposal of property and equipment | 10,934 | 12,674 | 3,303 |
| Change in other assets | | 1,766 | (1,766) |
| Net cash used in investing activities | (586,985) | (439,231) | (203,439) |
| Cash flows from financing activities: | | | |
| Purchase of treasury stock | (450,011) | (12,153) | (1,482) |
| Dividends paid | (45,825) | (27,339) | (10,021) |
| Tax benefit related to exercise of stock options | 1,087 | | |
| Proceeds from borrowings under line of credit | 274,000 | | |
| Repayments on line of credit | (154,000) | | |
| Line of credit issuance costs | (342) | | (780) |
| Proceeds from exercise of stock options and warrants | 1,946 | 43,474 | 24,519 |
| Net cash provided by (used in) financing activities | (373,145) | 3,982 | 12,236 |

| | | | |
|---|---|---|---|
| Effect of foreign exchange rate changes on cash | (53) | (1,203) | (100) |
| Net increase (decrease) in cash and cash equivalents | (123,013) | 24,027 | 11,888 |
| Cash and cash equivalents at beginning of year | 136,398 | 112,371 | 100,483 |
| Cash and cash equivalents at end of year | $ 13,385 | $ 136,398 | $ 112,371 |
| Supplemental disclosure of cash flow information: | | | |
| Net cash paid during the year for: | | | |
| Interest expense | $ (1,278) | $ (418) | $ (245) |
| Income taxes | (377,847) | (156,709) | (12,500) |

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

F-7

**PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

## 1. Description of Business and Summary of Significant Accounting Policies

***A description of the business and basis of presentation follows:***

*Description of business* Patterson-UTI Energy, Inc., together with its wholly-owned subsidiaries, (collectively referred to herein as Patterson-UTI or the Company ) is a leading provider of onshore contract drilling services to major and independent oil and natural gas operators in Texas, New Mexico, Oklahoma, Arkansas, Louisiana, Mississippi, Colorado, Utah, Wyoming, Montana, North Dakota, South Dakota and Western Canada. The Company provides pressure pumping services to oil and natural gas operators primarily in the Appalachian Basin. The Company provides drilling fluids, completion fluids and related services to oil and natural gas operators offshore in the Gulf of Mexico and on land in Texas, Southeastern New Mexico, Oklahoma and the Gulf Coast region of Louisiana. The Company is also engaged in the development, exploration, acquisition and production of oil and natural gas. The Company s oil and natural gas business operates primarily in producing regions of West and South Texas, Southeastern New Mexico, Utah and Mississippi.

*Basis of presentation* The consolidated financial statements include the accounts of Patterson-UTI and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated. The Company has no controlling financial interests in any entity that is not a wholly-owned subsidiary which would require consolidation.

The U.S. dollar is the functional currency for all of the Company s operations except for its Canadian operations, which use the Canadian dollar as their functional currency. The effects of exchange rate changes are reflected in accumulated other comprehensive income, which is a separate component of stockholders equity.

On April 28, 2004, the Company s Board of Directors authorized a two-for-one stock split in the form of a stock dividend which was distributed on June 30, 2004 to holders of record on June 14, 2004. At June 30, 2004, an adjustment was made to reclassify an amount from retained earnings to common stock to account for the par value of the common stock issued as a stock dividend. This adjustment had no overall effect on equity. Historical net income per common share amounts included in the Statements of Income and elsewhere in these financial statements have been presented as if the two-for-one stock split had occurred on January 1, 2004.

***A summary of the significant accounting policies follows:***

*Management estimates* The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from such estimates.

*Revenue recognition* Revenues are recognized when services are performed, except for revenues earned under turnkey contract drilling arrangements which are recognized using the completed contract method of accounting, as described below. The Company follows the percentage-of-completion method of accounting for footage and daywork contract drilling arrangements. Under the percentage-of-completion method, management estimates are relied upon in the determination of the total estimated expenses to be incurred drilling the well. Due to the nature of turnkey contract drilling arrangements and risks therein, the Company follows the completed contract method of accounting for such arrangements. Under this method, all drilling revenues and expenses related to a well in progress are deferred and recognized in the period the well is completed. Provisions for losses on incomplete or in-process wells are made when estimated total expenses are expected to exceed estimated total revenues. The Company recognizes reimbursements received from third parties for out-of-pocket expenses incurred as revenues and accounts for these out-of-pocket expenses as direct costs.

*Accounts receivable* Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts represents the Company s estimate of the amount of probable credit losses existing in the Company s accounts receivable. The Company reviews the adequacy of its allowance for doubtful accounts monthly. Significant individual accounts receivable balances and balances which have been outstanding greater than 90 days are reviewed individually for collectibility. Account balances, when determined to be uncollectible, are charged against the allowance.

*Inventories* Inventories consist primarily of chemical products to be used in conjunction with the Company s drilling and completion fluids and pressure pumping activities. The inventories are stated at the lower of cost or market, determined by the first-in, first-out method.

*Property and equipment* Property and equipment is carried at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives. The method of depreciation does not change when equipment becomes idle. The estimated useful lives, in years, are defined below.

| | **Useful Lives** |
|---|---|
| Drilling rigs and related equipment | 2-15 |
| Office furniture | 3-10 |
| Buildings | 15-20 |
| Automotive equipment | 3-7 |
| Other | 3-12 |

*Oil and natural gas properties* Oil and natural gas properties are accounted for using the successful efforts method of accounting. Under the successful efforts method of accounting, exploration costs which result in the discovery of oil and natural gas reserves and all development costs are capitalized to the appropriate well. Exploration costs which do not result in discovering oil and natural gas reserves are charged to expense when such determination is made. Costs of exploratory wells are initially capitalized to wells in progress until the outcome of the drilling is known. The Company reviews wells in progress quarterly to determine whether sufficient progress is being made in assessing the reserves and the economic operating viability of the respective projects. If no progress has been made in assessing the reserves and the economic operating viability of a project after one year following the completion of drilling, the Company considers the costs of the well to be impaired and recognizes the costs as expense. Geological and geophysical costs, including seismic costs, and costs to carry and retain undeveloped properties are charged to expense when incurred. The capitalized costs of both developmental and successful exploratory type wells, consisting of lease and well equipment, lease acquisition costs and intangible development costs, are depreciated, depleted and amortized on the units-of-production method, based on engineering estimates of proved oil and natural gas reserves of each respective field. The Company reviews its proved oil and natural gas properties for impairment when an event occurs such as downward revisions in reserve estimates or decreases in oil and natural gas prices. Proved properties are grouped by field and undiscounted cash flow estimates are provided by an independent petroleum engineer. If the net book value of a field exceeds its undiscounted cash flow estimate, impairment expense is measured and recognized as the difference between its net book value and discounted cash flow. Unproved oil and natural gas properties are reviewed quarterly to determine impairment. The Company s intent to drill, lease expiration and abandonment of area are considered. Assessment of impairment is made on a lease-by-lease basis. If an unproved property is determined to be impaired, costs related to that property are expensed.

*Goodwill* Goodwill is considered to have an indefinite useful economic life and is not amortized. As such, the Company assesses impairment of its goodwill annually or on an interim basis if events or circumstances indicate that the fair value of the asset has decreased below its carrying value.

*Depreciation, depletion and impairment* The following table summarizes depreciation, depletion and impairment expense for 2006, 2005 and 2004 (in millions):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Depreciation expense | $ 181.6 | $ 141.7 | $ 109.4 |
| Depletion expense | 9.8 | 10.3 | 10.1 |
| Amortization expense | | | 0.1 |
| Impairment of oil and natural gas properties | 5.0 | 4.4 | 3.2 |
| Total | $ 196.4 | $ 156.4 | $ 122.8 |

*Maintenance and repairs* Maintenance and repairs are charged to expense when incurred. Renewals and betterments which extend the life or improve existing property and equipment are capitalized.

*Retirements* Upon disposition or retirement of property and equipment, the cost and related accumulated depreciation are removed and any resulting gain or loss is credited or charged to operations.

*Net income per common share* The Company provides a dual presentation of its net income per common share; Basic net income per common share ( Basic EPS ) and Diluted net income per common share ( Diluted EPS ). Basic EPS excludes dilution and is computed by dividing net income by the weighted average number of unrestricted common shares outstanding during the year. Diluted EPS is based on the weighted average number of common shares outstanding plus the impact of dilutive instruments, including stock options, warrants and restricted shares using the treasury stock method. The following table presents information necessary to calculate net income per share for the years ended December 31, 2006, 2005 and 2004 as well as cash dividends per share paid and potentially dilutive securities excluded from the weighted average number of diluted common shares outstanding as their inclusion would have been anti-dilutive (in thousands, except per share amounts):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Net income | $ 673,254 | $ 372,740 | $ 94,346 |
| Weighted average number of unrestricted common shares outstanding | 165,159 | 170,426 | 166,258 |
| Basic net income per common share | $ 4.08 | $ 2.19 | $ 0.57 |
| Weighted average number of unrestricted common shares outstanding | 165,159 | 170,426 | 166,258 |
| Dilutive effect of stock options and restricted shares | 2,254 | 3,341 | 2,953 |
| Weighted average number of diluted common shares outstanding | 167,413 | 173,767 | 169,211 |
| Diluted net income per common share | $ 4.02 | $ 2.15 | $ 0.56 |
| Cash dividends per common share | $ 0.28 | $ 0.16 | $ 0.06 |
| Potentially dilutive securities excluded as anti-dilutive | 800 | | 640 |

*Income taxes* The asset and liability method is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for operating loss and tax credit carryforwards and for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the results of operations in the period that includes the enactment date. If applicable, a valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized.

*Stock based compensation* Prior to January 1, 2006, the Company accounted for stock based compensation related to employee stock options and shares of restricted stock using the recognition and measurement principles of

APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and related interpretations. Under the provisions of APB 25, expense associated with stock option grants was measured based on the intrinsic value of the option at the date of grant and expense associated with restricted stock grants was measured based on the fair value of the shares at the date of grant. Reductions in compensation expense associated with awards that were forfeited prior to vesting were recognized as those grants were forfeited. Effective January 1, 2006, the Company adopted the provisions of Financial Accounting Standards Board Statement No. 123(R), *Accounting for Stock-Based Compensation* ( SFAS 123(R) ). SFAS 123(R) requires the recognition of expense associated with the grant of both stock options and restricted stock based on the estimated fair value of the options or restricted stock at the date of grant, net of estimated forfeitures.

*Statement of cash flows* For purposes of reporting cash flows, cash and cash equivalents include cash on deposit, money market funds and investment grade municipal and commercial bonds with original maturities of 90 days or less.

*Recently Issued Accounting Standards* In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006 and became effective for the Company as of January 1, 2007. The implementation of this standard is not expected to have a material impact in 2007.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* ( FAS 157 ). FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurement. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. FAS 157 will be effective for the Company in the quarter ending March 31, 2008. The application of FAS 157 is not expected to have a material impact to the Company.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ). SAB 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. Traditionally, there have been two widely-recognized methods for quantifying the effects of financial statement misstatements. The roll-over method focuses primarily on the impact of a misstatement on the income statement (including the reversing effect of prior year misstatements) but its use can lead to the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. The Company currently uses the iron-curtain method for quantifying identified financial statement misstatements. In SAB 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company s financial statements and the related financial statement disclosures. This model is commonly referred to as a dual approach because it requires quantification of errors under both the iron curtain and the roll-over methods. The Company applied the provisions of SAB 108 in the quarter ended December 31, 2006 and there was no impact.

*Reclassifications* Certain reclassifications have been made to the 2005 and 2004 consolidated financial statements in order for them to conform with the 2006 presentation.

**2. Acquisitions**

***2005 Acquisitions***

*Key Energy Services, Inc.* On January 15, 2005, the Company purchased land drilling assets from Key Energy Services, Inc. for $61.8 million. The assets included 25 active and 10 stacked land-based drilling rigs, related drilling equipment, yard facilities and a rig moving fleet consisting of approximately 45 trucks and 100 trailers. The transaction was accounted for as an acquisition of assets and the purchase price was allocated among the assets acquired based on their estimated fair market values.

*Other* On June 17, 2005, the Company acquired one land-based drilling rig for $3.6 million and on September 29, 2005, the Company acquired five land-based drilling rigs and related drilling equipment for $8.2 million. The transactions were accounted for as acquisitions of assets and the purchase price was allocated among the assets acquired based on their estimated fair market values.

***2004 Acquisition***

*TMBR/Sharp Drilling, Inc.* On February 11, 2004, the Company completed its acquisition of TMBR, a Texas corporation, in which one of its wholly-owned subsidiaries acquired 100% of the outstanding shares of TMBR. Operations of TMBR subsequent to February 11, 2004, are included in the Company s consolidated financial statements. The transaction was accounted for as a business combination and the purchase price was allocated among the assets acquired and liabilities assumed based on their estimated fair market values. The assets of TMBR included 18 land-based drilling rigs and related equipment, shop facilities, equipment yards and oil and natural gas properties.

The purchase price was calculated as follows (in thousands, except per share data and exchange ratio):

| | | |
|---|---|---|
| Cash of $9.09 per share for the 4,447 TMBR shares outstanding at February 11, 2004, excluding the 1,059 TMBR shares owned by Patterson-UTI | $ | 40,423 |
| Patterson-UTI shares issued at $17.82 per share (4,447 TMBR shares X .624332 exchange ratio X $17.82) | | 49,476 |
| 1,059 TMBR shares previously acquired by the Company | | 19,771 |
| Acquisition costs | | 10,511 |
| Less: Cash acquired | | (7,909) |
| Total purchase price | $ | 112,272 |

The purchase price was allocated among assets acquired and liabilities assumed based on their estimated fair market values as follows (in thousands):

| | | |
|---|---|---|
| Current assets | $ | 7,181 |
| Property and equipment | | 60,784 |
| Other long term assets | | 172 |
| Deferred tax assets | | 13,080 |
| Goodwill | | 48,020 |
| Current liabilities | | (7,080) |
| Other long term liabilities | | (1,090) |
| Deferred tax liability | | (8,795) |
| Total purchase allocation | $ | 112,272 |

The Company acquired TMBR to increase its productive asset base in the Permian Basin, which is one of the most active land drilling regions in the U.S. TMBR was well established in the contract drilling industry and maintained favorable customer relationships. Goodwill was recognized in the transaction as a result of these factors.

F-12

The following represents pro-forma unaudited financial information as if the acquisition had been completed on January 1, 2004 (in thousands, except per share amounts):

| | 2004 |
|---|---|
| Revenue | $ 1,005,357 |
| Income before cumulative effect of change in accounting principle | 94,047 |
| Net income | 94,047 |
| Earnings per share: | |
| Basic | $ 0.57 |
| Diluted | $ 0.56 |

**3. Comprehensive Income**

The following table illustrates the Company s comprehensive income including the effects of foreign currency translation adjustments for the years ended December 31, 2006, 2005 and 2004 (in thousands):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Net income | $ 673,254 | $ 372,740 | $ 94,346 |
| Other comprehensive income: | | | |
| Foreign currency translation adjustment related to Canadian operations, net of tax | (175) | 1,215 | 2,961 |
| Comprehensive income | $ 673,079 | $ 373,955 | $ 97,307 |

**4. Property and Equipment**

Property and equipment consisted of the following at December 31, 2006 and 2005 (in thousands):

| | 2006 | 2005 |
|---|---|---|
| Equipment | $ 2,135,567 | $ 1,633,911 |
| Oil and natural gas properties | 85,143 | 79,079 |
| Buildings | 30,987 | 22,490 |
| Land | 7,507 | 5,611 |
| | 2,259,204 | 1,741,091 |
| Less accumulated depreciation and depletion | (823,400) | (687,246) |
| | $ 1,435,804 | $ 1,053,845 |

**5. Goodwill**

Goodwill is evaluated annually to determine if the fair value of the asset has decreased below its carrying value. At December 31, 2006 the Company performed its annual goodwill evaluation and determined that no adjustment to impair goodwill was necessary. Goodwill as of December 31, 2006 and 2005 included $89,092 in the contract drilling segment and $9,964 in the drilling and completion fluids segment. For purposes of impairment testing, goodwill is evaluated at the reporting unit level. The Company s reporting units for impairment testing have been determined to be its operating segments. There were no changes to goodwill during the years ended December 31, 2006 and 2005.

**6. Accrued Expenses**

Accrued expenses consisted of the following at December 31, 2006 and 2005 (in thousands):

| | 2006 | 2005 |
|---|---|---|
| Salaries, wages, payroll taxes and benefits | $ 42,751 | $ 33,816 |
| Workers compensation liability | 67,615 | 47,107 |
| Sales, use and other taxes | 11,043 | 9,484 |
| Insurance, other than workers compensation | 13,328 | 11,365 |
| Other | 10,726 | 10,704 |
| | $ 145,463 | $ 112,476 |

**7. Asset Retirement Obligation**

Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations,* ( SFAS 143 ), requires that the Company record a liability for the estimated costs to be incurred in connection with the abandonment of oil and natural gas properties in the future. The following table describes the changes to the Company s asset retirement obligations during 2006 and 2005 (in thousands):

| | 2006 | 2005 |
|---|---|---|
| Balance at beginning of year | $ 1,725 | $ 2,358 |
| Liabilities incurred | 154 | 101 |
| Liabilities settled | (104) | (808) |
| Accretion expense | 54 | 74 |
| Asset retirement obligation at end of year | $ 1,829 | $ 1,725 |

**8. Borrowings Under Line of Credit**

The Company entered into a five-year, $200 million unsecured revolving line of credit ( LOC ) in December 2004. Interest is to be paid on outstanding LOC balances at a floating rate ranging from LIBOR plus 0.625% to 1.0% or the prime rate. Any outstanding borrowings must be repaid at maturity on December 16, 2009. This arrangement includes various fees, including a commitment fee on the average daily unused amount (0.15% at December 31, 2006). There are customary restrictions and covenants associated with the LOC. Financial covenants provide for a maximum debt to capitalization ratio and a minimum interest coverage ratio. The Company does not expect that the restrictions and covenants will restrict its ability to operate or react to opportunities that might arise. On August 2, 2006, the Company entered into an agreement to amend the LOC. In connection with this amendment, the borrowing capacity under this LOC was increased to $375 million. No significant changes were made to the terms of the LOC including the interest to be paid on outstanding balances and financial covenants. As of December 31, 2006, the Company had borrowed $120 million under the LOC and $60 million in letters of credit were outstanding. As a result, the Company had available borrowing capacity of $195 million at December 31, 2006. The weighted average interest rate on borrowings outstanding at December 31, 2006 was 6.92%.

## 9. Commitments, Contingencies and Other Matters

*Commitments* The Company maintains letters of credit in the aggregate amount of approximately $60 million for the benefit of various insurance companies as collateral for retrospective premiums and retained losses which may become payable under the terms of the underlying insurance contracts. These letters of credit are typically renewed annually. No amounts have been drawn under the letters of credit.

As of December 31, 2006, the Company has signed non-cancelable commitments to purchase approximately $297 million of equipment to be received throughout 2007. This amount excludes a $24.7 million deposit that was paid during 2006 pursuant to an agreement that was entered into to purchase rig components to be used in the construction of 15 new land drilling rigs. This payment is presented as a deposit on equipment purchase contract in the consolidated balance sheet at December 31, 2006.

*Contingencies* The Company s contract services and oil and natural gas exploration and production operations are subject to inherent risks, including blowouts, cratering, fire and explosions which could result in personal injury or death, suspended drilling operations, damage to, or destruction of equipment, damage to producing formations and pollution or other environmental hazards.

As a protection against these hazards, the Company maintains general liability insurance coverage of $2.0 million per occurrence with $4.0 million of aggregate coverage and excess liability and umbrella coverages up to $100 million per occurrence and in the aggregate. The Company maintains a $1.0 million per occurrence deductible on its workers compensation insurance and its general liability insurance coverages.

The Company believes it is adequately insured for public liability and property damage to others with respect to its operations. However, such insurance may not be sufficient to protect the Company against liability for all consequences of well disasters, extensive fire damage, or damage to the environment. The Company also carries insurance to cover physical damage to, or loss of, its rigs. However, it does not cover the full replacement cost of the rigs and the Company does not carry insurance against loss of earnings resulting from such damage or loss.

Net income for the year ended December 31, 2005 includes a charge of $4.2 million related to the financial failure of a workers compensation insurance carrier that had provided coverage for the Company in prior years.

In November 2005, the Company discovered that its former Chief Financial Officer, Jonathan D. Nelson ( Nelson ), had fraudulently diverted approximately $77.5 million in Company funds for his own benefit. As a result, the Audit Committee of the Board of Directors commenced an investigation into Nelson s activities and retained independent counsel and independent forensic accountants to assist with the investigation. Nelson has been sentenced and is serving a term of imprisonment arising out of his embezzlement. A receiver has been appointed to take control of and liquidate the assets of Nelson in connection with his embezzlement of Company funds. The receiver is in the process of seeking court approval for a plan of distribution of the assets recovered by the receiver and the proceeds thereof, which total approximately $40 million. While the Company believes it has a claim for at least the full amount of funds embezzled from the Company, other creditors have asserted or may assert claims with respect to the assets held by the receiver.

In December 2005, two purported derivative actions were filed in Texas state court in Scurry County, Texas and in May 2006, a derivative action was filed in federal court in Lubbock, Texas, in each case, against the Company s directors, alleging that the directors breached their fiduciary duties to the Company as a result of alleged failure to timely discover the embezzlement of approximately $77.5 million by its former CFO, Jonathan D. Nelson. The Board of Directors formed a special litigation committee to review and inquire about these allegations and recommend the Company s response, if any. Further legal proceedings in these suits were stayed pending completion of the work of the special litigation committee. The lawsuits sought recovery on behalf of and for the Company and did not seek recovery from the Company. In November 2006, the parties to all three of the derivative actions reached an agreement to settle the actions. After a preliminary hearing and notice to the Company s stockholders, the state court held a hearing, approved the settlement, which required the implementation of certain corporate governance measures, and signed a final judgment on December 29, 2006. As contemplated by the settlement agreement, the federal court entered a final judgment on January 10, 2007. Pursuant to the terms of the settlement, the Company will pay a net amount of $230,000 to the attorneys for the plaintiffs in the suits.

The Company is party to various other legal proceedings arising in the normal course of its business. The Company does not believe that the outcome of these proceedings, either individually or in the aggregate, will have a material adverse effect on its financial condition.

*Other Matters* The Company has Change in Control Agreements with its Chairman of the Board, Chief Executive Officer and two Senior Vice Presidents (the Key Employees ). Each Change in Control Agreement generally has a three-year term with automatic twelve month renewals unless the Company notifies the Key Employee at least ninety days before the end of such renewal period that the term will not be extended. If a change in control of the Company occurs during the term of the agreement and the Key Employee s employment is terminated

(i) by the Company other than for cause or other than automatically as a result of death, disability or retirement or (ii) by the Key Employee for good reason (as those terms are defined in the Change in Control Agreements), then the Key Employee shall be entitled to, among other things,

bonus payment equal to the greater of the highest bonus paid after the Change in Control Agreement was entered into and the average of the two annual bonuses earned in the two fiscal years immediately preceding a change in control (such bonus payment prorated for the portion of the fiscal year preceding the termination date);

a payment equal to 2.5 times (in the case of the Chairman of the Board and Chief Executive Officer) or 1.5 times (in the case of the Senior Vice Presidents) of the sum of (i) the highest annual salary in effect for such Key Employee and (ii) the average of the three annual bonuses earned by the Key Employee for the three fiscal years preceding the termination date; and

continued coverage under the Company s welfare plans for up to three years (in the case of the Chairman of the Board and Chief Executive Officer) or two years (in the case of the Senior Vice Presidents).

Each Change in Control Agreement provides the Key Employee with a full gross-up payment for any excise taxes imposed on payments and benefits received under the Change in Control Agreements or otherwise, including other taxes that may be imposed as a result of the gross-up payment.

**10. Stockholders Equity**

The Company has granted restricted shares of the Company s common stock ( Restricted Shares ) to certain key employees under the Patterson-UTI Energy, Inc. 1997 Long-Term Incentive Plan, as amended, and the Patterson-UTI Energy, Inc. 2005 Long-Term Incentive Plan. As required by SFAS 123(R), the Restricted Shares were valued based upon the market price of the Company s common stock on the date of the grant. The restrictions on these shares lapse at various dates through 2010.

On June 7, 2004, the Company s Board of Directors authorized a stock buyback program for the purchase of up to $30 million of the Company s outstanding common stock. During 2004, the Company purchased 100,000 shares of its common stock under this program in the open market for approximately $1.5 million. During 2005, the Company purchased 355,000 shares of its common stock under this program in the open market for approximately $12.2 million. On March 27, 2006, the Company s Board of Directors increased the stock buyback program to allow for future purchases of up to $200 million of the Company s outstanding common stock. During the second quarter of 2006, the Company completed the purchase of 6,704,800 shares of its common stock under this program in the open market at a cost of approximately $200 million. On August 2, 2006, the Company s Board of Directors again increased the stock buyback program to allow for future purchases of up to $250 million of the Company s outstanding common stock. During the remainder of 2006, the Company purchased an additional 9,940,542 shares of its common stock under this program in the open market at a cost of approximately $250 million. Shares purchased under the stock buyback program have been accounted for as treasury stock.

On April 28, 2004, the Company s Board of Directors authorized a two-for-one stock split in the form of a stock dividend which was distributed on June 30, 2004 to holders of record on June 14, 2004. In connection with the two-for-one stock split, an adjustment was made to reclassify an amount from retained earnings to common stock to account for the par value of the common stock issued as a stock dividend. This adjustment had no overall effect on equity. Historical net income per common share amounts included in the Consolidated Statements of Income and elsewhere in these financial statements have been presented as if the two-for-one stock split had occurred on January 1, 2004.

On April 28, 2004, the Company s Board of Directors approved the initiation of a quarterly cash dividend of $0.02 on each share of its common stock which was paid on June 2, 2004, September 1, 2004 and December 1, 2004. Total dividends paid in 2004 were approximately $10.0 million. In February 2005, the Company s Board of Directors approved an increase in the quarterly cash dividend on the Company s common stock to $0.04 per share. Quarterly cash dividends in the amount of $0.04 per share were paid on March 4, 2005, June 1, 2005, September 1, 2005 and December 1, 2005. Total cash dividends in 2005 were approximately $27.3 million. On March 2, 2006, the Company s Board of Directors approved a cash dividend on its common stock in the amount of $0.04 per share which was paid on March 30, 2006. On April 26, 2006, the Company s Board of Directors approved an increase in its quarterly cash dividend from $0.04 to $0.08 on each outstanding share of its common stock. Cash dividends of $0.08 per share were paid on June 30, 2006, September 29, 2006 and December 29, 2006. Total cash dividends in 2006 were approximately $45.8 million. The amount and timing of all future dividend payments is subject to the discretion of the Board of Directors and will depend upon business conditions, results of operations, financial condition, terms of the Company s credit facilities and other factors.

In February 2004, the Company completed its acquisition of TMBR in which one of its wholly-owned subsidiaries acquired 100% of the outstanding shares of TMBR for a net cash payment of $32.5 million ($40.4 million paid to TMBR shareholders less $7.9 million in cash acquired in the transaction) and the issuance of 2.78 million shares of the Company s common stock valued at $17.82 per share (adjusted to reflect the two-for-one stock split on June 30, 2004). The assets of TMBR included 18 land-based drilling rigs and related equipment, shop facilities, equipment yards and their oil and natural gas properties. The transaction was accounted for as a business combination and the purchase price was allocated among the assets acquired and liabilities assumed based on their estimated fair market values (see Note 2).

**11. Stock-based Compensation**

The Company adopted FASB 123(R) on January 1, 2006 and recognizes the cost of share-based payments under the fair-value-based method. The Company uses share-based payments to compensate employees and non-employee directors. All awards have been equity instruments in the form of stock options or restricted stock awards and include only service conditions. The Company issues shares of common stock when vested stock option awards are exercised and when restricted stock awards are granted. For the year ended December 31, 2006, the Company recognized $16.3 million in stock-based compensation expense and a related income tax benefit of approximately $5.8 million and recognized a benefit in the form of a cumulative effect of change in accounting principle associated with the adoption of FAS 123(R) of $1.1 million, with a related tax expense of $398,000. As a result of the adoption of FAS 123(R) in 2006, operating income and income before income taxes was reduced by $8.4 million. Net income was reduced by $4.7 million. Basic EPS and Diluted EPS were reduced by $0.03 per share as a result of the adoption of FAS 123(R).

During 2005, the Company s shareholders approved the Patterson-UTI Energy, Inc. 2005 Long-Term Incentive Plan (the 2005 Plan ) and the Board of Directors adopted a resolution that no future grants would be made under any of the Company s other previously existing plans. The Company s share-based compensation plans at December 31, 2006 follow:

| Plan Name | Shares Authorized for Grant | Options & Restricted Shares Outstanding | Shares Available for Grant |
|---|---|---|---|
| Patterson-UTI Energy, Inc. 2005 Long-Term Incentive Plan | 6,250,000 | 1,540,252 | 4,140,197 |
| Patterson-UTI Energy, Inc. Amended and Restated 1997 Long-Term Incentive Plan, as amended ( 1997 Plan ) | | 5,090,885 | |
| Amended and Restated Patterson-UTI Energy, Inc. 2001 Long-Term Incentive Plan ( 2001 Plan ) | | 762,559 | |
| Amended and Restated Non-Employee Director Stock Option Plan of Patterson-UTI Energy, Inc. ( Non-Employee Director Plan ) | | 150,000 | |
| | | 95,800 | |

| | |
|---|---|
| Amended and Restated Patterson-UTI Energy, Inc. 1996 Employee Stock Option Plan (   1996 Plan   ) | |
| Patterson-UTI Energy, Inc., 1993 Incentive Stock Plan, as amended (   1993 Plan   ) | 123,800 |

A summary of the 2005 Plan follows:

The Compensation Committee of the Board of Directors administers the plan.

All employees including officers and directors are eligible for awards.

The Compensation Committee determines the vesting schedule for awards. Awards typically vest over 1 year for non-employee directors and 3 to 4 years for employees.

The Compensation Committee sets the term of awards and no option term can exceed 10 years.

All options granted under the plan are granted with an exercise price equal to or greater than the fair market value of the Company s common stock at the time the option is granted.

The plan provides for awards of incentive stock options, non-incentive stock options, tandem and freestanding stock appreciation rights, restricted stock awards, other stock unit awards, performance share awards, performance unit awards and dividend equivalents. As of December 31, 2006, only non-incentive stock options and restricted stock awards had been granted under the plan.

Options granted under the 1997 Plan typically vest over three or five years as dictated by the Compensation Committee. These options have terms of no more than ten years. All options were granted with an exercise price equal to the fair market value of the related common stock at the time of grant. Restricted Stock Awards granted under the 1997 Plan typically vest over four years.

Options granted under the 2001 Plan typically vest over five years as dictated by the Compensation Committee. These options have terms of no more than ten years. All options were granted with an exercise price equal to the fair market value of the Company s common stock at the time of grant.

Options granted under the Non-Employee Director Plan vest on the first anniversary of the option grant. Non-Employee Director Plan options have five year terms. All options were granted with an exercise price equal to the fair market value of the related common stock at the time of grant.

Options granted under the 1996 plan typically vest over one, four or five years as dictated by the Compensation Committee. These options have terms of no more than ten years. All options were granted with an exercise price equal to the fair market value of the Company s common stock at the time of grant.

Options granted under the 1993 Plan typically typically vest over five years as dictated by the Compensation Committee. These options have terms of no more than ten years. All options were granted with an exercise price equal to the fair market value of the Company s common stock at the time of grant.

*Stock Options* The Company accounted for all stock options under the intrinsic value method prior to January 1, 2006. Accordingly, no compensation expense was recognized in prior periods for stock options because they had no intrinsic value when granted as exercise prices were equal to the grant date market value of the related common stock. The Modified Prospective Application ( MPA ) method is being applied to transition from the intrinsic value method to the fair-value-based method for stock options. The effects of the application of the MPA method follow:

Previously reported amounts and disclosures are not affected.

Compensation cost, net of estimated forfeitures for the unvested portion of awards outstanding at January 1, 2006, is recognized under the fair-value-based method as the awards vest. Compensation cost is based on the grant-date estimated fair value of stock options as calculated for the Company s previously reported pro forma disclosures under FASB Statement No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ).

The fair-value based method is applied to new awards and to any awards outstanding at January 1, 2006 that are modified, repurchased or cancelled after that date.

The Company estimates grant date fair values of stock options using the Black-Scholes-Merton valuation model ( Black-Scholes ), except for stock options granted prior to 1996 that are not subject to FAS 123(R) and were not subject to FAS 123 pro forma disclosures. Volatility assumptions are based on the historic volatility of the Company s common stock over the most recent period equal to the expected term of the options as of the date the options were granted. The expected term assumptions are based on the Company s experience with respect to employee stock option activity. Dividend yield assumptions are based on the expected dividends at the time the options were granted. The risk-free interest rate assumptions are determined by reference to United States Treasury yields. Weighted-average assumptions used to estimate grant date fair values for stock options granted in the years ended December 31, 2006, 2005 and 2004 follow:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Volatility | 33.18% | 26.95% | 36.84% |
| Expected term (in years) | 4.00 | 4.00 | 3.84 |
| Dividend yield | 1.09% | 0.65% | 0.06% |
| Risk-free interest rate | 4.87% | 3.84% | 3.22% |

Stock option activity for the year ended December 31, 2006 follows:

| | Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding at beginning of year | 6,338,044 | $ 14.37 |
| Granted | 800,000 | $ 28.54 |
| Exercised | (180,726) | $ 10.77 |
| Forfeited | (17,000) | $ 10.94 |
| Expired | (4,389) | $ 9.28 |
| Cancelled(a) | (360,833) | $ 14.83 |
| Outstanding at end of year | 6,575,096 | $ 16.18 |
| Exercisable at end of year | 5,392,263 | $ 13.92 |

(a) Represents vested stock options held by the former CFO which were cancelled by the Company s Board of Directors.

Options outstanding at December 31, 2006 have an aggregate intrinsic value of approximately $51.4 million and have a weighted-average remaining contractual term of 6.21 years. Options exercisable at December 31, 2006 have an aggregate intrinsic value of approximately $50.6 million and have a weighted-average remaining contractual term of 5.60 years. Additional information with respect to options granted and exercised during the years ended December 31, 2006, 2005 and 2004 follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Weighted-average grant-date fair value of stock options granted (per share) | $ 8.62 | $ 6.33 | $ 6.25 |
| Aggregate intrinsic value of stock options exercised (in thousands) | $ 3,377 | $ 73,467 | $ 41,171 |

As of December 31, 2006, options to purchase 1,182,833 shares were outstanding and not vested. Substantially all of these non-vested options are expected to ultimately vest. Additional information as of December 31, 2006 with respect to these options that are expected to vest follows:

| | |
|---|---|
| Aggregate intrinsic value | $ 766,000 |
| Weighted-average remaining contractual term | 8.98 years |
| Weighted-average remaining expected term | 2.99 years |
| Weighted-average remaining vesting period | 1.99 years |
| Unrecognized compensation cost | $ 8.2 million |

*Restricted Stock* Under all restricted stock awards to date, shares were issued when granted, nonvested shares are subject to forfeiture for failure to fulfill service conditions and nonforfeitable dividends are paid on nonvested restricted shares. Restricted stock awards prior to January 1, 2006 were valued at the grant date market value of the underlying common stock, recognized as contra equity deferred compensation and amortized to expense under the graded-vesting method. Implementation of FAS 123(R) did not change the accounting for the Company s nonvested stock awards, except as follows:

Prior to January 1, 2006, forfeitures were recognized as they occurred;

From January 1, 2006 forward, forfeitures are estimated in the determination of periodic compensation cost;

Contra equity deferred compensation was reversed against paid-in-capital at January 1, 2006; and

Compensation expense is recognized as attributed to each period.

The Company uses the graded-vesting attribution method to determine periodic compensation cost from restricted stock awards.

Restricted stock activity for the year ended December 31, 2006 follows:

| | Shares | Weighted-Average Grant Date Fair Value |
|---|---|---|
| Outstanding at beginning of year | 623,150 | $ 21.44 |
| Granted | 613,400 | $ 30.46 |
| Vested | (1,351) | $ 14.73 |
| Forfeited | (46,999) | $ 26.00 |
| Outstanding at end of year | 1,188,200 | $ 25.92 |

As of December 31, 2006, approximately 1,059,000 shares of nonvested restricted stock outstanding are expected to vest. Additional information as of December 31, 2006 with respect to these shares that are expected to vest follows:

| | |
|---|---|
| Aggregate intrinsic value | $ 24.6 million |
| Weighted-average remaining vesting period | 2.51 years |
| Unrecognized compensation cost | $ 16.0 million |

*Dividends on Equity Awards* Nonforfeitable dividends paid on equity awards are recognized as follows:

Dividends are recognized as reductions of retained earnings for the portion of equity awards expected to vest.

Dividends are recognized as additional compensation cost for the portion of equity awards that are not expected to vest or that ultimately do not vest.

Vesting expectations, in regard to these dividend payments, correspond with forfeiture assumptions used to recognize compensation cost.

*Prior Period Pro Forma Disclosures* Prior to January 1, 2006, the Company accounted for share-based compensation under the intrinsic value method. Other than the restricted stock discussed above, no additional share-based compensation expense was reflected in earnings prior to January 1, 2006 since the exercise price was equal to the grant-date market value of the underlying common stock for all stock options granted prior to that date. The effect of share-based compensation, as if the Company had applied the fair-value-based method proscribed by FAS 123, on net income and earnings per share for the yeas ended December 31, 2005 and 2004 (in thousands, except per share amounts):

| | 2005 | 2004 |
|---|---|---|
| Net income, as reported | $ 372,740 | $ 94,346 |
| Add back: Share-based employee compensation cost, net of related tax effects, included in net income as reported | 1,795 | 773 |
| Deduct: Share-based employee compensation cost, net of related tax effects, that would have been included in net income if the fair-value-based method had been applied to all awards | (11,119) | (12,304) |
| Pro-forma net income | $ 363,416 | $ 82,815 |
| Net income per common share: | | |
| Basic, as reported | $ 2.19 | $ 0.57 |
| Basic, pro-forma | $ 2.13 | $ 0.50 |
| Diluted, as reported | $ 2.15 | $ 0.56 |
| Diluted, pro-forma | $ 2.11 | $ 0.49 |

**12. Leases**

The Company incurred rent expense of $31.8 million, $22.5 million and $17.8 million, for the years 2006, 2005 and 2004, respectively. The Company s obligations under non-cancelable operating lease agreements are not material to the Company s operations.

## 13. Income Taxes

Components of the income tax provision applicable for Federal, state and foreign income taxes for the years ended December 31, 2006, 2005 and 2004 are as follows (in thousands):

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Federal income tax expense (benefit): | | | |
| Current | $ 344,395 | $ 174,635 | $ 32,686 |
| Deferred | (5,851) | 14,182 | 12,366 |
| | 338,544 | 188,817 | 45,052 |
| State income tax expense: | | | |
| Current | 21,371 | 13,045 | 2,031 |
| Deferred | 1,392 | 1,431 | 1,555 |
| | 22,763 | 14,476 | 3,586 |
| Foreign income tax expense: | | | |
| Current | 9,607 | 7,238 | 5,235 |
| Deferred | 353 | 1,488 | 928 |
| | 9,960 | 8,726 | 6,163 |
| Total: | | | |
| Current | 375,373 | 194,918 | 39,952 |
| Deferred | (4,106) | 17,101 | 14,849 |
| Total income tax expense | $ 371,267 | $ 212,019 | $ 54,801 |

The difference between the statutory Federal income tax rate and the effective income tax rate for the years ended December 31, 2006, 2005 and 2004 is summarized as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Statutory tax rate | 35.0% | 35.0% | 35.0% |
| State income taxes | 1.4 | 1.8 | 1.6 |
| Permanent differences | (0.8) | (0.6) | 0.4 |
| Other, net | 0.0 | 0.1 | (0.3) |
| Effective tax rate | 35.6% | 36.3% | 36.7% |

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. The Company expects the deferred tax assets at December 31, 2006 to be realized as a result of the reversal during the carryforward period of existing taxable temporary differences giving rise to deferred tax liabilities and the generation of taxable income in the carryforward period; therefore, no valuation allowance is necessary.

The tax effect of significant temporary differences representing deferred tax assets and liabilities and changes therein were as follows (in thousands):

| | **December 31, 2006** | **Net Change** | **December 31, 2005** | **Net Change** | **December 31, 2004** | **Net Change** | **January 1, 2004** |
|---|---|---|---|---|---|---|---|
| Deferred tax assets: | | | | | | | |
| Current: | | | | | | | |
| Federal net operating loss carryforwards | $ 1,870 | $ | $ 1,870 | $ | $ 1,870 | $ 1,870 | $ |
| Workers compensation allowance | 26,363 | 6,902 | 19,461 | 4,584 | 14,877 | 1,545 | 13,332 |
| Embezzlement costs | 14,294 | 14,294 | | | | | |
| AMT credit | | | | | | (602) | 602 |
| Other | 14,501 | 3,137 | 11,364 | 4,386 | 6,978 | 1,238 | 5,740 |
| | 57,028 | 24,333 | 32,695 | 8,970 | 23,725 | 4,051 | 19,674 |
| Non-current: | | | | | | | |
| Federal net operating loss carryforwards | 374 | (1,871) | 2,245 | (1,870) | 4,115 | 4,115 | |
| AMT credit | 118 | | 118 | | 118 | 118 | |
| Federal benefit of foreign deferred tax liabilities | 8,549 | 353 | 8,196 | 1,488 | 6,708 | 933 | 5,775 |
| Federal benefit of state deferred tax liabilities | 4,692 | 460 | 4,232 | 717 | 3,515 | 421 | 3,094 |
| Embezzlement costs | | | | (22,178) | 22,178 | 7,193 | 14,985 |
| Other | 7,109 | 6,172 | 937 | 174 | 763 | 763 | |
| | 20,842 | 5,114 | 15,728 | (21,669) | 37,397 | 13,543 | 23,854 |
| Total deferred tax assets | 77,870 | 29,447 | 48,423 | (12,699) | 61,122 | 17,594 | 43,528 |
| Deferred tax liabilities: | | | | | | | |
| Current: | | | | | | | |
| Other | (8,161) | (1,848) | (6,313) | 1,421 | (7,734) | (4,509) | (3,225) |
| Non-current: | | | | | | | |
| Property and equipment basis difference | (203,500) | (23,775) | (179,725) | (6,381) | (173,344) | (25,534) | (147,810) |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Other | (5,301) | (110) | (5,191) | (663) | (4,528) | 167 | (4,695) |
| | (208,801) | (23,885) | (184,916) | (7,044) | (177,872) | (25,367) | (152,505) |
| Total deferred tax liabilities | (216,962) | (25,733) | (191,229) | (5,623) | (185,606) | (29,876) | (155,730) |
| Net deferred tax liability | $ (139,092) | $ 3,714 | $ (142,806) | $ (18,322) | $ (124,484) | $ (12,282) | $ (112,202) |

Management deducted accumulated net embezzlement losses in the Company s 2005 tax returns, which corresponds with the period in which the embezzlement was detected.

Other deferred tax assets consist primarily of various allowance accounts and tax deferred expenses expected to generate future tax benefit of approximately $22 million. Other deferred tax liabilities consist primarily of receivables from insurance companies and tax deferred income not yet recognized for tax purposes.

For tax purposes, the Company has available at December 31, 2006, Federal net operating loss carryforwards of approximately $5 million and $118,000 of alternative minimum tax credit carryforwards. These carryforwards are attributable to the acquisition of TMBR in February 2004.

The net operating loss carryforwards, if unused, are scheduled to expire as follows: 2018 $1 million and 2019 $4 million. The alternative minimum tax credit may be carried forward indefinitely.

**14. Employee Benefits**

The Company maintains a 401(k) plan for all eligible employees. The Company s operating results include expenses of approximately $3.1 million in 2006, $2.7 million in 2005 and $2.2 million in 2004 for the Company s discretionary contributions to the plan.

**15. Business Segments**

The Company conducts its business through four distinct operating segments: (1) contract drilling of oil and natural gas wells, (2) pressure pumping services, (3) drilling and completion fluids services to operators in the oil and natural gas industry, and (4) the exploration, development, acquisition and production of oil and natural gas. Each of these segments represents a distinct type of business based upon the type and nature of services and products offered. These segments have separate management teams which report to the Company s chief executive officer and have distinct and identifiable revenues and expenses.

*Contract Drilling* The Company markets its contract drilling services to major and independent oil and natural gas operators. As of December 31, 2006, the Company had 336 currently marketable land-based drilling rigs, of which 107 of the drilling rigs were based in the Permian Basin region, 50 in South Texas, 44 in the Ark-La-Tex region and Mississippi, 67 in the Mid-Continent region, 48 in the Rocky Mountain region and 20 in Western Canada.

*Pressure Pumping* The Company provides pressure pumping services primarily in the Appalachian Basin. Pressure pumping services consist primarily of well stimulation and cementing for the completion of new wells and remedial work on existing wells. Well stimulation involves processes inside a well designed to enhance the flow of oil, natural gas, or other desired substances from the well. Cementing is the process of inserting material between the hole and the pipe to center and stabilize the pipe in the hole.

*Drilling and Completion Fluids* The Company provides drilling fluids, completion fluids and related services to oil and natural gas operators offshore in the Gulf of Mexico and on land in Texas, Southeastern New Mexico, Oklahoma and the Gulf Coast region of Louisiana. Drilling and completion fluids are used by oil and natural gas operators during the drilling process to control pressure when drilling oil and natural gas wells.

*Oil and Natural Gas* The Company is engaged in the development, exploration, acquisition and production of oil and natural gas.

The following tables summarize selected financial information relating to the Company s business segments (in thousands):

| | Years Ended December 31, | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Revenues: | | | |
| Contract drilling(a) | $ 2,174,805 | $ 1,488,485 | $ 815,683 |
| Pressure pumping | 145,671 | 93,144 | 66,654 |
| Drilling and completion fluids(b) | 192,974 | 122,309 | 90,858 |
| Oil and natural gas | 39,187 | 39,616 | 33,867 |
| Total segment revenues | 2,552,637 | 1,743,554 | 1,007,062 |

| | | | |
|---|---|---|---|
| Elimination of intercompany revenues(a)(b) | (6,051) | (3,099) | (6,293) |
| Total revenues | $ 2,546,586 | $ 1,740,455 | $ 1,000,769 |
| Income before income taxes: | | | |
| Contract drilling | $ 991,449 | $ 572,562 | $ 146,626 |
| Pressure pumping | 44,835 | 21,664 | 16,747 |
| Drilling and completion fluids | 28,759 | 12,201 | 4,202 |
| Oil and natural gas | 8,660 | 13,405 | 10,764 |
| | 1,073,703 | 619,832 | 178,339 |

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Corporate and other | (22,054) | (14,245) | (11,264) |
| Other operating expenses(c) | (9,404) | (4,248) | 514 |
| Embezzlement costs, net of recoveries(d) | (3,081) | (20,043) | (19,122) |
| Interest income | 5,925 | 3,551 | 1,140 |
| Interest expense | (1,602) | (516) | (695) |
| Other | 347 | 428 | 235 |
| Income before income taxes | $ 1,043,834 | $ 584,759 | $ 149,147 |
| Identifiable assets: | | | |
| Contract drilling | $ 1,849,923 | $ 1,421,779 | $ 961,873 |
| Pressure pumping | 111,787 | 72,536 | 49,145 |
| Drilling and completion fluids | 106,032 | 90,904 | 62,970 |
| Oil and natural gas | 65,443 | 60,785 | 62,984 |
| | 2,133,185 | 1,646,004 | 1,136,972 |
| Corporate and other(e) | 59,318 | 149,777 | 119,813 |
| Total assets | $ 2,192,503 | $ 1,795,781 | $ 1,256,785 |
| Depreciation, depletion and impairment: | | | |
| Contract drilling | $ 168,607 | $ 131,740 | $ 101,779 |
| Pressure pumping | 9,896 | 7,094 | 5,112 |
| Drilling and completion fluids | 2,706 | 2,368 | 2,156 |
| Oil and natural gas | 14,368 | 14,456 | 13,309 |
| | 195,577 | 155,658 | 122,356 |
| Corporate and other | 793 | 735 | 444 |
| Total depreciation, depletion and impairment | $ 196,370 | $ 156,393 | $ 122,800 |
| Capital expenditures: | | | |
| Contract drilling | $ 531,087 | $ 329,073 | $ 140,945 |
| Pressure pumping | 41,262 | 25,508 | 17,705 |
| Drilling and completion fluids | 4,222 | 3,042 | 1,488 |
| Oil and natural gas | 21,198 | 17,163 | 14,451 |
| Corporate and other | 150 | 5,308 | |
| Total capital expenditures | $ 597,919 | $ 380,094 | $ 174,589 |

(a) Includes contract drilling intercompany revenues of approximately $5.4 million, $2.8 million and $6.0 million for the years ended December 31, 2006, 2005 and 2004, respectively.

(b) Includes drilling and completion fluids intercompany revenues of approximately $616,000, $298,000 and $301,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

(c) Other operating expenses relate to decisions of the executive management group regarding corporate strategy, credit risk, loss contingencies and restructuring activities. Due to the non-operating nature of these decisions, the related charges have been separately presented and excluded from the results of specific segments. These charges are primarily related to the contract drilling segment.

(d) The Company s former CFO has pleaded guilty to criminal charges and has been sentenced and is serving a term of imprisonment arising out of his embezzlement of funds totaling approximately $77.5 million from the Company over a period of more than five years, ending November 3, 2005. Embezzlement costs, net of recoveries include embezzled funds and other costs incurred as a result of the embezzlement. In 2006, the Company recovered $2.0 million from its insurance carrier related to the embezzlement loss.

(e) Corporate assets primarily include cash on hand managed by the parent corporation and certain deferred Federal income tax assets.

**16. Quarterly Financial Information (in thousands, except per share amounts) (unaudited)**

| | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter |
|---|---|---|---|---|
| **2006** | | | | |
| Operating revenues | $ 597,733 | $ 636,813 | $ 673,658 | $ 638,382 |
| Operating income | 245,599 | 268,913 | 281,905 | 242,747 |
| Net income | 159,256 | 171,690 | 185,990 | 156,318 |
| Net income per common share: | | | | |
| Basic | $ 0.93 | $ 1.02 | $ 1.14 | $ 0.99 |
| Diluted | $ 0.91 | $ 1.00 | $ 1.12 | $ 0.97 |
| **2005** | | | | |
| Operating revenues | $ 350,593 | $ 389,922 | $ 468,739 | $ 531,201 |
| Operating income | 91,833 | 116,651 | 167,446 | 205,366 |
| Net income | 58,220 | 74,026 | 106,305 | 134,189 |
| Net income per common share: | | | | |
| Basic | $ 0.34 | $ 0.44 | $ 0.62 | $ 0.78 |
| Diluted | $ 0.34 | $ 0.43 | $ 0.61 | $ 0.77 |

**17. Concentrations of Credit Risk**

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist primarily of demand deposits, temporary cash investments and trade receivables.

The Company believes that it places its demand deposits and temporary cash investments with high credit quality financial institutions. At December 31, 2006 and 2005, the Company s demand deposits and temporary cash investments consisted of the following (in thousands):

| | 2006 | 2005 |
|---|---|---|
| Deposits in FDIC and SIPC-insured institutions under $100,000 | $ 684 | $ 1,066 |
| Deposits in FDIC and SIPC-insured institutions over $100,000 | 21,859 | 153,261 |
| Deposits in Foreign Banks | 3,754 | 2,513 |
| | 26,297 | 156,840 |
| Less outstanding checks and other reconciling items | (12,912) | (20,442) |
| Cash and cash equivalents | $ 13,385 | $ 136,398 |

Concentrations of credit risk with respect to trade receivables are primarily focused on companies involved in the exploration and development of oil and natural gas properties. The concentration is somewhat mitigated by the diversification of customers for which the Company provides drilling services. As is general industry practice, the

Company typically does not require customers to provide collateral. No significant losses from individual customers were experienced during the years ended December 31, 2006, 2005, or 2004. The Company recognized bad debt expense for 2006, 2005 and 2004 of $5.4 million, $1.2 million and $897,000, respectively.

The carrying values of cash and cash equivalents, marketable securities, trade receivables and borrowings outstanding under the Company s line of credit approximate fair value due to the short-term maturity of these items.

**18. Related Party Transactions**

*Joint Operation of Oil and Natural Gas Properties* The Company operates certain oil and natural gas properties in which certain of its affiliated persons have participated, either individually or through entities they control. These participations have typically been through working interests in prospects or properties originated or acquired by Patterson Petroleum LP, LLLP, a wholly owned subsidiary of Patterson-UTI. At December 31, 2006, affiliated persons were working interest owners in 281 of 330 total wells operated by Patterson-UTI. Sales of working interests to affiliated parties were made by Patterson-UTI at its cost, comprised of Patterson-UTI s costs of acquiring and preparing the working interests for sale plus a promote fee in some cases. These costs were paid by the working interest owners on a pro rata basis based upon their working interest ownership percentage. The price at which working interests were sold to affiliated persons was the same price at which working interests were sold to unaffiliated persons except that in some cases the affiliated persons also paid a promote fee. The affiliated persons earned oil and natural gas production revenue (net of royalty) of $15.8 million, $15.5 million and $13.8 million from these properties in 2006, 2005 and 2004, respectively. These persons or entities in turn paid for joint operating costs (including drilling and other development expenses) of $14.1 million, $9.5 million and $7.5 million incurred in 2006, 2005 and 2004, respectively. These activities resulted in a payable to the affiliated persons of approximately $1.5 million and $1.5 million and a receivable from the affiliated persons of approximately $1.6 million and $1.2 million at December 31, 2006 and 2005, respectively.

**PATTERSON-UTI ENERGY, INC. AND SUBSIDIARIES**

**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**

| Description | Beginning Balance | Charged to Costs and Expenses(1) | Deductions(2) | Ending Balance |
|---|---|---|---|---|
| | (In thousands) | | | |
| **Year Ended December 31, 2006** | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | $ 2,199 | $ 5,400 | $ 115 | $ 7,484 |
| **Year Ended December 31, 2005** | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | $ 1,909 | $ 1,231 | $ 941 | $ 2,199 |
| **Year Ended December 31, 2004** | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | $ 2,133 | $ 897 | $ 1,121 | $ 1,909 |

(1) Net of recoveries.

(2) Uncollectible accounts written off.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Patterson-UTI Energy, Inc. has duly caused this Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

PATTERSON-UTI ENERGY, INC.

By: /s/ Cloyce A. Talbott
Cloyce A. Talbott
*President and Chief Executive Officer*

Date: February 26, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report on Form 10-K has been signed by the following persons on behalf of Patterson-UTI Energy, Inc. and in the capacities indicated as of February 26, 2007.

| Signature | Title |
|---|---|
| /s/ Mark S. Siegel<br>Mark S. Siegel | Chairman of the Board |
| /s/ Cloyce A. Talbott<br>Cloyce A. Talbott<br>*(Principal Executive Officer)* | President, Chief Executive Officer and Director |
| /s/ John E. Vollmer III<br>John E. Vollmer III<br>*(Principal Financial and Accounting Officer)* | Senior Vice President Corporate Development, Chief Financial Officer and Treasurer |
| /s/ Kenneth N. Berns<br>Kenneth N. Berns | Senior Vice President and Director |
| /s/ Robert C. Gist<br>Robert C. Gist | Director |
| /s/ Curtis W. Huff<br>Curtis W. Huff | Director |
| /s/ Terry H. Hunt<br>Terry H. Hunt | Director |

| | |
|---|---|
| /s/ Kenneth R. Peak | Director |
| Kenneth R. Peak | |
| | Director |
| Nadine C. Smith | |

**EXHIBIT INDEX**

| | |
|---|---|
| 3.1 | Restated Certificate of Incorporation, as amended (filed August 9, 2004 as Exhibit 3.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference). |
| 3.2 | Amendment to Restated Certificate of Incorporation, as amended (filed August 9, 2004 as Exhibit 3.2 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference). |
| 3.3 | Amended and Restated Bylaws (filed March 19, 2002 as Exhibit 3.2 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2001 and incorporated herein by reference). |
| 4.1 | Rights Agreement dated January 2, 1997, between Patterson Energy, Inc. and Continental Stock Transfer & Trust Company (filed January 14, 1997 as Exhibit 2 to the Company s Registration Statement on Form 8-A and incorporated herein by reference). |
| 4.2 | Amendment to Rights Agreement dated as of October 23, 2001 (filed October 31, 2001 as Exhibit 3.4 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2001 and incorporated herein by reference). |
| 4.3 | Restated Certificate of Incorporation, as amended (See Exhibits 3.1 and 3.2). |
| 4.4 | Registration Rights Agreement with Bear, Stearns and Co. Inc., dated March 25, 1994, as assigned by REMY Capital Partners III, L.P.(filed March 19, 2002 as Exhibit 4.3 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2001 and incorporated herein by reference). |
| 10.1 | For additional material contracts, see Exhibits 4.1, 4.2 and 4.4. |
| 10.2 | Patterson-UTI Energy, Inc., 1993 Stock Incentive Plan, as amended (filed March 13, 1998 as Exhibit 10.1 to the Company s Registration Statement on Form S-8 (File No. 333-47917) and incorporated herein by reference).* |
| 10.3 | Patterson-UTI Energy, Inc. Non-Employee Directors Stock Option Plan, as amended (filed November 4, 1997 as Exhibit 10.1 to the Company s Registration Statement on Form S-8 (File No. 333-39471) and incorporated herein by reference).* |
| 10.4 | Amended and Restated Patterson-UTI Energy, Inc. 2001 Long-Term Incentive Plan (filed November 27, 2002 as Exhibit 4.4 to Post Effective Amendment No. 1 to the Company s Registration Statement on Form S-8 (File No. 333-60470) and incorporated herein by reference).* |
| 10.5 | Patterson-UTI Energy, Inc. Amended and Restated 1997 Long-Term Incentive Plan (filed July 28, 2003 as Exhibit 4.7 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003 and incorporated herein by reference).* |
| 10.6 | Amendment to the Patterson-UTI Energy, Inc. Amended and Restated 1997 Long-Term Incentive Plan (filed August 9, 2004 as Exhibit 10.7 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).* |
| 10.7 | Amended and Restated Patterson-UTI Energy, Inc. Non-Employee Director Stock Option Plan(filed July 28, 2003 as Exhibit 4.8 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003 and incorporated herein by reference).* |
| 10.8 | Amended and Restated Patterson-UTI Energy, Inc. 1996 Employee Stock Option Plan (filed July 25, 2001 as Exhibit 4.4 to Post-Effective Amendment No. 1 to the Company s Registration Statement on Form S-8 (File No. 333-60466) and incorporated herein by reference).* |
| 10.9 | Patterson-UTI Energy, Inc. 2005 Long-Term Incentive Plan, including Form of Executive Officer Restricted Stock Award Agreement, Form of Executive Officer Stock Option Agreement, Form of Non-Employee Director Restricted Stock Award Agreement and Form of Non-Employee Director Stock Option Agreement (filed June 15, 2005 as Exhibit 10.1 to the Company s Current Report on Form 8-K, and incorporated herein by reference).* |
| 10.10 | |

| | |
|---|---|
| | Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and Mark S. Siegel (filed August 9, 2004 as Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).* |
| 10.11 | Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and Cloyce A. Talbott (filed August 9, 2004 as Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).* |

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|---|---|
| 10.12 | Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and A. Glenn Patterson (filed August 9, 2004 as Exhibit 10.3 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).* |
| 10.13 | Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and Kenneth N. Berns (filed August 9, 2004 as Exhibit 10.4 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).* |
| 10.14 | Restricted Stock Award Agreement dated April 28, 2004 between Patterson-UTI Energy, Inc. and John E. Vollmer III (filed August 9, 2004 as Exhibit 10.6 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004 and incorporated herein by reference).* |
| 10.15 | Patterson-UTI Energy, Inc. Change in Control Agreement, effective as of January 29, 2004, by and between Patterson-UTI Energy, Inc. and Mark S. Siegel (filed on February 4, 2004 as Exhibit 10.2 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).* |
| 10.16 | Employment Agreement, effective as of May 3, 2006 between Patterson-UTI Energy, Inc. and A. Glenn Patterson (filed on May 5, 2006 as Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 206 and incorporated herein by reference).* |
| 10.17 | Patterson-UTI Energy, Inc. Change in Control Agreement, effective as of January 29, 2004, by and between Patterson-UTI Energy, Inc. and Cloyce A. Talbott (filed on February 4, 2004 as Exhibit 10.4 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).* |
| 10.18 | Patterson-UTI Energy, Inc. Change in Control Agreement, effective as of January 29, 2004, by and between Patterson-UTI Energy, Inc. and Kenneth N. Berns (filed on February 4, 2004 as Exhibit 10.5 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).* |
| 10.19 | Patterson-UTI Energy, Inc. Change in Control Agreement, effective as of January 29, 2004, by and between Patterson-UTI Energy, Inc. and John E. Vollmer III (filed on February 4, 2004 as Exhibit 10.7 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference).* |
| 10.20 | Form of Letter Agreement regarding termination, effective as of January 29, 2004, entered into by Patterson-UTI Energy, Inc. with each of Mark S. Siegel, Kenneth N. Berns and John E. Vollmer III (filed on February 25, 2005 as Exhibit 10.23 to the Company s Annual Report on Form 10-K for the year ended December 31, 2004 and incorporated herein by reference).* |
| 10.21 | Form of Indemnification Agreement entered into by Patterson-UTI Energy, Inc. with each of Mark S. Siegel, Cloyce A. Talbott, A. Glenn Patterson, Kenneth N. Berns, Robert C. Gist, Curtis W. Huff, Terry H. Hunt, Kenneth R. Peak, Nadine C. Smith and John E. Vollmer III (filed April 28, 2004 as Exhibit 10.11 to the Company s Annual Report on Form 10-K, as amended, for the year ended December 31, 2003 and incorporated herein by reference).* |
| 10.22 | Credit Agreement dated as of December 17, 2004 among Patterson-UTI Energy, Inc., as the Borrower, Bank of America, N.A., as administrative agent, L/C Issuer and a Lender and the other lenders and agents party thereto (filed on December 23, 2004 as Exhibit 10.1 to the Company s Current Report on Form 8-K and incorporated herein by reference). |
| 10.23 | Commitment Increase and Joinder Agreement, dates as of August 2, 2006, by and among Patterson-UTI Energy, Inc., the guarantors party thereto, the lenders party thereto, and Bank of America, N.A. as Administrative Agent, L/C Issuer and Lender (filed August 21, 2006 as Exhibit 10.1 to the Company s Current Report on Form 8-K and incorporated herein by reference). |
| 10.24 | Letter Agreement dated February 6, 2006 between Patterson-UTI Energy, Inc. and John E. Vollmer III (filed May 1, 2006 as Exhibit 10.25 to the Company s Annual Report on Form 10-K, as amended, and incorporated herein by reference).* |

| | |
|---|---|
| 14.1 | Patterson-UTI Energy, Inc. Code of Business Conduct and Ethics for Senior Financial Executives (filed on February 4, 2004 as Exhibit 14.1 to the Company s Annual Report on Form 10-K for the year ended December 31, 2003 and incorporated herein by reference). |
| 21.1 | Subsidiaries of the Registrant. |
| 23.1 | Consent of Independent Registered Public Accounting Firm. |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended. |

| | |
|---|---|
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

* Management Contract or Compensatory Plan identified as required by Item 15(a)(3) of Form 10-K.