FLOTEK INDUSTRIES INC/CN/
Form 10-K
March 16, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number 1-13270

FLOTEK INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

Delaware	**90-0023731**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
7030 Empire Central Drive, Houston, Texas	**77040**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code (713) 849-9911

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange of which registered
Common Stock, $0.0001 par value	**American Stock Exchange**

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy of information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. x

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

Large accelerated filer ¨ Accelerated filer **x** Non-accelerated filer ¨

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

The aggregate market value of the common stock held by non-affiliates of the registrant was approximately $87,611,000 as of the last business day of the Registrant s recently completed second fiscal quarter June 30, 2006. As of March 12, 2007, the Registrant had 9,011,472 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s Proxy Statement for its 2007 annual meeting of shareholders have been incorporated by reference into Part II and III of this Form 10-K.

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FORWARD-LOOKING STATEMENTS

We have included or incorporated by reference in this Annual Report on Form 10-K, and from time to time our management may make, statements that may constitute forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not historical facts but instead represent only our current belief regarding future events, many of which, by their nature, are inherently uncertain and outside our control. The forward-looking statements contained in this Annual Report are based on information as of the date of this Annual Report. Many of these forward looking statements relate to future industry trends, actions, future performance or results of current and anticipated initiatives and the outcome of contingencies and other uncertainties that may have a significant impact on our business, future operating results and liquidity. We try, whenever possible, to identify these statements by using words such as anticipate, believe, should, estimate, expect, plan, project and similar expressions. We caution you that these statements predictions and are not guarantees of future performance. These forward-looking statements and our actual results, developments and business are subject to certain risks and uncertainties that could cause actual results and events to differ materially from those anticipated by these statements. By identifying these statements for you in this manner, we are alerting you to the possibility that our actual results may differ, possibly materially, from the anticipated results indicated in these forward-looking statements. Important factors that could cause actual results to differ from those in the forward-looking statements include, among others, those discussed below and under Risk Factors in Part I, Item 1A and Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7.

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PART I

Item 1. Business.
General

Flotek Industries, Inc. is a diversified global supplier of drilling and production related products and services to the energy and mining industries. Our core focus is oilfield specialty chemicals and logistics, downhole drilling tools and downhole production tools. Flotek offers its products primarily through its sales organizations, as well as through independent distributors and agents. Flotek was founded in 1985 and is headquartered in Houston, Texas. On July 27, 2005, our common stock began trading on the American Stock Exchange (AMEX) under the stock ticker symbol FTK . Prior to this date, our common stock was traded on the OTC Bulletin Board under the stock ticker symbol, FLTK or FLTK.OB . Our website is located at *http://www.flotekind.com.* Information contained in our website or links contained on our website are not part of this filing. As used herein, Flotek, Company, we, our and us may refer to Flotek Industries, Inc. and/or its subsidiaries. The use of t terms is not intended to connote any particular corporate status or relationships.

Historical Development

Flotek was originally incorporated under the laws of the Province of British Columbia on May 17, 1985. On October 23, 2001, we approved a change in our corporate domicile to the state of Delaware and a reverse stock split of 120 to 1. On October 31, 2001, we completed a reverse merger with CESI Chemical, Inc. (CESI). Since that date, we have entered into the following acquisitions that were outside the ordinary course of our business:

- acquired IBS 2000, Inc., a Denver-based company engaged in the development and manufacturing of environmentally neutral chemicals for the oil industry, on February 19, 2002,

- acquired manufacturing assets, inventory and intellectual property rights to produce oilfield shale shaker screens from Phoenix E&P Technology, LLC on January 28, 2005,

- acquired Spidle Sales and Services, Inc. (Spidle), a downhole tool company with rental, sales and manufacturing operations throughout the Rocky Mountains, on February 14, 2005,

- acquired the assets of Harmon s Machine Works, Inc. (Harmon), a downhole oilfield and mining tool company with manufacturing and sales operations located in Midland, Texas, on August 19, 2005,

- acquired the assets of Precision-LOR, Ltd. (LOR), a drilling tool rental and inspection service provider in South Texas, on August 31, 2005,

- acquired the assets of Can-Ok Oil Field Services, Inc. and Stabilizer Technology, Inc. (collectively Can-Ok) a downhole oilfield tool company located in Chickasha, Oklahoma on January 2, 2006,

- acquired the tangible assets and licensed the rights to exercise the exclusive worldwide rights to a patented gas separator used in coal bed methane production in the Powder River Basin from Total Well Solutions, LLC. (TWS) on April 3, 2006,

acquired the assets of LifTech, LLC (LifTech) which markets and services electric submersible pumps and downhole gas/water separators primarily to coal bed methane gas producers in the Powder River Basin on June 6, 2006,

acquired the assets of Triumph Drilling Tools, a downhole tool company with rental, inspection and manufacturing operations throughout the Gulf Coast and Mid-Continent regions, on January 4, 2007,

acquired a 50% partnership interest in CAVO Drilling Motors Ltd Co. on January 31, 2007, a downhole mud-motor company with domestic rentals and international sales operations.

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Description of Operations

Our reportable segments are strategic business units that offer various products and services. Each business segment requires different technology and marketing strategies, and is managed independently. All three segments market products domestically and internationally.

Chemicals and Logistics

The specialty chemical division offers a full spectrum of oilfield specialty chemicals used for drilling, cementing, stimulation, and production. The specialty chemical division provides chemical technology solutions to maximize recovery from both new and mature fields. Two laboratories focus on design, development and testing of new chemical formulations and enhancement of existing products, often in cooperation with our customers. The development of specialty chemicals with enhanced performance characteristics to withstand a wide range of downhole pressures, temperatures and other well-specific conditions is key to the success of this business unit.

The customer base for the specialty chemical business is primarily oil and gas pumping service companies, including both major and independent oilfield service companies. The segment manufactures its products in Oklahoma and The Netherlands. We distinguish ourselves through the strength of our innovative and proprietary products, dedication to product quality and superior customer service. The division s products provide measurable productivity increases and solutions to environmental problems.

Our logistics division designs, project manages and operates automated bulk material handling and loading facilities for oilfield service companies. The domestic customer base for this segment consists of one major independent oilfield service company which specializes in pressure pumping, cementing and stimulation services. We also contract with international customers to design and project manage the construction of bulk handling facilities. Our client s bulk facilities handle oilfield products including sand and other materials for well fracturing operations, dry cement and additives for oil and gas well cementing, and supplies and materials used in oilfield operations which we blend to specification.

Drilling Products

The Drilling Products segment is a leading provider of downhole drilling tools used in the oilfield, mining, water-well and industrial drilling sectors. We manufacture, sell, rent and inspect specialized equipment for use with drilling, completion, production and workover activities. Through internal growth and acquisitions, we have increased the size and breadth of our rental tool inventory and geographic scope of operations so that we now conduct operations throughout the United States and in select international market areas. Our rental tools include stabilizers, drill collars, reamers, wipers, jars and mud-motors.

Our sales efforts include centralizers and bits. We manufacture a line of fixed, rigid and integral joint centralizers used in oil and gas well cementing programs to increase the effectiveness of such operations. In addition, we market a wide variety of drill bits including tricone and PDC bits.

Our customers in the Drilling Products segment are primarily oil and gas exploration and production companies, including major oil companies, which own producing oil and gas wells and are involved in the drilling and cementing of oil and gas wells. Marketing for our products is focused primarily in the Gulf of Mexico, Mid-Continent and Rocky Mountain regions of the United States, with international sales conducted through agents.

Artificial Lift

The Artificial Lift (renamed from Production Products) segment provides pumping system components including electric submersible pumps (ESP), gas separators, production valves and services. Our products

address the needs of coal bed methane, traditional gas and heavy crude production. The majority of our products are manufactured in China and assembled and distributed domestically. Our customers are primarily domestic and international oil and gas exploration and production companies.

Product Demand and Marketing

The demand for our products and services is generally correlated to the level of oil and gas drilling activity, workover activity and gas production levels, both in the United States and internationally. We market our products primarily through direct sales to our customers through Company managers and sales employees. We have established customer relationships which provide for repeat sales. The majority of our marketing is currently conducted within the United States. However, we have been expanding our international sales efforts and we expect international sales to continue to increase. Internationally, we operate primarily through agents in Canada, Mexico, Central and South America, the Middle East, Asia and Russia.

Customers

The customers for our products and services include the major integrated oil and natural gas companies, independent oil and natural gas companies, pressure pumping service companies and state-owned national oil companies. Although we are not dependent on one or a few major customers, five customers accounted for approximately 30% of consolidated revenue for the year ended December 31, 2006, 32% of consolidated revenue for the year ended December 31, 2005 and 47% of consolidated revenue for the year ended December 31, 2004. The majority of these sales were in the Chemicals and Logistics segment and collectively accounted for approximately 47% of revenue for the segment for the year ended December 31, 2006, 49% of revenue for this segment for the year ended December 31, 2005 and 57% of revenue for this segment for the year ended December 31, 2004. One customer of the five accounted for approximately 8% of consolidated revenue for the year ended December 31, 2006. The same customer accounted for approximately 15% of revenue of our Chemicals and Logistics segment for the year ended December 31, 2006.

Research and Development

We are engaged in research and development activities directed primarily toward the improvement of existing products and services, the design of specialized products to meet specific customer needs and the development of new products, processes and services. We incurred $0.7 million, $0.6 million and $0.3 million in research and development expenses for the years ended December 31, 2006, 2005 and 2004, respectively.

Intellectual Property

We have followed a policy of seeking patent protection both within and outside the United States for products and methods that appear to have commercial significance and qualify for patent protection. The decision to seek patent protection considers whether such protection can be obtained on a cost-effective basis and is likely to be effective in protecting our commercial interests. We believe our patents and trademarks, together with our trade secrets and proprietary design, manufacturing and operational expertise, are reasonably adequate to protect our intellectual property and provide for the continued operation of our business. We maintain patents on our production valve design and casing centralizer design, and trade secrets and pending patents on certain specialty chemicals.

Competition

Our ability to compete in the oilfield services market is dependent on our ability to differentiate our products and services, provide superior quality and service, and maintain a competitive cost structure. Activity levels in our three segments are driven primarily by current and expected commodity prices, drilling rig count, oil and gas production levels, and customer capital spending allocated for drilling and production. The regions in

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which we operate are highly competitive. The competitive environment has intensified as recent mergers among oil and gas companies have reduced the number of available customers. Many other oil and gas service companies are larger than we are and have greater resources than we have. These competitors are better able to withstand industry downturns, compete on the basis of price and acquire new equipment and technologies, all of which could affect our revenue and profitability. These competitors compete with us both for customers and for acquisitions of other businesses. This competition may cause our business to suffer. We believe that competition for contracts will continue to be intense in the foreseeable future.

Raw Materials

The Chemical and Logistics segment s operations purchase their principal raw material and chemical feed stocks on the open market. Collection and transportation of these raw materials to the Company s facilities can be adversely affected by extreme weather conditions. Prices for the chemical feed stocks also vary in relation to the general business cycle and global demand. The Drilling Products and Artificial Lift segments purchase their principal raw material and steel on the open market. Except for a few chemical additives, the raw materials are available in most cases from several suppliers at market prices. We use multiple suppliers, both domestically and internationally, for our key raw materials purchases.

Government Regulations

We are subject to federal, state and local environmental and occupational safety and health laws and regulations in the United States and other countries in which we do business. We strive to comply fully with these requirements and are not aware of any material instances of noncompliance. Many of the products within our Chemicals and Logistics segment are considered hazardous or flammable. If a leak or spill occurs in connection with our operations, we could incur material costs, net of insurance, to remediate any resulting contamination.

Employees

As of December 31, 2006, we employed 253 employees, of which 246 were full-time and 7 were part-time. None of our employees are covered by collective bargaining agreements.

Item 1A. Risk Factors.

This document and our other filings with the Securities and Exchange Commission (the SEC), and other materials released to the public contain forward-looking statements, as defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements may discuss our prospects, expected revenue, expenses and profits, strategies for our operations and other subjects, including conditions in the oilfield service and oil and natural gas industries and in the United States and international economy in general.

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

Risks Related to Our Business

We may pursue strategic acquisitions, which could have an adverse impact on our business.

Our business strategy includes growing our business through strategic acquisitions of complementary businesses. Acquisitions that we may make in the future may entail a number of risks that could adversely affect our business and results of operations. The process of negotiating potential acquisitions or integrating newly

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acquired businesses into our business could divert our management s attention from other business concerns and could be expensive and time consuming. Acquisitions could expose our business to unforeseen liabilities or risks associated with entering new markets or businesses. Consequently, we might not be successful in integrating our acquisitions into our existing operations, which may result in unforeseen operational difficulties or diminished financial performance or require a disproportionate amount of our management s attention and resources. Even if we are successful in integrating our acquisitions into our existing operations, we may not derive the benefits, such as operational or administrative synergies, that we expect from such acquisitions, which may result in the commitment of capital resources without the anticipated returns on such capital. In addition, we may not be able to continue to identify attractive acquisition opportunities or successfully acquire identified targets. Competition for acquisition opportunities may escalate, increasing our cost of making further acquisitions or causing us to refrain from making additional acquisitions. We also must meet certain financial covenants in order to borrow money under our senior credit facility to fund future acquisitions and to borrow for other purposes which, if not met, could prevent us from making future acquisitions.

If we do not manage the potential difficulties associated with expansion successfully, our operating results could be adversely affected.

We have grown over the last several years through internal growth and strategic acquisitions of other businesses and assets. We believe our future success depends in part on our ability to manage the growth we have experienced. The following factors could present difficulties to our business going forward:

- lack of sufficient experienced management personnel;
- increased administrative burdens; and
- increased logistical problems common to large, expansive operations.

If we do not manage these potential difficulties successfully, our operating results could be adversely affected. In addition, we may have difficulties managing the increased costs associated with our growth, which could adversely affect our operating margins. The historical financial information incorporated by reference herein is not necessarily indicative of the results that we would have achieved had we operated the companies we recently acquired under a fully integrated corporate structure or the results that we may realize in the future.

Our business depends primarily on domestic spending by the oil and gas industry, and this spending and our business may be adversely affected by industry conditions that are beyond our control.

We depend primarily on our customers willingness to make operating and capital expenditures to explore for, develop and produce oil and gas in the United States. Customers expectations for lower market prices for oil and gas may curtail spending thereby reducing demand for our products and services. Industry conditions in the United States are influenced by numerous factors over which we have no control, such as the supply of and demand for oil and gas, domestic and international economic conditions, political instability in oil and gas producing countries and merger and divestiture activity among oil and gas producers. The volatility of the oil and gas industry and the consequent effect on exploration and production activity could adversely affect the level of drilling and production activity by some of our customers. This reduction may cause a decline in the demand for, or adversely affect the price of, our products and services. Reduced discovery rates of new oil and gas reserves in our market areas could also have a negative long-term impact on our business, even in an environment of stronger oil and gas prices, to the extent existing production is not replaced or the number of drilling and producing wells declines because of substantial depletion of existing domestic reserves or the availability of cheaper reserves outside the United States. In addition, domestic demand for oil and gas may be uniquely affected by public attitudes in the United States regarding drilling in environmentally sensitive areas, vehicle emissions and other environmental standards, alternative fuels and taxation of oil and gas and excess profits of oil and gas companies, and the potential changes in federal and state regulation and policy that may result from such public attitudes.

Our future success and profitability may be adversely affected if we or our suppliers fail to develop and introduce new and innovative products and services that appeal to our customers.

The oil and gas drilling industry is characterized by continual technological developments that have resulted in, and likely will continue to result in, substantial improvements in the scope and quality of oilfield chemicals, drilling and artificial lift products and services and product function and performance. As a result, our future success depends, in part, upon our and our suppliers continued ability to develop and introduce new and innovative products and services in order to address the increasingly sophisticated needs of our customers and anticipate and respond to technological and industry advances in the oil and gas drilling industry in a timely manner. If we or our suppliers fail to successfully develop and introduce new and innovative products and services that appeal to our customers, or if new market entrants or our competitors offer such products and services, our revenue and profitability may suffer.

Our ability to grow and compete in the future will be adversely affected if adequate capital is not available.

The ability of our business to grow and compete depends on the availability of adequate capital, which in turn depends in large part on our cash flow from operations and the availability of equity and debt financing. We cannot assure you that our cash flow from operations will be sufficient or that we will be able to obtain equity or debt financing on acceptable terms or at all to implement our growth strategy. For example, our senior credit facility restricts our ability to incur additional indebtedness and requires us to meet certain financial covenants in order to borrow money, including borrowings to fund future acquisitions, a key component of our growth strategy. As a result, we cannot assure you that adequate capital will be available to finance our current growth plans, take advantage of business opportunities or respond to competitive pressures, any of which could harm our business.

If we lose the services of key members of our management, we may not be able to manage our operations and implement our growth strategy effectively.

We will depend on the continued service of Jerry D. Dumas, age 71, our Chairman and Chief Executive Officer, who possesses significant expertise and knowledge of our business and industry. We do not have an employment agreement with Mr. Dumas, nor do we carry key man life insurance on him. Any loss or interruption of the services of Mr. Dumas could significantly reduce our ability to manage effectively our operations and implement our growth strategy, and we cannot assure you that we would be able to find appropriate replacements should the need arise.

Our current insurance policies may not be adequate to protect our business from all potential risks.

Our operations are subject to hazards inherent in the oil and gas industry, such as, but not limited to, accidents, blowouts, explosions, fires, oil and chemical spills and other hazards. These conditions can cause personal injury or loss of life, damage to property, equipment and the environment, and suspension of oil and gas operations of our customers. Litigation arising from a catastrophic occurrence at a location where our equipment, products or services are being used may result in us being named as a defendant in lawsuits asserting large claims. We maintain insurance coverage that we believe to be customary in the industry against these hazards. However, we do not have insurance against all foreseeable risks, either because insurance is not available or because of the high premium costs. In addition, we may not be able to maintain adequate insurance in the future at rates we consider reasonable. As a result, losses and liabilities arising from uninsured or underinsured events could have a material adverse effect on our business, financial condition and results of operations.

We are subject to complex federal, state and local laws and regulations that could adversely affect our operations.

Our operations are subject to federal, state and local laws and regulations relating to protection of natural resources and the environment, health and safety, waste management and transportation of waste and other

materials. In order to conduct our operations in compliance with these laws and regulations, we must obtain and maintain permits, approvals and certificates from various federal, state and local governmental authorities. We may incur substantial costs in order to maintain compliance with these existing laws and regulations. In addition, our costs of compliance may increase if existing laws and regulations are amended or reinterpreted, or if new laws and regulations become applicable to our operations. Such amendments or reinterpretations of existing laws or regulations and the adoption of new laws or regulations could curtail exploratory or developmental drilling for and production of oil and gas which, in turn, could limit demand for our products and services. In addition, under these laws and regulations, we may become liable for penalties, damages or costs of remediation which could increase our costs of doing business.

We are subject to environmental laws and regulations which expose us to costs and liabilities that could have a material adverse effect on our business, financial condition and results of operation.

Our Chemicals and Logistics segment includes chemical manufacturing, packaging, handling and delivery operations that pose risks of environmental liability that could result in fines and penalties, expenditures for remediation, and liability for property damage and personal injuries. Sanctions for noncompliance with applicable environmental laws and regulations also may include assessment of administrative, civil and criminal penalties, revocation of permits and issuance of corrective action orders.

Laws protecting the environment generally have become more stringent over time and are expected to continue to do so, which could lead to material increases in costs for future environmental compliance and remediation. The modification or interpretation of existing laws or regulations, or the adoption of new laws or regulations, could curtail exploratory or developmental drilling for oil and gas and could severely limit opportunities to sell the Company s products and services. Some environmental laws and regulations may impose strict liability, which means that in some situations we could be exposed to liability as a result of our conduct that was lawful at the time it occurred or conduct of, or conditions caused by, prior operators or other third parties. Clean-up costs and other damages arising as a result of environmental laws, and costs associated with changes in environmental laws and regulations, could be substantial and could have a material adverse effect on our financial condition.

If we are unable to adequately protect our intellectual property rights our business is likely to be adversely affected.

We rely on a combination of patents, trademarks, non-disclosure agreements and other security measures to establish and protect our proprietary rights. Although we believe that those measures, together with our trade secrets and proprietary design, manufacturing and operational expertise, are reasonably adequate to protect our intellectual property and provide for the continued operation of our business, it is uncertain that the measures we have taken or may take in the future will prevent misappropriation of our proprietary information or that others will not independently develop similar products or services, design around our proprietary or patented technology or duplicate our products or services.

We and our customers are subject to risks associated with doing business outside of the United States which may expose us to political, foreign exchange and other uncertainties.

During the years ended December 31, 2006, 2005 and 2004, approximately 7%, 16% and 14%, respectively, of our consolidated revenue was derived from the sale of products for use outside of the United States. Accordingly, we and our customers are subject to certain risks inherent in doing business outside of the United States, including governmental instability, war and other international conflicts, civil and labor disturbances, requirements of local ownership, partial or total expropriation or nationalization, currency devaluation, foreign exchange control and foreign laws and policies, each of which may limit the movement of assets or funds or result in the deprivation of contract rights or the taking of property without fair compensation. Collections and recovery of rental tools from international customers and agents may also prove more difficult due to the

uncertainties of foreign law and judicial procedure. We may therefore experience significant difficulty resulting from the political or judicial climate in countries in which we operate or in which our products are used. In addition, from time to time the United States has passed laws and imposed regulations prohibiting or restricting trade with certain nations.

Although most of our international revenue is derived from transactions denominated in United States dollars, we have conducted and likely will continue to conduct some business in currencies other than the United States dollar. We currently do not hedge against foreign currency fluctuations. Accordingly, our profitability could be affected by fluctuations in foreign exchange rates. We have no assurance that future laws and regulations will not materially adversely affect our international business.

Failure to maintain effective disclosure controls and procedures and internal controls over financial reporting could have an adverse effect on our operations and the trading price of our common stock.

Effective internal controls are necessary for us to provide reliable financial reports, effectively prevent fraud and operate successfully as a public company. If we cannot provide reliable financial reports or prevent fraud, our reputation and operating results could be harmed. Our efforts to maintain our internal controls may not be successful, and we may be unable to maintain adequate controls over our financial processes and reporting in the future, including compliance with the obligations under Section 404 of the Sarbanes-Oxley Act of 2002. Any failure to maintain effective controls, or difficulties encountered in their implementation or other effective improvement of our internal controls could harm our operating results or cause us to fail to meet our reporting obligations. Ineffective internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our common stock.

Risks Related to Our Industry

Volatility or decline in oil and natural gas prices may result in reduced demand for our products and services which may adversely affect our business, financial condition and results of operation.

The markets for oil and natural gas have historically been extremely volatile. We anticipate that these markets will continue to be volatile in the future. Although oil and gas prices have increased significantly in recent years, there can be no guarantees that these prices will remain at current levels. Such volatility in oil and gas prices, or the perception by our customers of unpredictability in oil and natural gas prices, affects the spending patterns in our industry. The demand for our products and services is, in large part, driven by current and anticipated oil and gas prices and the related general levels of production spending and drilling activity. In particular, volatility or a decline in oil and gas prices may cause a decline in exploration and drilling activities. This, in turn, could result in lower demand for our products and services and may cause lower prices for our products and services. As a result, volatility or a prolonged decline in oil or natural gas prices may adversely affect our business, financial condition and results of operations.

Competition from new and existing competitors within our industry could have an adverse effect on our results of operations.

The oil and gas industry is highly competitive and fragmented. Our principal competitors include numerous small companies capable of competing effectively in our markets on a local basis as well as a number of large companies that possess substantially greater financial and other resources than we do. Our larger competitors may be able to devote greater resources to developing, promoting and selling their products and services. We may also face increased competition due to the entry of new competitors including current suppliers that decide to sell their products and services directly. As a result of this competition, we may experience lower sales or greater operating costs, such as marketing costs, which may have an adverse effect on our margins and results of operations.

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Our industry has experienced a high rate of employee turnover. Any difficulty we experience attracting or retaining personnel could adversely affect our business.

We operate in a highly competitive industry for securing qualified personnel with the required technical skills and experience. Our services require skilled personnel who can perform physically demanding work. Due to industry volatility and the demanding nature of the work, workers may choose to pursue employment in fields that offer a more desirable work environment at wages that are competitive with ours. As a result, we may not be able to find enough labor to meet our needs, which could limit our growth. In addition, the cost of attracting and retaining qualified personnel has increased over the past several years due to competition, and we expect it will continue to increase in the future. In order to attract and retain qualified personnel we may be required to offer increased wages and benefits. If we are not able to increase the prices of our products and services to compensate for increases in compensation, or if we are unable to attract and retain qualified personnel, our operating results could be adversely affected.

Severe weather could have a material adverse impact on our business.

Our business could be materially and adversely affected by severe weather. Hurricanes, tropical storms, blizzards and cold weather and other weather hazards may cause the curtailment of services, damages to our equipment and facilities, interruptions in the transportation of our products and materials in accordance with contract schedules and loss of productivity. If our customers are unable to operate or are required to reduce their operations due to severe weather, and as a result curtail the purchases of our products and services, our business could be materially adversely affected.

A terrorist attack or armed conflict could harm our business.

Terrorist activities, anti-terrorist efforts and other armed conflict involving the United States may adversely affect the United States and global economies and could prevent us from meeting our financial and other obligations. We may experience loss of business or delays or defaults in payments from payers that have been affected by actual or potential terrorist activities. In addition, such activities could reduce the overall demand for oil and natural gas which, in turn, could reduce the demand for our products and services. We have implemented certain security measures in response to the threat of terrorist activities. Terrorist activities and the threat of potential terrorist activities and any resulting economic downturn could adversely affect our results of operations, impair our ability to raise capital or otherwise adversely impact our ability to execute our business strategy.

Risks Related to Our Indebtedness

Our senior credit facility contains certain covenants that may limit our flexibility and prevent us from taking certain actions, which could adversely affect our ability to execute our business strategy.

Our senior credit facility includes a number of significant restrictive covenants. These covenants could adversely affect us by limiting our ability to plan for or react to market conditions, meet our capital needs and execute our business strategy. These covenants, among other things, limit our ability, without the consent of the lender, to:

- incur certain types and amounts of additional debt;
- consolidate, merge or sell our assets or materially change the nature of our business;
- pay dividends on capital stock and make restricted payments;
- make voluntary prepayments, or materially amend the terms, of subordinated debt;
- enter into certain types of transactions with affiliates;

make certain investments;

- make certain capital expenditures; and
- incur certain liens.

These covenants may restrict our operating and financial flexibility and limit our ability to respond to changes in our business or competitive activities. Our senior credit facility also requires us to maintain certain financial ratios and satisfy certain financial conditions, several of which may require us to reduce our debt or take some other action in order to comply with the covenants. If we fail to comply with these covenants, we could be in default. In the event of a default, our lender could elect to declare all the amounts borrowed, together with accrued and unpaid interest, to be due and payable. In addition, the lender could elect to terminate its commitment to us, and we or one or more of our subsidiaries could be forced into liquidation or bankruptcy. Any of the foregoing consequences could restrict our ability to execute our business strategy.

We may not be able to generate sufficient cash flows to meet our debt service obligations.

Due to an extensive capital expenditure program in 2006 we exceeded the indebtedness covenant, fixed charge coverage ratio and capital expenditures limit set forth in our senior credit facility in 2006. We obtained waivers from our principal lender of those covenants on September 30, 2006 and redefined the covenant limits based on an expanded capital expenditures program. Our ability to generate sufficient cash flows from operations to make scheduled payments on these debt obligations will depend on our future financial performance, which will be affected by a range of economic, competitive, regulatory and industry factors, many of which are beyond our control. If we are unable to generate sufficient cash flows or otherwise obtain the funds required to make principal and interest payments on our indebtedness, we may have to undertake alternative financing plans, such as refinancing or restructuring our debt, selling assets, reducing or delaying capital investments or seeking to raise additional capital. We cannot assure that any refinancing would be possible or that any assets could be sold on acceptable terms or otherwise to meet our debt obligations. Our inability to generate sufficient cash flows to satisfy such obligations, or to refinance our obligations on commercially reasonable terms, would have an adverse effect on our business, financial condition and results of operations.

Risks Related to the Common Stock

The market price of our common stock could drop significantly following sales of substantial amounts of our common stock in the public markets.

We are unable to predict the amount or timing of sales by the selling shareholders of our common stock, but sales of substantial amounts in the public market could lower the market price of our stock.

The market price of our common stock has been and may continue to be volatile.

The market price of our common stock has historically been subject to significant fluctuations. The following factors, among others, could cause the price of our common stock in the public market to fluctuate significantly:

- variations in our quarterly results of operation;
- changes in market valuations of companies in our industry;
- fluctuation in stock market prices and volume;
- fluctuation in oil and natural gas prices;
- issuance of common stock or other securities in the future;

the addition or departure of key personnel; and

announcements by us or our competitors of new business, acquisitions or joint ventures.

The stock market has experienced extreme price and volume fluctuations in recent years that have significantly affected the prices of the common stock of many companies, including companies in our industry. The changes often occur without regard to specific operating performance. The price of our common stock could continue to fluctuate based upon factors that have little to do with our company, and these fluctuations could materially reduce our stock price. Class action lawsuits have frequently been brought against companies following periods of volatility in the market price of their common stock. If we become involved in this type of litigation it could be expensive and divert management s attention and company resources, which could have a material adverse effect on our business, financial condition and results of operation.

An active market for our common stock may not continue to exist or may not continue to exist at current trading levels.

Our common stock is quoted on the American Stock Exchange. While there is currently one specialist in our common stock, this specialist is not obligated to continue to make a market in our common stock. In the event it does not continue to make a market in our common stock, the liquidity of our common stock could be adversely impacted and a stockholder could have difficulty obtaining accurate stock quotes. Trading volume for our common stock has historically been low. Despite the increase in the number of shares of common stock publicly held as a result of a private placement in 2005 and the exercise of warrants, we cannot assure you that an active trading market for our common stock will develop or be sustained.

We have no plans to pay dividends on our common stock, and therefore, investors will have to look to stock appreciation for return on their investments.

We do not anticipate paying any cash dividends on our common stock in the foreseeable future. We currently intend to retain all future earnings to fund the development and growth of our business. Any payment of future dividends will be at the discretion of our board of directors and will depend on, among other things, our earnings, financial condition, capital requirements, level of indebtedness, statutory and contractual restrictions applying to the payment of dividends and other considerations that the board of directors deems relevant. Certain covenants of our senior credit facility restrict the payment of dividends without the prior written consent of the lenders. Investors must rely on sales of their common stock after price appreciation, which may never occur, in order to realize a return on their investment.

Certain anti-takeover provisions of our charter documents and under Delaware law could discourage or prevent others from acquiring our company, which may adversely affect the market price of our common stock.

Our certificate of incorporation and bylaws contain provisions that:

- permit us to issue, without stockholder approval, up to 100,000 shares of preferred stock, in one or more series and, with respect to each series, to fix the designation, powers, preferences and rights of the shares of the series;
- limit the ability of stockholders to act by written consent or to call special meetings;
- prohibit cumulative voting;
- prohibit stockholders from amending or repealing the bylaws;
- require advance notice for stockholder proposals and nominations for election to the board of directors to be acted upon at meetings of stockholders.

In addition, Section 203 of the Delaware General Corporation Law limits business combinations with owners of more than 15% of our stock that have not been approved by the board of directors. These provisions and other similar provisions make it more difficult for a third party to acquire us without negotiation. Our board of directors could choose not to negotiate with an acquirer that it did not feel was in our strategic interest. If the acquirer were discouraged from offering to acquire us or prevented from successfully completing a hostile acquisition by the anti-takeover measures, you could lose the opportunity to sell your shares at a favorable price.

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Future issuance of additional shares of our common stock could cause dilution of ownership interests and adversely affect our stock price.

The company may in the future issue its previously authorized and unissued securities, resulting in the dilution of the ownership interests of its current stockholders. We are currently authorized to issue 20,000,000 shares of common stock with such rights as determined by our board of directors. The potential issuance of such additional shares of common stock may create downward pressure on the trading price of our common stock. We may also issue additional shares of our common stock or other securities that are convertible into or exercisable for common stock for capital raising or other business purposes. Future sales of substantial amounts of common stock, or the perception that sales could occur, could have a material adverse effect on the price of our common stock.

We may issue shares of preferred stock with greater rights than our common stock.

Subject to the rules of the American Stock Exchange, our articles of incorporation authorize our board of directors to issue one or more series of preferred stock and set the terms of the preferred stock without seeking any further approval from holders of our common stock. Currently, there are 100,000 preferred shares authorized but none issued. Any preferred stock that is issued may rank ahead of our common stock in terms of dividends, priority and liquidation premiums and may have greater voting rights than holders of our common stock.

Item 1B. Unresolved Staff Comments.

The Company has no unresolved staff comments as of the date of this report.

Item 2. Properties.

The following table describes the location and general character of the principal physical properties used in each of our company s businesses as of December 31, 2006.

Segment	**Own/Lease**	**Location**
Chemicals and Logistics	Owned	Marlow, Oklahoma
	Leased	Raceland, Louisiana
	Owned	Raceland, Louisiana
	Leased	Denver, Colorado
Drilling Products	Owned	Midland, Texas
	Owned	Robstown, Texas
	Owned	Vernal, Utah
	Owned	Evanston, Wyoming
	Owned	Mason, Texas
	Leased	Houston, Texas
	Owned	Chickasha, Oklahoma
	Leased	Grand Junction, Colorado
	Leased	Lafayette, Louisiana
Artificial Lift	Leased	Gillette, Wyoming
	Owned	Gillette, Wyoming
	Leased	Sheridan, Wyoming
	Leased	Houston, Texas
General Corporate	Leased	Houston, Texas

We consider our facilities to be in good condition and suitable for the conduct of our business.

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Item 3. Legal Proceedings.

We are involved, on occasion, in routine litigation incidental to our business.

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

No matters were submitted to a vote of security holders during our fourth quarter of 2006.

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PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

As of July 27, 2005, our common stock began trading on the AMEX under the stock ticker symbol FTK . Prior to this date, our common stock was traded on the OTC Bulletin Board under the ticker symbols, FLTK or FLTK.OB . The following table sets forth, on a per share basis for the periods indicated, our high and low closing sales prices reported by the AMEX, as provided by Yahoo Finance, and the high and low bid information on the OTC Bulletin Board. The OTC Bulletin Board quotations, denoted with a *, were provided by Yahoo Finance and reflect inter-dealer prices, without retail mark-up or commission and may not represent actual transactions.

Fiscal 2006	High	Low
4th Quarter	$ 28.05	$ 14.19
3rd Quarter	$ 20.00	$ 13.75
2nd Quarter	$ 29.77	$ 15.50
1st Quarter	$ 28.65	$ 18.92

Fiscal 2005	High	Low
4th Quarter	$ 22.00	$ 17.95
3rd Quarter	$ 20.45	$ 9.40
2nd Quarter*	$ 9.60	$ 7.45
1st Quarter*	$ 9.25	$ 4.00

As of March 1, 2007, our closing stock price, as quoted on the AMEX, was $27.09. As of March 1, 2007, there were 8,961,806 common shares outstanding held by approximately 2,800 holders of record.

Dividend Policy

We have not historically paid cash dividends on our common stock. We intend to retain future earnings to meet our working capital requirements and to finance the future operations of our business. Therefore, we do not plan to declare or pay cash dividends to holders of our common stock in the foreseeable future. In addition, some of our credit agreements contain provisions that limit our ability to pay cash dividends on our common stock.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table summarizes information regarding our equity securities that are authorized for issuance under individual stock option compensation agreements:

Equity Compensation Agreement Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance
Equity compensation plans approved by security holders	823,220	$ 4.94	428,572

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Item 6. Selected Financial Data.

The following table sets forth certain selected historical financial data and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes thereto which are included elsewhere herein. The selected operating and financial position data as of and for each of the years for the five-years ended December 31, 2006 have been derived from our audited consolidated financial statements, some of which appear elsewhere in this Annual Report on Form 10-K.

	As of and For the Years Ended December 31,				
	2006	2005	2004	2003	2002
	(in thousands, except per share data)				
Operating Data					
Revenue	$ 100,642	$ 52,869	$ 21,881	$ 14,844	$ 11,341
Operating expenses	81,789	42,755	18,869	19,934	13,954
Income (loss) from operations	18,853	10,114	3,012	(5,090)	(2,613)
Interest expense	(1,005)	(827)	(691)	(618)	(504)
Other, net	85	86	46	27	
Provision for income taxes	(6,583)	(1,653)	(213)		
Discontinued operations				(1,703)	(1,893)
Cumulative effect of change in accounting principle					(453)
Net income (loss)	$ 11,350	$ 7,720	$ 2,154	$ (7,384)	$ (5,463)
Earnings (loss) per share					
Basic	$ 1.31	$ 1.06	$ 0.32	$ (1.23)	$ (1.10)
Diluted	$ 1.22	$ 0.94	$ 0.31	$ (1.23)	$ (1.10)
Depreciation and amortization	$ 2,750	$ 1,768	$ 690	$ 713	$ 518
Capital expenditures	$ 9,201	$ 2,397	$ 113	$ 575	$ 1,314
Financial Position Data (end of year)					
Property, plant and equipment, net	$ 19,302	$ 9,961	$ 2,117	$ 2,645	$ 2,692
Total assets	$ 82,890	$ 52,158	$ 15,957	$ 13,970	$ 20,940
Long-term debt, less current portion	$ 8,185	$ 7,277	$ 5,272	$ 2,166	$ 3,039
Stockholders equity	$ 53,509	$ 35,205	$ 4,823	$ 2,560	$ 9,345

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis should be read in conjunction with our consolidated financial statements included elsewhere in this Annual Report on Form 10-K. The following information contains forward-looking statements, which are subject to risks and uncertainties. Should one or more of these risks or uncertainties materialize, our actual results may differ from those expressed or implied by the forward-looking statements. See Forward-Looking Statements at the beginning of this Annual Report on Form 10-K.

Executive Summary

We are a global provider of oilfield services and equipment. We focus on serving the drilling-related needs of oil and gas companies primarily through our Chemicals and Logistics and our Drilling Products segments, and the production-related needs of oil and gas companies through our Artificial Lift and Chemicals and Logistics segments.

We were incorporated in 1985 and currently trade on the American Stock Exchange. Our headquarters are in Houston, Texas. We have expanded geographically so that we now have a growing presence in select domestic and international market areas in Oklahoma, Arkansas, New Mexico, the Gulf Coast, the Rocky Mountains, Canada, Mexico, Latin America, South America, Europe and Asia. We market our products domestically and internationally in over 20 countries.

Several factors contributed to our financial performance in 2006, including:

- increased acceptance of our specialty chemicals by the major pumping pressure companies.
- expansion of our rental tool and inspection services with the acquisition of Can-Ok and the purchase of 50 drilling mud motors.
- expansion of our Artificial Lift segment with the acquisition of TWS and LifTech.
- record domestic rig count levels, gas prices and oil prices.

Over the past three years, we have grown both organically and through successful acquisitions of complementary or competing businesses. We continue to actively seek profitable acquisition or merger candidates in our core businesses to either decrease costs of providing products or add new products and customer base to diversify our market. We strive to mitigate cyclical risk in the oilfield service sector by balancing our operations between onshore versus offshore; drilling versus production; rental tools versus service; domestic versus international; and natural gas versus crude oil.

We operate as a diversified oilfield service company through our three business segments. We believe that our product and service offerings and geographical presence through our three business segments provide us with diverse sources of cash flow. Each segment has its own technical expertise and a common commitment to provide its customers with competitively priced quality equipment and services.

- The Chemicals and Logistics segment is made up of two business units. The specialty chemical business unit develops, manufactures and markets specialty chemicals used by oilfield service companies in oil and gas well cementing, stimulation, drilling and production. Our research laboratories support the specific drilling and production needs of our customers. The logistics division designs and manages automated bulk material handling, loading facilities, and blending capabilities for oilfield service companies.
- The Drilling Products segment rents, inspects, manufactures and markets downhole drilling equipment for the energy, mining, water well and industrial drilling sectors.

The Artificial Lift segment manufactures and markets artificial lift equipment which includes the Petrovalve line of beam pump components, electric submersible pumps, gas separators, valves and services to support coal bed methane production.

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The customers for our products and services include the major integrated oil and natural gas companies, independent oil and natural gas companies, pressure pumping service companies and state-owned national oil companies. Our ability to compete in the oilfield services market is dependent on our ability to differentiate our products and services, provide superior quality and service, and maintain a competitive cost structure. Activity levels in our three segments are driven primarily by current and expected commodity prices, drilling rig count, oil and gas production levels, and customer capital spending allocated for drilling and production.

Critical Accounting Policies and Estimates

Our critical accounting policies and procedures include but are not limited to the following:

Cash and Cash Equivalents

We consider all short-term investments with an original maturity of three months or less to be cash equivalents.

Inventories

Inventories consist of raw materials, finished goods and work-in-process. Finished goods inventories include raw materials, direct labor and production overhead. Inventories are carried at the lower of cost or market using the weighted average cost method. The Company maintains a reserve for slow-moving and obsolete inventories, which is reviewed for adequacy on a periodic basis.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. The cost of ordinary maintenance and repairs is charged to operations, while replacements and major improvements are capitalized. Depreciation or amortization is provided at rates considered sufficient to amortize the cost of the assets using the straight-line method over the following estimated useful lives:

Buildings and leasehold improvements	3-39 years
Machinery, equipment and rental tools	3-7 years
Furniture and fixtures	3-7 years
Transportation equipment	3-5 years
Computer equipment	3-5 years

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds either the fair value or the estimated discounted cash flows of the assets, whichever is more readily measurable. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Goodwill and Intangible Assets

Goodwill represents the excess of the aggregate price paid by us in acquisitions over the fair market value of the tangible and identifiable intangible net assets acquired. Separable intangible assets that are not deemed to have indefinite lives will be amortized over their useful lives.

Financial Instruments

We consider the fair value of all financial instruments (primarily long-term debt) not to be materially different from their carrying values at the end of each fiscal year based on management s estimate of our ability to borrow funds under terms and conditions similar to those of our existing debt and because the majority of our debt carries a floating rate.

We have no off-balance sheet debt or other off-balance sheet financing arrangements. We have not entered into derivative or other hedging financial instruments.

Revenue Recognition

Revenue for product sales is recognized when all of the following criteria have been met: (i) evidence of an agreement exists, (ii) products are shipped or services rendered to the customer and all significant risks and rewards of ownership have passed to the customer, (iii) the price to the customer is fixed and determinable and (iv) the collectibility is reasonably assured. Accounts receivable are recorded at that time net of any discounts. Earnings are charged with a provision for doubtful accounts based on a current review of collectibility of the accounts receivable. Accounts receivable deemed ultimately uncollectible are applied against the allowance for doubtful accounts. Deposits and other funds received in advance of delivery are deferred until the transfer of ownership is complete. Our logistics division recognizes revenue of its design and construction oversight contracts under the percentage-of-completion method of accounting, measured by the percentage of costs incurred to date to the total estimated costs of completion. This percentage is applied to the total estimated revenue at completion to calculate revenue earned to date. Contract costs include all direct labor and material costs and those indirect costs related to manufacturing and construction operations. General and administrative costs are charged to expense as incurred. Changes in job performance and estimated profitability, including those arising from contract bonus or penalty provisions and final contract settlements, may result in revisions to costs and income and are recognized in the period in which such revisions appear probable. All known or anticipated losses on contracts are recognized in full when such amounts become apparent.

Foreign Currency

We have sales that are denominated in currencies other than the United States dollar. Any foreign currency transaction gains or losses are included in our results of operations. We have not entered into any forward foreign exchange contracts to hedge the potential impact of currency fluctuations on our foreign currency denominated sales.

Research and Development Costs

Expenditures for research activities relating to product development and improvement are charged to expense as incurred.

Income Taxes

Income taxes are computed under the liability method. We provide deferred income tax assets and liabilities for the expected future tax consequences attributable to differences between the financial statement carrying amounts and the respective tax basis of assets and liabilities. These deferred assets and liabilities are based on enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred income tax assets to amounts which are more likely than not to be realized.

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Earnings Per Share

Basic earnings per common share is calculated by dividing net income attributable to common stockholders by the weighted average number of common shares outstanding. Dilutive earnings per share is calculated by dividing net income attributable to common stockholders by the weighted average number of common shares outstanding and dilutive effect of stock options.

Use of 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 certain assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. While management believes current estimates are reasonable and appropriate, actual results could differ from these estimates.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued its Statement of Financial Accounting Standards No. 157 (FAS No. 157), Fair Value Measurements. FAS No. 157 establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact that FAS No. 157 will have on our results of operations and financial position.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 provides guidance on the consideration of effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 requires the analysis of misstatements using both a balance sheet and income statement approach and contains guidance on correcting errors under the dual approach, as well as providing transition guidance for correcting errors existing in prior years. SAB 108 is effective for the first fiscal year ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on our results of operations or financial position.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes . FIN 48 is an interpretation of FASB Statement No. 109 Accounting for Income Taxes and was adopted by the Company effective January 1, 2007. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements uncertain tax positions that the Company has taken or expects to take in its tax returns. We are currently in the process of evaluating the impact of FIN 48 on our financial statements.

In May 2005, the FASB issued FASB Statement (SFAS) No. 154, Accounting Changes and Error Corrections . SFAS No. 154 requires that all voluntary changes in accounting principles, including corrections of errors, are retrospectively applied to prior financial statements as if that principle had always been used, unless it is impracticable to do so. When it is impracticable to calculate the effects on all prior periods, SFAS No. 154 requires that the new principle be applied to the earliest period practicable. The Company adopted SFAS No. 154 as of December 31, 2005.

In December 2004, the FASB issued Statement No. 123R, Share Based Payment (SFAS 123R). This statement revises Statement 123 and supersedes APB 25 and amends FASB Statement No. 95, Statement of Cash Flows . SFAS 123R requires companies to expense the fair value of employee services received in exchange for an award of equity instruments, including stock options. SFAS 123R also provides guidance on valuing and expensing these awards, as well as disclosure requirements with respect to these equity arrangements.

We adopted SFAS 123R effective as of January 1, 2006. We are following the modified prospective method of adoption of SFAS 123R whereby earnings for prior periods will not be restated as though stock based compensation had been expensed, rather than the modified retrospective method which would entail restatement of previously published earnings. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow. The impact of adoption of SFAS 123R will depend on levels of share-based compensation, particularly stock options, granted in the future and the fair value assigned thereto. The adoption of SFAS 123R has not had a material financial impact on our consolidated financial position, results of operations or cash flows.

On December 22, 2005, the Compensation Committee, on behalf of the Board of Directors (Board), approved the acceleration of the vesting of all previously unvested stock options granted under our 2003 and 2005 Long Term Incentive Plans (the Plans). The vesting acceleration represents options exercisable for a total of 313,140 shares of our common stock, including a total of 175,875 shares of common stock underlying options held by our executive officers. The options have exercise prices ranging from $4.25 to $9.40 per share. The closing price of our common stock on December 22, 2005 was $18.80. The acceleration of the vesting schedule of the options was effected pursuant to Section 4(c)(x) of the Plans, which authorizes the Board, in its sole discretion, to substitute an accelerated vesting schedule for options granted under the Plans. In most instances, stock options granted under the Plans vested over a four-year period.

The Board imposed selling restrictions on shares received through the exercise of accelerated options. These restrictions prohibit the sale of shares purchased under accelerated options until the date on which the options would otherwise have vested under the original option grants or six months after the date on which the options would otherwise have vested under the original option grants if the employee is no longer employed by the Company.

Results of Operations

	For the Years Ended December 31,		
	2006	2005	2004
		(in thousands)	
Revenue	$ 100,642	$ 52,869	$ 21,881
Cost of revenue	59,464	30,946	12,529
Gross profit	41,178	21,923	9,352
Gross profit %	40.9%	41.5%	42.7%
Expenses:			
Selling, general and administrative costs	18,919	9,486	5,350
Depreciation and amortization	2,750	1,768	690
Research and development costs	656	555	300
Total expenses	22,325	11,809	6,340
Income from operations	18,853	10,114	3,012
Income from operations %	18.7%	19.1%	13.8%
Other income (expense):			
Interest expense	(1,005)	(827)	(691)
Other, net	85	86	46
Total other income (expense)	(920)	(741)	(645)
Income before income taxes	17,933	9,373	2,367
Provision for income taxes	(6,583)	(1,653)	(213)
Net income	$ 11,350	$ 7,720	$ 2,154

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Results for fiscal 2006 compared to fiscal 2005 Consolidated

Revenue for the twelve months ended December 31, 2006 were $100.6 million, an increase of 90.4% compared to $52.9 million for the year 2005. Revenue increased in all of our business segments due to increased acceptance of our products, acquisitions completed in the third quarter of 2005 and in 2006, rental revenue from the investment in additional equipment, improved pricing, and opening new operating locations. Revenue increased most significantly due to organic growth of our Chemical and Logistics division, followed by the acquisition of Can-Ok in January, TWS in April and LifTech in June of 2006. These acquisitions accounted for $16.5 million of the increase in revenue, with the remaining $31.2 million coming from internal revenue growth within the Chemicals and Logistics segment and the Drilling Products segment. International revenue made up approximately 6.5% of total revenue in 2006 versus 15.9% in 2005.

Gross profit for the year ended December 31, 2006 increased 87.8% to $41.2 million, or 40.9% of revenue, compared to $21.9 million, or 41.5%, of revenue for the year 2005. The increase in gross profit is due to the increase in revenue in all of our business segments, with high margin tool rentals and specialty chemical sales contributing most significantly. The decrease in gross profit as a percentage of revenue is primarily due to the acquisition of two artificial lift acquisitions which typically have lower margins than our existing businesses.

As the Company matures, and with the addition of new products and services from acquisitions, margins within the segments have shifted. Organically, management s focus has been placed on expanding sales of our higher margin products and services. This has been offset by the addition of several new products that generate lower margins but complement the existing businesses and allow the Company to cross sell products and services in new markets, and spread corporate costs over a larger base of operations.

Selling, general and administrative costs are not directly attributable to products sold or services rendered. Selling, general and administrative costs were $18.9 million in 2006 versus $9.5 million in 2005. The largest increase in expenses related to corporate activities which rose to $5.8 million in 2006 compared to $2.9 million in 2005. The increase was driven by a $1.0 million increase in tax, accounting and audit fees associated with Sarbanes-Oxley compliance. In addition, we incurred $0.7 million in professional fees related to due diligence efforts for a significant acquisition terminated in August 2006. The balance of the increase is primarily due to increased sales and field support costs in all three segments.

Depreciation and amortization increased from $1.8 million in 2005 to $2.8 million in 2006. The increase is due to additional depreciable assets resulting from acquisitions and capital expenditures. Approximately $3.2 million was spent in 2006 to expand our chemical manufacturing facilities and $2.9 million to expand our base of rental tools including the purchase of drilling mud motors.

Research and development (R&D) costs increased from $0.6 million in 2005 to $0.7 million in 2006 due to the expansion of our product development department. We plan to significantly expand our research efforts in 2007 with a budget that is triple the amount spent in 2006. As part of our research and development program in 2007 we are relocating our development laboratory to The Woodlands, Texas and will have a dedicated experienced sales professional for each major pressure pumping service company. The sales representatives will work directly with our R&D team to develop new products and applications for our customers. We currently employ 14 degreed chemists, 5 of whom have PhD s. Over the years, we have made a number of technological advances, including the development of an environmentally benign line of specialty chemicals. Substantially all of the new technologies have resulted from requests and guidance from our clients, particularly major oil companies. Research and development expenditures are charged to expense as incurred.

Interest expense was $1.0 million in 2006 versus $0.8 million in 2005. The increase was a result of the increase in our overall debt level associated with acquisitions, coupled with higher variable interest rates. The majority of our indebtedness carries a variable interest rate tied to the prime rate or LIBOR.

A provision for income taxes of $6.6 million was recorded in 2006. An effective tax rate of 36.7% was applied in 2006 versus 17.6% in 2005, resulting in a $4.9 million, or 298.2% increase in the tax provision. The

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significant increase in taxes is a result of an increase in our projected federal statutory rate based on estimated income levels, and an increase in our estimated state income tax liability.

Results for fiscal 2005 compared to fiscal 2004 Consolidated

Revenue increased by $31.0 million or 141.6% for the year 2005 versus 2004. As discussed in the segment analysis that follows, this increase in revenue was due to the expansion of our Drilling Products segment through acquisitions and continued strong performance by our Chemicals and Logistics segment. We expanded our revenue both domestically and internationally, with international revenue making up approximately 15.9% of consolidated revenue.

Gross profit increased by $12.6 million or 134.5% for the year 2005 versus 2004. Gross profit as a percentage of revenue decreased from 42.7% for the year 2004 to 41.5% in 2005. The gross profit is best analyzed on a segment by segment basis, discussed below, as gross profit varies between operating segments and can vary significantly from year to year.

Selling, general and administrative costs increased to $9.5 million for the year 2005 from $5.3 million for the year 2004, however, decreased as a percentage of revenue. Measured as a percentage of revenue, selling, general and administrative costs dropped from 24.5% for the year 2004 to 17.9% in 2005. Significant emphasis continues to be placed on growing revenue while controlling selling, general, and administrative costs across the organization. General and administrative corporate expenses increased to $2.7 million in 2005 from $1.6 million in 2004. As a percentage of revenue, these costs decreased from 7.2% in 2004 to 5.2% in 2005. The absolute increase is due to the continued expansion of the Company and the corporate personnel required to support a growing public company. In 2005, the Company incurred expenses and costs associated with the private placement, proxy statement, and Form SB-2 registration statement, and expenses related to the listing on the American Stock Exchange.

Depreciation and amortization increased $1.1 million or 156.3% for the year 2005 compared to the same period in 2004 as a result of higher levels of property, plant and equipment associated with the drilling tool acquisitions and the expansion of our chemical laboratory and production facilities. In addition, we incurred increased intangible asset amortization associated with acquisition costs and non-compete agreements. During the first nine months of 2005, we depreciated our rentals tools using the straight line method with an estimated useful life of three years. Based on a review of industry practices and tax guidelines we modified the estimated useful life of rental tools from three years to seven years effective October 1, 2005. The change in estimated useful life was made prospectively.

Research and development costs increased due to expansion of our applied research department. We continued to expand our research staff and currently employ twelve degreed chemists, four of whom have PhD s. Over the years, we have made a number of technological advances, including the development of an environmentally benign line of specialty chemicals. Substantially all of the new technologies have resulted from requests and guidance from our clients, particularly major oil companies. Research and development expenditures are charged to expense as incurred. We intend to continue committing financial resources and effort to the development and acquisition of new products and services.

Interest expense increased from $0.7 million in 2004 to $0.8 million in 2005. The increase was a result of the increase in our overall debt level associated with the acquisition of Spidle, offset by lower interest rates on the senior credit facility obtained in February 2005. Flotek s senior borrowing rates were reduced approximately 300 basis points as a result of the new financing. The majority of our indebtedness carries a variable interest rate tied to the prime rate.

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Based on our profitability, a $1.7 million provision for income taxes was recorded for the year 2005. The provision was made for estimated federal and state income tax, assuming a portion of our net operating losses would be used to partially offset federal income taxes. The effective income tax rate differs from the statutory rate primarily as a result of anticipated utilization of our net operating loss carryforwards, as well as, a reduction in the valuation allowance against certain deferred tax assets that we now believe are more than likely than not to be utilized in the future.

Results by Segment

Chemicals and Logistics

	For the Years Ended December 31,		
	2006	**2005**	**2004**
		(in thousands)	
Revenue	$ 50,545	$ 29,638	$ 17,983
Gross profit	22,670	11,780	7,467
Gross profit %	44.9%	39.7%	41.5%
Income from operations	16,845	8,188	4,731
Income from operations %	33.3%	27.6%	26.3%

Results for fiscal 2006 compared to fiscal 2005 Chemicals and Logistics

Chemicals and Logistics revenue increased $20.9 million or 70.5% for the year 2006 compared to 2005. The increase in revenue is a result of an increase in volume coupled with higher prices, particularly of our proprietary specialty chemicals. The most significant revenue growth occurred in the Rocky Mountains, Mid-Continent, Permian Basin regions and Canada. Sales of our proprietary biodegradable environmentally benign green chemicals grew 217.1% from $8.2 million in 2005 to $26.0 million in 2006. Margins continue to increase as we focus on shifting more of our sales mix to higher margin patented and proprietary products.

Gross profit as a percentage of revenue increased from 39.7% in 2005 to 44.9% in 2006. The increase in gross profit is due to price increases and a reduction in cost of goods as a percentage of total revenue. Margins continue to increase as the sales mix shifts to higher margin patented and proprietary products. Managing chemical feedstock and transportation prices and passing cost increases on to our customers is critical to maintain our gross profits. As of the end of 2006, construction of a 30,000 square foot expansion to our production facilities was substantially completed. This facility triples production capabilities and allows the division to manage larger volumes of inputs to take further advantage of volume pricing discounts.

Income from operations increased from $8.2 million in 2005 to $16.8 million in 2006, and the income from operations as a percentage of revenue increased from 27.6% to 33.3%, respectively.

Results for fiscal 2005 compared to fiscal 2004 Chemicals and Logistics

Chemicals and Logistics revenue increased $11.7 million or 64.8%, for the year 2005 compared to 2004. The increase is due to an increase in the volume of specialty chemicals sales coupled with price increases that were put into effect in 2005. MTI partially offset an approximate 25% decrease in throughput at our Louisiana based bulk handling facility during 2005 as compared to 2004, by increasing revenue associated with the design and construction oversight of bulk handling facilities in Mexico and Texas during 2005. CESI s focus on applied research has resulted in the penetration of new markets, continued expansion of our customer base, product portfolio and increased margins. CESI differentiates itself through the strength of its innovative and proprietary products, the depth of the laboratory staff, dedication to product quality, and superior customer service.

Fiscal 2005 compared to 2004, international sales grew by 131.3%, outpacing domestic growth. Sales into Mexico, Canada and Russia have been the main drivers for growth in international sales. Domestic sales have continued to grow in our established core markets, the Mid-Continent and Permian Basin, but have increased

dramatically in the Rocky Mountains and East Texas. We continue to focus on expanding our international sales and expanding the footprint of our domestic sales coverage to increase overall sales and diversify sales concentration risk. Growth of international sales has outpaced our domestic growth, and made up 17.5% of total sales for the year 2005 as compared to 12.5% of total sales for the same period in 2004.

Sales of our proprietary specialty chemicals continued to grow at a strong pace. The sales of our environmentally friendly green chemicals increased $4.2 million, or 105.0%, from $4.0 million for the year 2004 compared to $8.2 million for the year ending December 31, 2005. In 2005, our biodegradable specialty chemical additive received approval for use in the North Sea and passed Canadian biotox protocols, further expanding our geographic market penetration. With this approval we began preparations to open our first international operation in The Netherlands to service the European and African markets in 2006. A product that was developed in 2005 and will be marketing in 2006 is an environmentally friendly acid iron control system used to prevent the oxidation and deposition of iron in the formation.

Gross profit increased $4.3 million or 57.8% for the year 2005 compared to 2004. Gross profit as a percentage of revenue decreased from 41.5% for the year 2004 to 39.7% in 2005. The decrease in margin is attributable to an increase in cost of goods sold in our specialty chemical division without concurrently timed equivalent price increases to pass these costs on to our customers. Price increases were implemented in June 2005 and will continue to be evaluated by management throughout 2006.

Income from operations increased $3.5 million, or 73.0%, during 2005 compared to 2004, primarily as a result of increased revenue in the Chemical division and reduction of operating costs as a percentage of revenue. The completion of the Mexico and Texas bulk handling plants also increased revenue and operating income for this segment during 2005. Expansion of our proprietary product line and customer base has driven the increase in sales and operating income during 2005.

Drilling Products

	For the Years Ended December 31,		
	2006	2005	2004
		(in thousands)	
Revenue	$ 36,753	$ 21,875	$ 3,315
Gross profit	15,172	9,413	1,593
Gross profit %	41.3%	43.0%	48.0%
Income from operations	6,325	4,663	359
Income from operations %	17.2%	21.3%	10.8%

Results for fiscal 2006 compared to fiscal 2005 Drilling Products

During 2005 and 2006 an emphasis was placed on expanding our drilling products sales through acquisition, allowing us to expand geographically and to grow our line of products and services. In August 2005 we acquired the assets of Harmon, a downhole oilfield and mining tool company with manufacturing and sales operations located in Midland, Texas, and the assets of LOR, a drilling tool rental and inspection service provider in South Texas. In January 2006 we acquired the assets of Can-Ok, a drilling tool sales and rental provider in Oklahoma, Louisiana and Arkansas. These acquisitions expanded or provided machining, repair, tool rental and inspection service capability within our drilling products group.

Drilling Products revenue increased $14.9 million or 68.0% for the year 2006 compared to 2005. The drilling tool acquisitions completed in August 2005 and January 2006 coupled with downhole mud motor rentals and higher centralizer sales contributed to the increase in overall sales.

Gross profit increased $5.8 million or 61.2% for the year 2006 compared to 2005. Gross profit as a percentage of revenue decreased from 43.0% in 2005 versus 41.3% for 2006. The decrease in gross profit as a percentage of revenue relates to higher inventory related expenses. In addition we incurred significant costs in building up our capacity and improving overall conditions with our acquired businesses.

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Income from operations increased $1.7 million or 35.6% for the year 2006 compared to 2005. Costs associated with developing our machining and repair capacity, and the expenses required to improve facility conditions and equipment negatively impacts income from operations in 2006 for this division.

Results for fiscal 2005 compared to fiscal 2004 Drilling Products

Drilling Products revenue increased $18.6 million for the year 2005 compared to 2004. This increase relates primarily to the expansion of our segment with the acquisition of Spidle, Harmon and LOR. Spidle contributed $17.0 million in revenue during 2005. Harmon and LOR, which were acquired in the third quarter of 2005, contributed $1.9 million in revenue.

Gross profit increased $7.8 million for the year 2005 compared to 2004. Gross profit as a percentage of revenue decreased from 48.0% in 2004 to 43.0% in 2005. The decrease is attributable to a change in the base of operations with the addition of Spidle, Harmon and LOR. Our Turbeco operations have historically been focused on the manufacturing and marketing of drilling tools. The acquisitions made during 2005 expand drilling tool operations into the manufacturing and marketing of a much broader offering of drilling tools, drilling tool rentals, mud motor rentals and pipe inspection services.

Income from operations increased $4.3 million during 2005 compared to 2004, primarily due to the expansion of the division. We believe we will continue to see improvements in income from operations as a percentage of revenue as we capitalize on the geographic, customer and product synergies among the three acquisitions made this year and the other business units, as well as increased utilization of the inventory acquired with Spidle.

Artificial Lift (previously known as Production Products)

	For the Years Ended December 31,		
	2006	2005	2004
		(in thousands)	
Revenue	$ 13,344	$ 1,356	$ 583
Gross profit	3,336	464	292
Gross profit %	25.0%	34.3%	49.9%
Income from operations	1,514	180	(356)
Income from operations %	11.3%	13.3%	(61.0)%

Results for fiscal 2006 compared to fiscal 2005 Artificial Lift

In the second quarter of 2006 we acquired TWS and LifTech as part of our goal to develop a significant Artificial Lift segment and expand our production driven revenue base. The combined companies provide a broad spectrum of electric submersible pumps, gas separators, valves and services to support the coal bed methane producers in the Powder River Basin region and beyond. We believe the recent artificial lift acquisitions will provide additional marketing opportunities for our patented Petrovalve line of pump components, our patented gas separator, and our line of electric submersible pumps.

Management continues to focus on effectively marketing the Petrovalve line of pump components. Our patented guided valves are the only product which can be placed horizontally allowing a pump to be placed at the production zone in horizontally completed wells reducing the effort needed to pump the product to the surface. The Petrovalve can effectively lift highly viscous oil in heavy oil or tar sand production zones. Because of this we signed an exclusive agreement with a major equipment distributor in Canada and have aligned ourselves with a major domestic pump manufacturer to build pumps with our valve.

Revenue was $13.3 million for the year 2006 versus $1.4 million in 2005. Acquisitions accounted for $12.7 million of the increase. The strategic complement of TWS and LifTech, which operate now as Flotek Pump Services, increased the Company s production activity driven revenue base.

Gross profit increased $2.9 million primarily due to the acquisitions. The gross profit as a percentage of revenue decreased from 34.3% in 2005 to 25.0% in 2006. The decrease in gross margin as a percentage of revenue is due to a shift in product mix. The product revenue associated with the two acquisitions are lower margin product sales compared to our existing Petrovalve sales. Although several of our new products generate lower margins, they complement our existing businesses and allow the company to cross sell products and services in new markets, and spread corporate costs over a larger base of operations. We believe we can improve the gross margins of the acquisitions primarily through better supply chain management and product mix.

Income from operations increased from $0.2 million in 2005 to $1.5 million in 2006.

Results for fiscal 2005 compared to fiscal 2004 Artificial Lift

Revenue increased $0.8 million in 2005 compared to 2004 due to sales to customers in Russia, Oman and Venezuela. Gross profit also increased 59.6% in 2005 compared to 2004. The Artificial Lift segment generated $0.2 million in income from operations in 2005 as compared to a loss from operations of $0.4 million in 2004. The turnaround in this group is a result of increased international revenue into Central and South America, Russia and the Middle East.

We are focused on increasing total revenue in 2006 by partnering with pump manufacturers and expanding the segment by broadening our artificial lift products and services. Petrovalve is actively marketed in the U.S., Canada, Mexico, Central America, South America, the Middle East, Russia and Asia. In 2005 Petrovalve has representation in 18 countries.

Capital Resources and Liquidity

Capital resources and liquidity continued to improve during the year ended December 31, 2006 compared to the same period in 2005. During 2006 we generated net income of $11.4 million based on a 36.7% effective tax rate, versus $7.7 million taxed at a 17.6% effective tax rate in 2005. Cash flows from operations increased significantly from $2.1 million in 2005 to $12.4 million in 2006. The improvement in cash flow from operations is a direct result of improved operating results offset by increased estimated tax payments based on the projected increase in our estimated effective tax rate. The decrease in cash and cash equivalents of $6.9 million for 2006 was primarily a result of the acquisitions of Can-Ok, TWS and LifTech coupled with significant capital expenditures to expand our Chemicals and Logistics and Drilling Products operations.

Net working capital uses of cash increased $2.1 million in 2006 versus an increase in uses of cash of $6.1 million for the same period in 2005. The net increases in uses of working capital were primarily driven by a net $7.4 million increase in accounts receivable, a $4.9 million increase in inventory offset by a $10.5 million increase in accounts payables and accrued liabilities. We anticipate working capital requirements to increase as we grow overall sales.

Capital expenditures for 2006 totaled approximately $9.2 million. The most significant expenditures related to the expansion of our chemical manufacturing facilities and base of rental tools including the purchase of drilling mud motors. The expansion of our chemical manufacturing facilities tripled our specialty chemical production capacity. In 2005 and 2006, Flotek has built a significant inventory of downhole mud motors. Based on the success of the motors, Flotek acquired a 50% interest in CAVO in January 2007. CAVO is a complete downhole motor solutions provider specializing in the rental, servicing and sale of high performance mud motors for a variety of drilling applications. Looking to 2007 we anticipate significant capital expenditures associated with the construction of our liquids blending facility in Louisiana and continued expansion of our mud motor fleet.

In February 2005, we obtained the Senior Credit Facility with Wells Fargo which includes a revolving loan agreement, equipment term loans and a real estate term loans. In August 2006 we amended the Senior Credit

Facility. The amendment to the Senior Credit Facility increased the maximum amount outstanding on the revolving line of credit from the lesser of (a) $10.0 million or (b) the sum of 80% of eligible domestic trade accounts receivable and 50% of eligible inventory, as defined. The terms are interest-only, maturing in August 2009.

As of December 31, 2006, we had $2.9 million outstanding under the revolving line of credit of the amended Senior Credit Facility. Bank borrowings are subject to certain covenants and a material adverse change subjective acceleration clause. Affirmative covenants include compliance with laws, various reporting requirements, visitation rights, maintenance of insurance, maintenance of properties, keeping of records and books of account, preservation of existence of assets, notification of adverse events, ERISA compliance, joinder agreement with new subsidiaries, borrowing base audits, and use of treasury management services. Negative covenants include limitations associated with liens, indebtedness, change in nature of business, transactions with affiliates, investments, distributions, subordinate debt, leverage ratio, fixed charge coverage ratio, consolidated net income, prohibition of fundamental changes, asset sales and capital expenditures. As of December 31, 2006 we were in compliance with all covenants except the indebtedness covenant which restricts the Company from exceeding $500,000 in secured indebtedness to finance the purchase of assets necessary in the Company s ordinary course of business. As of December 31, 2006 the Company had approximately $0.7 million in vehicle loans and capitalized vehicle leases.

In January 2007, we amended the Senior Credit Facility in conjunction with the acquisition of Triumph Drilling Tools. The amendment to the Senior Credit Facility increased the maximum amount outstanding on the revolving line of credit from the lesser of (a) $20.0 million or (b) the sum of 80% of eligible domestic trade accounts receivable and 50% of eligible inventory, as defined. The terms of the revolving loan agreement were modified to provide for borrowings that bear interest at LIBOR rate plus 175 basis points maturing in August 2009. The equipment term loan was amended to provide for borrowings of $35.0 million bearing interest at LIBOR rate plus 175 basis points payable over 84 months. The amendment increased many of our principal covenants including our leverage ratio, fixed charge coverage ratio and net capital expenditures. The real estate term loans remained unchanged. Our bank borrowings are collateralized by substantially all of our assets. Based on the amended maturity date, the current revolving line of credit is classified as long-term debt.

We have funded our capital requirements with operating cash flows, debt borrowings, and by issuing shares of our common stock. Common stock issued during 2006 is described below:

In the acquisition of Can-Ok in January 2006, we issued 25,020 shares of common stock.

In the acquisition of LifTech in April 2006, we issued 178,223 shares of common stock.

Warrants to purchase 26,490 shares were exercised with proceeds of approximately $0.3 million paid to the Company.

Stock options to purchase 300,216 shares (19,750 shares are restricted) were exercised by officers, directors and employees with proceeds of approximately $0.6 million paid to the Company.

Contractual Obligations

	Payments Due by Period				
	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
			(in thousands)		
Long-term debt obligations	$ 10,066	$ 2,308	$ 6,259	$ 1,499	$
Capital lease obligations	708	281	421	6	
Operating lease obligations	1,381	475	569	316	21
Other long-term liabilities	6,300	400	800	800	4,300
Total	$ 18,455	$ 3,464	$ 8,049	$ 2,621	$ 4,321

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The amount in the other long-term liabilities of the table relates to a guaranteed minimum royalty that we owe per an exclusive license agreement that we entered into with Total Well Solutions, LLC in April 2006.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Certain of the financial instruments we have used to obtain capital are subject to market risks from fluctuations in market interest rates. As of December 31, 2006, we have $9.3 million of variable rate indebtedness within our credit facility. As a result, a fluctuation in market interest rates of one percentage point over the next twelve months would impact our interest expense by approximately $0.1 million.

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Item 8. Financial Statements and Supplementary Data.

MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

We are responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined by the Securities and Exchange Act of 1934 Rule 13a-15(f). Our internal controls are designed to provide reasonable assurance as to the reliability of our financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Internal control over financial reporting has inherent limitations and may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance, not absolute, assurance with respect to the financial statement preparation and presentation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

Under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our internal control over financial reporting as of December 31, 2006 as required by the Securities and Exchange Act of 1934 Rule 13a-15(c). In making its assessment, we have utilized the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control Integrated Framework.* We concluded that based on our evaluation, our internal control over financial reporting was ineffective as of December 31, 2006.

Our assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by UHY LLP, an independent registered public accounting firm, as stated in their report which is included herein.

/s/ Jerry D. Dumas Sr.	/s/ Lisa G. Meier
Jerry D. Dumas Sr.	**Lisa G. Meier**
Chief Executive Officer	**Chief Financial Officer**

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Flotek Industries, Inc. and Subsidiaries:

We have audited the accompanying Consolidated Balance Sheets of Flotek Industries, Inc. and Subsidiaries as of December 31, 2006 and 2005, and the related Consolidated Statements of Income and Comprehensive Income, Stockholders Equity and Cash Flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Flotek Industries, Inc. and Subsidiaries as of December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Flotek Industries, Inc. and Subsidiaries 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 criteria), and our report dated March 16, 2007 expressed an unqualified opinion on management s assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria, and because of the effects of the material weaknesses described therein, the Company has not maintained effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

UHY LLP

Houston, Texas

March 16, 2007

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and

Stockholders of Flotek Industries, Inc. and Subsidiaries:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that Flotek Industries, Inc. and its Subsidiaries (the Company) did not maintain effective internal control over financial reporting as of December 31, 2006, because of the effect of the material weaknesses identified in management s assessment as described below, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

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

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

Because of 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.

A material weakness is a significant deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by employees in the normal course of their work. The following material weaknesses have been identified and included in management s assessment. The material weaknesses included inadequate staffing within the Company s accounting and finance department, and a lack of overall effective Company monitoring controls. As a result of these material weaknesses, the Company recorded adjustments to the consolidated financial statements for the year ended December 31, 2006 prior to the issuance of the Company s consolidated financial statements. Due to the pervasiveness of these deficiencies and the potential misstatements that could occur as a result of these deficiencies, there is a more than remote likelihood that a material misstatement of the annual and interim consolidated financial statements would not have been prevented or detected. These material weaknesses were considered in determining the nature, timing and extent of audit tests applied in our audit of the Company s consolidated financial statements as of and for the year ended December 31, 2006, and this report does not affect our report dated March 16, 2007 on those consolidated financial statements.

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In our opinion, management s assessment that Flotek Industries, Inc. and Subsidiaries did not maintain effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also, in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Flotek Industries, Inc. and Subsidiaries as of December 31, 2006, and the related consolidated statements of income and comprehensive income, stockholders equity, and cash flows for the year ended December 31, 2006, and our report dated March 16, 2007 expressed an unqualified opinion.

UHY LLP

Houston, Texas

March 16, 2007

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FLOTEK INDUSTRIES, INC.

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2006	2005
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 510	$ 7,377
Accounts receivable, net of allowance for doubtful accounts of $562 and $67, respectively	19,077	10,407
Inventories, net	17,899	10,658
Other current assets	578	234
Total current assets	38,064	28,676
Property, plant and equipment, net	19,302	9,961
Goodwill	24,185	12,388
Intangible and other assets, net	1,339	1,133
	$ 82,890	$ 52,158
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 9,941	$ 3,805
Accrued liabilities	7,457	3,296
Current portion of long-term debt	2,589	2,016
Current portion of deferred tax liability	675	319
Total current liabilities	20,662	9,436
Long-term debt, less current portion	8,185	7,277
Deferred tax liability, less current portion	534	240
Total liabilities	29,381	16,953
Commitments and contingencies (See Note 13)		
Stockholders equity:		
Preferred stock, 100,000 shares authorized, none issued		
Common stock, $.0001 par value; 20,000,000 shares authorized; shares issued and outstanding: 8,827,464 shares and 8,317,265 shares, respectively	1	1
Additional paid-in capital	46,661	39,744
Accumulated other comprehensive income	37	
Retained earnings (accumulated deficit)	6,810	(4,540)
Total stockholders equity	53,509	35,205
	$ 82,890	$ 52,158

See notes to consolidated financial statements.

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FLOTEK INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	For the Years Ended December 31,		
	2006	**2005**	**2004**
	(in thousands, except per share data)		
Revenue	$ 100,642	$ 52,869	$ 21,881
Cost of revenue	59,464	30,946	12,529
Gross profit	41,178	21,923	9,352
Expenses:			
Selling, general and administrative costs	18,919	9,486	5,350
Depreciation and amortization	2,750	1,768	690
Research and development costs	656	555	300
Total expenses	22,325	11,809	6,340
Income from operations	18,853	10,114	3,012
Other income (expense):			
Interest expense	(1,005)	(827)	(691)
Other, net	85	86	46
Total other income (expense)	(920)	(741)	(645)
Income before income taxes	17,933	9,373	2,367
Provision for income taxes	(6,583)	(1,653)	(213)
Net income	$ 11,350	$ 7,720	$ 2,154
Other comprehensive income:			
Foreign currency translation adjustment	37		
Comprehensive income	$ 11,387	$ 7,720	$ 2,154
Basic and diluted earnings per common share:			
Basic earnings per common share	$ 1.31	$ 1.06	$ 0.32
Diluted earnings per common share	$ 1.22	$ 0.94	$ 0.31
Weighted average common shares used in computing basic earnings per common share	8,645	7,303	6,659
Incremental common shares from stock options and warrants	649	952	354
Weighted average common shares used in computing diluted earnings per common share	9,294	8,255	7,013

See notes to consolidated financial statements.

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FLOTEK INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

	Common Stock		Additional Paid-in Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income	Total Stockholders Equity
	Shares	Amount		(in thousands)		
Balance January 1, 2004	6,522	$ 1	$ 16,973	$ (14,414)	$	$ 2,560
Common stock issued, net of offering costs	133		100			100
Stock options exercised	15		9			9
Net income				2,154		2,154
Balance December 31, 2004	6,670	1	17,082	(12,260)		4,823
Common stock issued, net of offering costs	1,566		22,519			22,519
Stock options exercised	81		143			143
Net income				7,720		7,720
Balance December 31, 2005	8,317	1	39,744	(4,540)		35,205
Common stock issued, net of offering costs	203		4,383			4,383
Stock options exercised	301		568			568
Tax benefit of stock options exercised			1,618			1,618
Warrants exercised	26		348			348
Foreign currency translation adjustment					37	37
Net income				11,350		11,350
Balance December 31, 2006	8,847	$ 1	$ 46,661	$ 6,810	$ 37	$ 53,509

See notes to consolidated financial statements.

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FLOTEK INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended December 31, (in thousands)		
	2006	**2005**	**2004**
Cash flows from operating activities:			
Net income	$ 11,350	$ 7,720	$ 2,154
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,750	1,768	690
(Gain) loss on sale of equipment	(68)	1	
Deferred tax liability	529	(1,231)	
Change in assets and liabilities:			
Restricted cash		37	(37)
Accounts receivable	(7,427)	(4,140)	(1,394)
Inventories	(4,913)	(2,946)	(543)
Deposits and other	(331)	(186)	73
Accounts payable	4,774	(231)	(320)
Accrued liabilities	5,772	1,335	995
Net cash provided by operating activities	12,436	2,127	1,618
Cash flows from investing activities:			
Proceeds from sale of equipment	309	8	
Acquisition earn-out payment		(154)	(320)
Acquisitions, net of cash acquired	(12,763)	(7,499)	
Other assets	(45)	(248)	(59)
Capital expenditures	(9,201)	(2,397)	(113)
Net cash used in investing activities	(21,700)	(10,290)	(492)
Cash flows from financing activities:			
Issuance of stock, net of offering costs	915	20,212	109
Proceeds from indebtedness	23,231	17,557	302
Repayments of indebtedness	(21,749)	(21,777)	(1,138)
Payments to related parties		(737)	(114)
Net cash provided by (used in) financing activities	2,397	15,255	(841)
Net increase (decrease) in cash and cash equivalents	(6,867)	7,092	285
Cash and cash equivalents at beginning of year	7,377	285	
Cash and cash equivalents at end of year	$ 510	$ 7,377	$ 285
Supplementary schedule of non-cash investing and financing activities (See Note 3):			
Fair value of net assets acquired	$ 17,354	$ 17,458	$
Less cash acquired	(208)	(134)	
Less debt issued		(7,375)	
Less equity issued	(4,383)	(2,450)	
Acquisitions, net of cash acquired	$ 12,763	$ 7,499	$
Supplemental disclosure of cash flow information:			

Interest paid	$ 864	$ 810	$ 687
Income taxes paid	$ 5,380	$ 1,994	$ 75

See notes to consolidated financial statements.

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Business and Basis of Presentation

Flotek Industries, Inc. and subsidiaries was incorporated under the laws of the Province of British Columbia on May 17, 1985. On October 23, 2001, we changed our corporate domicile to the state of Delaware. We are engaged in the manufacturing and marketing of innovative specialty chemicals and downhole drilling and production equipment, and in the management of automated bulk material handling, loading and blending facilities. Flotek serves major and independent companies in the domestic and international oilfield service and mining industries. The Company s headquarters are located in Houston, Texas, and we have operations in Texas, Oklahoma, Colorado, New Mexico, Louisiana, Utah, Wyoming and The Netherlands. We market our products domestically and internationally in over 20 countries.

The consolidated financial statements consist of Flotek Industries, Inc. and its wholly-owned subsidiaries, collectively referred to herein as the Company or Flotek . All significant intercompany transactions and balances have been eliminated in consolidation.

Note 2 Summary of Significant Accounting Policies

Consolidation Policy Specifically Described: The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary corporations, after elimination of all material intercompany accounts, transactions, and profits. The Company does not have any investment in unconsolidated subsidiaries or non-marketable investments.

Cash and Cash Equivalents: Cash equivalents consist of highly liquid investments with an original maturity of three months or less.

Restricted Cash: Restricted cash serves as collateral for a standby letter of credit that provides financial assurance that the Company will fulfill its obligations related to an international contract to design and project manage the construction of a bulk handling facility in Mexico.

Allowance for Doubtful Accounts: The Company performs credit evaluations of the Company customer s current credit worthiness, as determined by our review of their available credit information. While such credit losses have historically been within our expectations and the provisions established, we cannot give any assurances that we will continue to experience the same credit loss rates that we have in the past. The cyclical nature of our industry may affect our customers operating performance and cash flows, which could impact our ability to collect on these obligations. Additionally, some of our customers are located in certain international areas that are inherently subject to risks of economic, political and civil instabilities, which may impact our ability to collect these receivables.

Inventories: Inventories consist of raw materials, work-in-process and finished goods. Finished goods inventories include raw materials, direct labor and production overhead. The Company determines the value of acquired work-in-process inventories by estimating the selling prices of finished goods or replacement cost less the sum of (a) cost to complete, (b) costs of disposal, and (c) a reasonable profit allowance for the completing and selling effort of the Company based on profit for similar finished goods. Inventories are carried at the lower of cost or market using the weighted average cost method. The Company maintains a reserve for slow-moving and obsolete inventories, which is reviewed for adequacy on a periodic basis.

FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Property, Plant and Equipment: Property, plant and equipment are stated at cost. The Company determines the value of acquired property, plant and equipment at the lower of (a) replacement cost or (b) appraised value. The cost of ordinary maintenance and repairs is charged to operations, while replacements and major improvements are capitalized. Depreciation is provided at rates considered sufficient to depreciate the cost of the assets using the straight-line method over the following estimated useful lives:

Buildings and leasehold improvements	3-39 years
Machinery, equipment and rental tools	3-7 years
Furniture and fixtures	3-7 years
Transportation equipment	3-5 years
Computer equipment	3-5 years

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds either the fair value or the estimated discounted cash flows of the assets, whichever is more readily measurable. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Goodwill and Intangible Assets: Goodwill represents the excess of the purchase price over the estimated fair value of the assets acquired net of the fair value of liabilities assumed in the acquisition. SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142) requires that intangible assets with indefinite lives, including goodwill, be evaluated on an annual basis for impairment or more frequently if an event occurs or circumstances change which could potentially result in an impairment.

The impairment test requires the allocation of goodwill and all other assets and liabilities to reporting units. If the fair value of the reporting unit is less than the book value (including goodwill) then goodwill is reduced to its implied fair value and the amount of the write-down is charged against earnings.

The Company completed its annual impairment review during the fourth quarter of 2006. No impairment was deemed necessary. Increases in estimated future costs or decreases in projected revenue could lead to an impairment of all or a portion of the Company s goodwill in future periods.

Financial Instruments: The Company considers the fair value of all financial instruments (primarily accounts receivable and long-term debt) not to be materially different from their carrying values at the end of each fiscal year based on management s estimate of the collectibility of net accounts receivable and due to our ability to borrow funds under terms and conditions similar to those of our existing debt and because the majority of our debt carries a floating rate.

The Company has no off-balance sheet debt or other off-balance sheet financing arrangements. The Company has not entered into derivatives or other financial hedging instruments.

Revenue Recognition: Revenue for product sales is recognized when all of the following criteria have been met: (i) evidence of an agreement exists, (ii) products are shipped or services rendered to the customer and all significant risks and rewards of ownership have passed to the customer, (iii) the price to the customer is fixed and determinable and (iv) collectibility is reasonably assured. Accounts receivable are recorded at that time, net of any discounts. Earnings are charged with a provision for doubtful accounts based on a current review of collectibility of the accounts receivable. Accounts receivable deemed ultimately uncollectible are applied against

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the allowance for doubtful accounts. Deposits and other funds received in advance of delivery are deferred until the transfer of ownership is complete.

The Logistics group recognizes revenue of its design and construction oversight contracts under the percentage-of-completion method of accounting, measured by the percentage of costs incurred to date to the total estimated costs of completion. This percentage is applied to the total estimated revenue at completion to calculate revenue earned to date. Contract costs include all direct labor and material costs and those indirect costs related to manufacturing and construction operations. General and administrative costs are charged to expense as incurred. Changes in job performance and estimated profitability, including those arising from contract bonus or penalty provisions and final contract settlements, may result in revisions to costs and income and are recognized in the period in which such revisions appear probable. All known or anticipated losses on contracts are recognized in full when such amounts become apparent. Bulk material transload revenue is recognized as services are performed for the customer.

Within the Drilling Products segment payments from customers for the cost of oilfield rental equipment that is damaged or lost-in-hole are reflected as revenue with the carrying value of the related equipment charged to cost of sales.

The Company is generally not contractually obligated to accept returns, except for defective products. If a product is determined to be defective, the Company will replace the product or issue a credit memo. Based on historical return rates, no provision is made for returns at the time of sale. All costs associated with product returns are expensed as incurred.

Foreign Currency: The Company has revenue that is denominated in currencies other than the United States dollar. Foreign currency transaction gains or losses are included in the Company s results of operations. The Company has not entered into any forward foreign exchange contracts to hedge the potential impact of currency fluctuations on our foreign currency denominated revenue.

Research and Development Costs: Expenditures for research activities relating to product development and improvement are charged to expense as incurred.

Income Taxes: Income taxes are computed under the liability method. The Company provides deferred income tax assets and liabilities for the expected future tax consequences attributable to differences between the financial statement carrying amounts and the respective tax basis of assets and liabilities. These deferred assets and liabilities are based on enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred income tax assets to amounts which are more likely than not to be realized.

Earnings Per Share: Basic earnings per common share is calculated by dividing net income attributable to common stockholders by the weighted average number of common shares outstanding. Dilutive earnings per share is calculated by dividing net income attributable to common stockholders by the weighted average number of common shares outstanding and dilutive effect of stock options and warrants.

Debt Issuance Costs: The costs related to the issuance of debt are capitalized and amortized to interest expense using the straight-line method, which approximates the interest method, over the maturity periods of the related debt.

Stock-Based Compensation: We adopted SFAS No. 123R, *Share-Based Payment* (SFAS No. 123R), effective January 1, 2006. This statement requires all share-based payments to employees, including grants of

FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

employee stock options, to be recognized in the financial statements based on their grant-date fair values. We did not have any unvested stock options outstanding as of January 1, 2006. We did not issues and stock options or restricted stock during 2006.

Prior to January 1, 2006, we accounted for our stock-based compensation using Accounting Principle Board Opinion No. 25 (APB No. 25). Under APB No. 25, compensation expense is recognized for stock options with an exercise price that is less than the market price on the grant date of the option.

Use of 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 certain assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. While management believes current estimates are reasonable and appropriate, actual results could differ from these estimates.

Reclassifications: Certain amounts for fiscal 2005 and 2004 have been reclassified in the accompanying consolidated condensed financial statements to conform to the current year presentation.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued its Statement of Financial Accounting Standards No. 157 (FAS No. 157), Fair Value Measurements. FAS No. 157 establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact that FAS No. 157 will have on our results of operations and financial position.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 provides guidance on the consideration of effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 requires the analysis of misstatements using both a balance sheet and income statement approach and contains guidance on correcting errors under the dual approach, as well as providing transition guidance for correcting errors existing in prior years. SAB 108 is effective for the first fiscal year ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on our results of operations or financial position.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes . FIN 48 is an interpretation of FASB Statement No. 109 Accounting for Income Taxes and was adopted by the Company effective January 1, 2007. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements uncertain tax positions that the Company has taken or expects to take in its tax returns. We are currently in the process of evaluating the impact of FIN 48 on our financial statements.

In May 2005, the FASB issued FASB Statement (SFAS) No. 154, Accounting Changes and Error Corrections . The Company s effective date for the pronouncement was December 15, 2005. SFAS No. 154 requires that all voluntary changes in accounting principles, including corrections of errors, are retrospectively applied to prior financial statements as if that principle had always been used, unless it is impracticable to do so. When it is impracticable to calculate the effects on all prior periods, SFAS No. 154 requires that the new principle be applied to the earliest period practicable. The Company adopted SFAS No. 154 as of December 31, 2005.

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In December 2004, the FASB issued Statement No. 123R, Share Based Payment (SFAS 123R). This statement revises Statement 123 and supersedes APB 25 and amends FASB Statement No. 95, Statement of Cash Flows . SFAS 123R requires companies to expense the fair value of employee services received in exchange for an award of equity instruments, including stock options. SFAS 123R also provides guidance on valuing and expensing these awards, as well as disclosure requirements with respect to these equity arrangements.

We adopted SFAS 123R effective as of January 1, 2006. We are following the modified prospective method of adoption of SFAS 123R whereby earnings for prior periods will not be restated as though stock based compensation had been expensed, rather than the modified retrospective method which would entail restatement of previously published earnings. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow. The impact of adoption of SFAS 123R will depend on levels of share-based compensation, particularly stock options, granted in the future and the fair value assigned thereto. The adoption of SFAS 123R has not had a material financial impact on our consolidated financial position, results of operations or cash flows.

On December 22, 2005, the Compensation Committee, on behalf of the Board of Directors (Board), approved the acceleration of the vesting of all previously unvested stock options granted under our 2003 and 2005 Long Term Incentive Plans (the Plans). The vesting acceleration represents options exercisable for a total of 313,140 shares of our common stock, including a total of 175,875 shares of common stock underlying options held by our executive officers. The options have exercise prices ranging from $4.25 to $9.40 per share. The closing price of our common stock on December 22, 2005 was $18.80. The acceleration of the vesting schedule of the options was effected pursuant to Section 4(c)(x) of the Plans, which authorizes the Board, in its sole discretion, to substitute an accelerated vesting schedule for options granted under the Plans. In most instances, stock options granted under the Plans vested over a four-year period.

The Board imposed selling restrictions on shares received through the exercise of accelerated options. These restrictions prohibit the sale of shares purchased under accelerated options until the date on which the options would otherwise have vested under the original option grants or six months after the date on which the options would otherwise have vested under the original option grants if the employee is no longer employed by the Company.

Note 3 Acquisitions

The Company purchased from Phoenix E&P Technology, LLC (Phoenix), its manufacturing assets, inventory and intellectual property rights to produce oilfield shale shaker screens and assumed accrued liabilities on January 28, 2005. The assets were purchased for $46,640 with a three-year royalty interest on all shale shaker screens produced. No royalty fees were generated during 2006.

On February 14, 2005, the Company completed the purchase of Spidle Sales and Services, Inc. (Spidle). The consolidated income statements include the results of operations of Spidle commencing January 1, 2005. A written agreement transferred effective control of Spidle to the Company as of January 1, 2005 without restrictions except those required to protect the shareholders of Spidle. Spidle is accounted for as a wholly-owned subsidiary of the Company.

The purchase price of the Spidle acquisition was allocated to the assets acquired and liabilities assumed based on estimated fair values, following the completion of an independent appraisal and other evaluations. In the twelve months following the acquisition date, we obtained third party inventory replacement cost data, which management believes to be a more accurate estimate of fair value. The acquired assets and assumed liabilities

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

were remeasured as of the acquisition date, and depreciation and amortization has been adjusted as if the fair values had been known at the acquisition date. This remeasurement resulted in a reduction in the fair value of the inventory acquired of $2.0 million, an increase in the fair value of property, plant and equipment of $1.8 million, and an increase in the fair value of long-term intangible assets of $0.2 million. The remeasurement resulted in approximately $0.5 million additional depreciation and amortization expense during 2005.

In accordance with SFAS No. 141, Accounting for Business Combinations , the excess of the net fair value of the assets acquired over the purchase price was allocated proportionately to reduce the values assigned to non-current assets in determining their fair values. In applying SFAS No. 141 to the transaction, the net value of property, plant and equipment was reduced by $14.1 million. A deferred tax liability of $1.8 million was recorded as a result of the fair value of the assets for book purposes being higher than the tax basis, which is carried at original cost. The total purchase price consisted of $6.1 million in cash, a $1.3 million seller note payable over three years, and 129,271 shares of the Company s common stock.

	Fair Value Investment	Application of SFAS No. 141 (in thousands)	Recorded Investment
Cash	$ 134	$	$ 134
Receivables	2,496		2,496
Inventories	4,871		4,871
Deferred tax asset	74	(74)	
Property, plant and equipment	17,485	(14,132)	3,353
Intangible assets	1,078	(871)	207
Accounts payable	(928)		(928)
Accrued liabilities	(113)		(113)
Federal income taxes payable	(156)		(156)
Deferred tax liability		(1,789)	(1,789)
Less: Total purchase price	8,075		8,075
Excess of investment over purchase price	$ 16,866	$ (16,866)	$

On August 19, 2005, the Company purchased the assets of privately-held Harmon s Machine Works, Inc., a downhole oilfield and mining tool company located in Midland, Texas, for approximately $4.9 million. The assets acquired included approximately $2.2 million of property, plant and equipment, $0.4 million in accounts receivable, $0.4 million in inventory and approximately $2.1 million in goodwill and other intangible assets. Consideration paid consisted of approximately $3.9 million in cash, $0.6 million in the Company s common stock and the assumption of $0.2 million of net liabilities. The Company financed the acquisition utilizing an equipment term loan of $1.3 million, an acquisition loan of $1.0 million, a real estate term loan of $0.2 million and $1.3 million of a revolving credit facility (See Note 7). The assets purchased have become part of the Company s Drilling Products segment.

On August 31, 2005, the Company purchased the assets of privately held Precision-LOR, Ltd. (LOR), a drilling tool rental and inspection service provider located in South Texas, for approximately $4.9 million. The assets acquired included approximately $1.3 million of equipment and approximately $3.5 million in goodwill and other intangible assets. Consideration paid consisted of approximately $3.6 million in cash and $1.2 million in the Company s common stock. Cash proceeds from the Company s equity issuance were utilized for the purchase. The assets purchased have become part of the Company s Drilling Products segment.

The Company made three acquisitions in 2006. On January 2, 2006, the Company purchased the assets of Can-Ok Oil Field Services, Inc. and Stabilizer Technology, Inc. (collectively Can-Ok), a downhole oilfield tool

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

company located in Chickasha, Oklahoma. On April 3, 2006, the Company purchased the tangible assets and licensed the rights to exercise the exclusive worldwide rights to a patented gas separator used in coal bed methane production from Total Well Solutions, LLC (TWS). TWS markets and services electric submersible pumps and downhole gas/water separators primarily to coal bed methane gas producers in the Powder River Basin. On June 6, 2006, the Company purchased the assets of LifTech, LLC (LifTech) which markets and services electric submersible pumps and downhole gas/water separators primarily to coal bed methane gas producers in the Powder River Basin.

Acquisitions have been accounted for using the purchase method of accounting under SFAS No. 141 Accounting for Business Combinations . The acquired companies results have been included in the accompanying financial statements from their respective dates of acquisition. Allocation of the purchase price for acquisitions was based on the estimates of fair value of the net assets acquired and is subject to adjustment upon finalization of the purchase price allocation within the one year anniversary of the acquisition.

The assets acquired, liabilities assumed and consideration paid were as follows for the 2006 acquisitions (in thousands, except share data):

	Can-Ok	TWS	LifTech
Assets acquired:			
Cash	$ 38	$	$ 170
Accounts receivable, net	453		754
Inventory	85	1,565	863
Plant, property and equipment	1,938	170	291
Goodwill	4,981	2,977	3,898
Intangible and other assets	206	160	173
Total assets acquired	$ 7,701	$ 4,872	$ 6,149
Liabilities assumed:			
Accounts payable	$ 395	$	$ 967
Accrued liabilities	6		
Total liabilities assumed	$ 401	$	$ 967
Net assets acquired	$ 7,300	$ 4,872	$ 5,182
Consideration paid:			
Cash	$ 6,775	$ 4,872	$ 1,323
Common stock	525		3,859
Total consideration paid	$ 7,300	$ 4,872	$ 5,182
Common stock shares issued	25,020		178,223

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4 Inventories

The components of inventories for the year ended December 31, 2006 and 2005 were as follows:

	December 31, 2006	December 31, 2005
	(in thousands)	
Raw materials	$ 4,415	$ 2,409
Work-in-process	700	51
Finished goods (includes in-transit)	13,646	8,603
Gross inventories	18,761	11,063
Less: Slow-moving and obsolescence reserve	(862)	(405)
Inventories, net	$ 17,899	$ 10,658

Note 5 Property, Plant and Equipment

For the year ended December 31, 2006 and 2005, property, plant and equipment were comprised of the following:

	December 31, 2006	December 31, 2005
	(in thousands)	
Land	$ 609	$ 409
Buildings and leasehold improvements	3,665	3,026
Machinery, equipment and rental tools	13,941	7,882
Equipment in progress	3,856	464
Furniture and fixtures	318	123
Transportation equipment	2,144	1,068
Computer equipment	491	433
Gross property, plant and equipment	25,024	13,405
Less: Accumulated depreciation	(5,722)	(3,444)
Property, plant and equipment, net	$ 19,302	$ 9,961

Note 6 Goodwill

In February 2002, we acquired IBS 2000, Inc., a Denver-based company engaged in the development and manufacturing of environmentally neutral chemicals for the oil industry. The terms of the acquisition called for an Earn-Out Payment based on 25% of the division s earnings before interest and taxes for the three one-year periods ending on March 31, 2003, 2004 and 2005. During 2004, the Company recorded additional goodwill of $320,012 associated with an earn-out for the period March 31, 2003 through December 31, 2004 to reflect additional acquisition consideration related to this agreement. In the first quarter of 2005 the Company recorded additional goodwill of $153,830 to reflect

the final amount of additional acquisition consideration related to this agreement. As of July 31, 2005, $175,411 had been paid. On August 2, 2005, the remaining balance of $298,431 was settled in 34,080 shares of common stock.

We evaluate the carrying value of goodwill during the fourth quarter of each year and on an interim basis, if events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

below its carrying amount. Such circumstances could include, but are not limited to: (i) a significant adverse change in legal factors or in business climate, (ii) unanticipated competition, or (iii) an adverse action or assessment by a regulator. When evaluating whether goodwill is impaired, the Company compares the fair value of the reporting unit to which the goodwill is assigned to the reporting unit s carrying amount, including goodwill. The fair value of the reporting unit is estimated using a combination of the income, or discounted cash flows approach and the market approach, which utilizes comparable companies data. If the carrying amount of a reporting unit exceeds its fair value, then the amount of the impairment loss must be measured. The impairment loss would be calculated by comparing the implied fair value of reporting unit goodwill to its carrying amount. In calculating the implied fair value of reporting unit s goodwill, the fair value of the reporting unit is allocated to all of the other assets and liabilities of that unit based on their fair values. The excess of the fair value of a reporting unit over the amount assigned to its other assets and liabilities is the implied fair value of goodwill. An impairment loss would be recognized when the carrying amount of goodwill exceeds its implied fair value. The Company s evaluation of goodwill completed during 2006 resulted in no impairment losses.

The following is a reconciliation of goodwill by segment:

	Chemicals & Logistics	Drilling Products	Artificial Lift	Total
		(in thousands)		
Balance at December 31, 2004	$ 7,466	$	$	$ 7,466
Earn-out payment	154			154
Acquisitions		4,768		4,768
Balance at December 31, 2005	7,620	4,768		12,388
Acquisitions		4,921	6,876	11,797
Balance at December 31, 2006	$ 7,620	$ 9,689	$ 6,876	$ 24,185

Note 7 Long-term Debt

Long-term debt at December 31, 2006 and 2005 consisted of the following:

	December 31, 2006	2005
	(in thousands)	
Senior Credit Facility		
Equipment term loan	$ 4,317	$ 5,717
Real estate term loan	724	803
Revolving line of credit	2,911	
Amendments to Senior Credit Facility		
Equipment term loan	1,165	1,289
Real estate term loan	209	222
Promissory notes to stockholders of acquired businesses, maturing February 2008	740	1,004
Other	708	258
Total	10,774	9,293
Less current portion	(2,589)	(2,016)

Long-term debt, less current portion	$ 8,185	$ 7,277

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In February 2005, we obtained the Senior Credit Facility with Wells Fargo which includes a revolving loan agreement, equipment term loans and a real estate term loans. In August 2006 we amended the Senior Credit Facility. The amendment to the Senior Credit Facility increased the maximum amount outstanding on the revolving line of credit from the lesser of (a) $10.0 million or (b) the sum of 80% of eligible domestic trade accounts receivable and 50% of eligible inventory, as defined. The terms are interest-only, maturing in August 2009.

As of December 31, 2006, we had $2.9 million outstanding under the revolving line of credit of the amended Senior Credit Facility. Bank borrowings are subject to certain covenants and a material adverse change subjective acceleration clause. Affirmative covenants include compliance with laws, various reporting requirements, visitation rights, maintenance of insurance, maintenance of properties, keeping of records and books of account, preservation of existence of assets, notification of adverse events, ERISA compliance, joinder agreement with new subsidiaries, borrowing base audits, and use of treasury management services. Negative covenants include limitations associated with liens, indebtedness, change in nature of business, transactions with affiliates, investments, distributions, subordinate debt, leverage ratio, fixed charge coverage ratio, consolidated net income, prohibition of fundamental changes, asset sales and capital expenditures. As of December 31, 2006 we were in compliance with all covenants except the indebtedness covenant which restricts the Company from exceeding $500,000 in secured indebtedness to finance the purchase of assets necessary in the Company s ordinary course of business. As of December 31, 2006 the Company had approximately $0.7 million in vehicle loans and capitalized vehicle leases.

In January 2007, we amended the Senior Credit Facility in conjunction with the acquisition of Triumph Drilling Tools. The amendment to the Senior Credit Facility increased the maximum amount outstanding on the revolving line of credit from the lesser of (a) $20.0 million or (b) the sum of 80% of eligible domestic trade accounts receivable and 50% of eligible inventory, as defined. The terms of the revolving loan agreement were modified to provide for borrowings that bear interest at LIBOR rate plus 175 basis points maturing in August 2009. The equipment term loan was amended to provide for borrowings of $35.0 million bearing interest at LIBOR rate plus 175 basis points payable over 84 months. The amendment increased many of our principal covenants including our leverage ratio, fixed charge coverage ratio and net capital expenditures. The real estate term loans remained unchanged. Our bank borrowings are collateralized by substantially all of our assets. Based on the amended maturity date, the current revolving line of credit is classified as long-term debt.

The Company believes the fair value of its long-term debt approximates the recorded value as of December 31, 2006, as the majority of the long-term debt carries a floating interest rate based on the prime rate.

Maturities of debt obligations at December 31, 2006 are as follows (in thousands):

	Debt	Capital Leases	Total
Year Ending December 31,:			
2007	$ 2,308	$ 281	$ 2,589
2008	1,753	274	2,027
2009	4,506	147	4,653
2010	1,499	6	1,505
2011			
Thereafter			
Total	$ 10,066	$ 708	$ 10,774

FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8 Common Stock, Stock Options and Warrants

On August 29, 2005, we completed a private offering of 1,300,000 shares of common stock at a price of $16.30 per share to 18 accredited investors. Gross proceeds from the private offering were $21,190,000; costs associated with the offering were $1,381,400. Proceeds from the sale were used for general corporate purposes, strategic acquisitions, and repayment of existing indebtedness. In connection with the sale, we committed with the private placement investors to file a registration statement with the Securities and Exchange Commission (the SEC) within 60 days of the completion of the private offering, covering resale of the shares by those investors. We submitted our Form SB-2 registration statement with the SEC on October 28, 2005, within 60 days of the completion of the private offering. The SEC declared the SB-2 effective December 30, 2005.

The amount of common shares issued and outstanding is summarized as follows:

Issued and outstanding as of December 31, 2005	8,317,265
Shares issued for Can-Ok acquisition (See Note 3)	25,020
Shares issued for LifTech acquisition (See Note 3)	178,223
Warrants converted	26,490
Stock options exercised (less restricted shares)	280,466
Issued and outstanding as of December 31, 2006	8,827,464

We have the 2003 and 2005 Long-Term Incentive Plans (the Plans) under which our officers, key employees, and non-employee directors may be granted options to purchase shares of our authorized but unissued common stock. As of December 31, 2006, there were no shares available for future grants under the 2003 Plan and 428,572 available under the 2005 Plan. Under the Plans, the option exercise price is equal to the fair market value of our common stock at the date of grant. Options currently expire no later than 10 years from the grant date and generally vest within four years or less. Proceeds received by us from exercises of stock options are credited to common stock and additional paid-in capital.

Additional information with respect to the Plans stock option activity is as follows:

	Number of Shares	Weighted-average Exercise Price
Outstanding as of January 1, 2004	657,839	$ 1.54
Granted	447,664	$ 3.30
Exercised	(15,000)	$ 0.61
Cancelled	(42,500)	$ 0.60
Outstanding as of December 31, 2004	1,048,003	$ 2.13
Granted	195,264	$ 14.12
Exercised	(80,801)	$ 1.77
Cancelled	(39,030)	$ 4.05
Outstanding as of December 31, 2005	1,123,436	$ 4.13
Exercised	(300,216)	$ 1.91
Outstanding as of December 31, 2006	823,220	$ 4.94

Options exercisable as of December 31, 2004	560,878	$	2.05
Options exercisable as of December 31, 2005	1,123,436	$	4.13
Options exercisable as of December 31, 2006	823,220	$	4.94

FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The weighted average contractual life remaining on outstanding stock options was approximately eight years as of December 31, 2006, eight years as of December 31, 2005 and nine years as of December 31, 2004.

As of December 31, 2006, the Company has 20,000 warrants outstanding to purchase common stock. The warrants have an exercise price of $5.42 per share and expired in February 2007.

Note 9 Earnings Per Share (EPS)

Basic EPS excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS is based on the weighted average number of shares outstanding during each period and the assumed exercise of dilutive instruments (stock options and warrants) less the number of treasury shares assumed to be purchased with the exercise proceeds using the average market price of the Company s common stock for each of the periods presented.

The following table presents information necessary to calculate earnings per share for the periods presented.

	For the Years Ended December 31,		
	2006	2005	2004
	(in thousands, except per share data)		
Net income	$ 11,350	$ 7,720	$ 2,154
Weighted-average common shares outstanding	8,645	7,303	6,659
Basic earnings per common share	$ 1.31	$ 1.06	$ 0.32
Diluted earnings per common share	$ 1.22	$ 0.94	$ 0.31
Weighted-average common shares outstanding	8,645	7,303	6,659
Effect of dilutive securities	649	952	354
Weighted-average common equivalent shares outstanding	9,294	8,255	7,013

A reconciliation of the number of shares used for the basic earnings per share calculation on a pro forma basis for 2004 had the acquisition of Spidle occurred January 1, 2004 is as follows:

	For the Year Ended December 31,	
	2005	2004
	(in thousands, except per share data)	
Pro forma revenue	$ 52,869	$ 38,082
Pro forma income from operations	$ 10,114	$ 4,520
Pro forma net income	$ 7,720	$ 2,961
Pro forma weighted-average common shares outstanding	7,303	6,789
Basic earnings per common share	$ 1.06	$ 0.44

Note 10 Stock Based Compensation Expense

We adopted SFAS No. 123R, *Share-Based Payment* (SFAS No. 123R), effective January 1, 2006. This statement requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their grant-date fair values. Compensation cost for awards granted prior to, but not vested, as of January 1, 2006 would be based on the grant date attributes

originally used to value those awards for pro forma purposes under SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). We adopted SFAS No. 123R using the modified prospective transition method, utilizing the

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Black-Scholes option pricing model for the calculation of the fair value of our employee stock options. Under the modified prospective method, we would record compensation cost related to unvested stock awards as of December 31, 2005 by recognizing the unamortized grant date fair value of these awards over the remaining vesting periods of those awards with no change in historical reported earnings. We did not have any unvested options outstanding as of December 31, 2005 .

Prior to January 1, 2006, we accounted for our stock-based compensation using Accounting Principle Board Opinion No. 25 (APB No. 25). Under APB No. 25, compensation expense is recognized for stock options with an exercise price that is less than the market price on the grant date of the option. For stock options with exercise prices at or above the market value of the stock on the grant date, we adopted the disclosure-only provisions of SFAS No. 123. We also adopted the disclosure-only provisions of SFAS No. 123 for the stock options granted to our employees and directors. Accordingly, no compensation cost was recognized under APB No. 25. All of our outstanding options were fully vested as of December 31, 2005 and no additional options or restricted stock were issued in 2006 there were compensation costs related to share-based payments in 2006.

Had compensation expense for the options granted been recorded based on the fair value at the grant date for the options, consistent with the provisions of SFAS 123, our net income (loss) and net income (loss) per share for the years ended December 31, 2005 and 2004 would have been decreased to the pro forma amounts indicated below (in thousands, except per share amounts):

	For the Years Ending December 31,	
	2005	**2004**
	(in thousands, except per share data)	
Net income:		
As reported	$ 7,720	$ 2,154
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,539)	(376)
Pro forma	$ 5,181	$ 1,778
Basic earnings per share:		
As reported	$ 1.06	$ 0.32
Pro forma	$ 0.71	$ 0.27
Diluted earnings per share:		
As reported	$ 0.94	$ 0.31
Pro forma	$ 0.63	$ 0.25

The weighted-average estimated fair value of stock options granted during 2005 and 2004 was $9.41 and $2.22 per share, respectively. These amounts were determined using the Black-Scholes option-pricing model, which values options based on the stock price at the grant date, the expected life of the option, the estimated volatility of the stock, the expected dividend payments, and the risk-free interest rate over the expected life of the option. The assumptions used in the Black-Scholes model were as follows for stock options granted in 2005 and 2004:

	For the Years Ended December 31,	
	2005	**2004**
Risk-free interest rate	4.17% 4.55%	3.82% 4.38%
Expected volatility of common stock	50%	50%
Expected life of options	10 years	10 years

Vesting period	0 4 years	0 4 years

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FLOTEK INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Black-Scholes option valuation model was developed for estimating the fair value of traded options that have no vesting restrictions and are fully-transferable. Because option valuation models require the use of subjective assumptions, changes in these assumptions can materially affect the fair value of the options, and our options do not have the characteristics of traded options, the option valuation models do not necessarily provide a reliable measure of the fair value of its options.

On December 22, 2005, the Compensation Committee, on behalf of the Board of Directors (Board) approved the acceleration of the vesting of all previously unvested stock options granted under the Company s 2003 and 2005 Long Term Incentive Plans (the Plans). The vesting acceleration represents options exercisable for a total of 313,140 shares of the Company s common stock, including a total of 175,875 shares of common stock underlying options held by the Company s executive officers. The options have exercise prices ranging from $4.25 to $9.40 per share. The closing price of the Company s common stock on December 22, 2005 was $18.80. The acceleration of the vesting schedule of the Company s options was effected pursuant to Section 4(c)(x) of the Plans, which authorizes the Board, in its sole discretion, to substitute an accelerated vesting schedule for options granted under the Plans. In most instances, stock options granted under the Plans vested over a four-year period.

Note 11 Income Taxes

The following are the components of total income tax expense broken out among the various categories of income in which the provision for income taxes is reported:

	For the Years Ended December 31,		
	2006	2005	2004
	(in thousands)		
Current:			
Federal	$ 5,142	$ 2,601	$ 75
State	594	254	138
Foreign	305	28	
Total current	6,041	2,883	213

			$ 3,077	$42,322	$46,479	$(28,326)	$18,153		
March 31, 2017									
High CQR	$183	$ 663	$ 755	$1,601	$1,165	$23,359	$26,125	$(12,003)	$14,122
Average CQR	28	5	-	33	555	18,725	19,313	(13,732)	5,581
Low CQR	-	-	3,086	3,086	-	-	3,086	-	3,086
Total	$211	$ 668	$ 3,841	$4,720	$1,720	$42,084	$48,524	$(25,735)	$22,789

We estimate losses on our net credit exposure to be between 0% - 5% for customers with highest CQR, as these customers are investment grade or the equivalent of investment grade. We estimate losses on our net credit exposure to be between 2% - 15% for customers with average CQR, and between 15% - 100% for customers with low CQR, which includes customers in bankruptcy.

6. PROPERTY, EQUIPMENT, OTHER ASSETS AND LIABILITIES

Our property, equipment, other assets and liabilities consist of the following (in thousands):

	September 30, 2017	March 31, 2017
Other current assets:		
Deposits & funds held in escrow	$ 26,843	$ 39,161
Prepaid assets	4,136	3,388
Other	952	815
Total other current assets	$ 31,931	$ 43,364
Property, equipment and other assets		
Property and equipment, net	$ 8,363	$ 6,690
Deferred costs	5,908	3,536
Other	2,007	1,730
Total other assets - long term	$ 16,278	$ 11,956

	September 30, 2017	March 31, 2017
Other current liabilities:		
Accrued expenses	$ 8,506	$ 7,450
Accrued income taxes payable	1,378	1,761
Other	10,554	9,968
Total other current liabilities	$ 20,438	$ 19,179
Other liabilities:		
Deferred revenue	$ 8,204	$ 4,704
Contingent consideration long-term	11,713	1,500
Other	439	876
Total other liabilities - long term	$ 20,356	$ 7,080

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As of September 30, 2017 we had a contingent consideration long-term liability balance of $11.7 million, of which $10.0 million relates to a recent acquisition. For details on the contingent consideration liability, refer to Note 15, "Business Combinations."

As of September 30, 2017 and March 31, 2017 we had customer deposits and funds held in escrow of $26.8 million and $39.2 million, respectively. These balances relate to financial assets that were sold to third-party banks. In conjunction with those sales, a portion of the proceeds were placed in escrow and will be released to us upon payment of outstanding invoices related to the underlying financing arrangements that were sold.

7. NOTES PAYABLE AND CREDIT FACILITY

Non-recourse and recourse obligations consist of the following (in thousands):

	September 30, 2017	March 31, 2017
Recourse notes payable with interest rates ranging from 3.20% to 4.13% as of March 31, 2017 and ranging from 3.20% to 3.40% September 30, 2017.		
Current	$ 688	$ 908
Non-recourse notes payable secured by financing receivables and investment in operating leases with interest rates ranging from 2.00% to 7.75% as of March 31, 2017 and ranging from 2.00% to 8.45% September 30, 2017.		
Current	$ 31,767	$ 26,085
Long-term	4,666	10,431
Total non-recourse notes payable	$ 36,433	$ 36,516

Principal and interest payments on non-recourse notes payable are generally due monthly in amounts that are approximately equal to the total payments due from the customer under the leases or notes receivable that collateralize the notes payable. The weighted average interest rate for our non-recourse notes payable was 3.62% and 3.73%, as of September 30, 2017 and March 31, 2017, respectively. The weighted average interest rate for our recourse notes payable was 3.22% and 3.45%, as of September 30, 2017 and March 31, 2017, respectively. Under recourse financing, in the event of a default by a customer, the lender has recourse to the customer, the assets serving as collateral, and us. Under non-recourse financing, in the event of a default by a customer, the lender generally only has recourse against the customer, and the assets serving as collateral, but not against us.

Our technology segment, through our subsidiary ePlus Technology, inc., finances its operations with funds generated from operations, and with a credit facility with Wells Fargo Commercial Distribution Finance, LLC ("WFCDF"). This facility provides short-term capital for our technology segment. There are two components of the WFCDF credit facility: (1) a floor plan component, and (2) an accounts receivable component. Under the floor plan component, we had outstanding balances of $120.2 million and $132.6 million as of September 30, 2017 and March 31, 2017, respectively. Under the accounts receivable component, we had no outstanding balances as of September 30, 2017 and March 31, 2017.

On July 27, 2017, we executed an amendment to the WFCDF credit facility which temporarily increases the aggregate limit of the two components from $250.0 million to $325.0 million from the date of the agreement through October 31, 2017, and provides us an election beginning July 1 in each subsequent year to similarly temporarily increase the aggregate limit of the two components to $325.0 million ending the earlier of 90 days following the date of election or October 31 of that same year.

As of September 30, 2017, the facility agreement had an aggregate limit of the two components of $325 million, and the accounts receivable component had a sub-limit of $30 million, which bears interest assessed at a rate of the One Month LIBOR plus two and one half percent.

The credit facility has full recourse to ePlus Technology, inc. and is secured by a blanket lien against all its assets, such as receivables and inventory. Availability under the facility may be limited by the asset value of equipment we purchase or accounts receivable, and may be further limited by certain covenants and terms and conditions of the facility. These covenants include but are not limited to a minimum excess availability of the facility and minimum earnings before interest, taxes, depreciation and amortization ("EBITDA") of ePlus Technology, inc. We were in compliance with these covenants as of September 30, 2017. In addition, the facility restricts the ability of ePlus Technology, inc. to transfer funds to its affiliates in the form of dividends, loans or advances with certain exceptions for dividends to ePlus inc. The facility also requires that financial statements of ePlus Technology, inc. be provided within 45 days of each quarter and 90 days of each fiscal year end and also includes that other operational reports be provided on a regular basis. Either party may terminate with 90 days' advance notice. We are not, and do not believe that we are reasonably likely to be, in breach of the WFCDF credit facility. In addition, we do not believe that the covenants of the WFCDF credit facility materially limit our ability to undertake financing. In this regard, the covenants apply only to our subsidiary, ePlus Technology, inc. This credit facility is secured by the assets of only ePlus Technology, inc. and the guaranty as described below.

The facility provided by WFCDF requires a guaranty of $10.5 million by ePlus inc. The guaranty requires ePlus inc. to deliver its annual audited financial statements by certain dates. We have delivered the annual audited financial statements for the year ended March 31, 2017, as required. The loss of the WFCDF credit facility could have a material adverse effect on our future results as we currently rely on this facility and its components for daily working capital and liquidity for our technology segment and as an operational function of our accounts payable process.

Fair Value

As of September 30, 2017 and March 31, 2017, the fair value of our long-term recourse and non-recourse notes payable approximated their carrying value.

8. COMMITMENTS AND CONTINGENCIES

Legal Proceedings

We are not currently a party to any legal proceedings with loss contingencies that are expected to be material. From time to time, we may be a plaintiff or a defendant in legal actions arising from our normal business activities, none of which has had a material effect on our business, results of operations or financial condition. Legal proceedings which may arise in the ordinary course of business include preference payment claims asserted in customer bankruptcy proceedings, tax audits, claims of alleged infringement of patents, trademarks, copyrights and other intellectual property rights, claims of alleged non-compliance with contract provisions, employment-related claims, claims by competitors, vendors or customers, claims related to alleged violations of laws and regulations, and claims relating to alleged security or privacy breaches. We attempt to ameliorate the effect of potential litigation through insurance coverage and contractual protections such as rights to indemnifications and limitations of liability. We do not expect that the outcome in any of these matters, individually or collectively, will have a material adverse effect on our financial condition or results of operations, however, litigation is inherently unpredictable. Therefore, judgments could be rendered or settlements entered that could adversely affect our results of operations or cash flows in a particular period. We provide for costs related to contingencies when a loss is probable and the amount is reasonably determinable.

9. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing net earnings available to common shareholders by the basic weighted average number of shares of common stock outstanding during each period. Diluted earnings per share is calculated by dividing net earnings available to common shareholders by the basic weighted average number of shares

of common stock outstanding plus common stock equivalents during each period.

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The following table provides a reconciliation of the numerators and denominators used to calculate basic and diluted net income per common share as disclosed on our consolidated statements of operations for the three and six months ended September 30, 2017 and 2016 (in thousands, except per share data).

	Three Months Ended September 30,		Six Months Ended September 30,	
	2017	2016	2017	2016
Net earnings attributable to common shareholders - basic and diluted	$ 17,221	$ 16,775	$ 30,644	$ 27,446
Basic and diluted common shares outstanding:				
Weighted average common shares outstanding — basic	13,879	13,818	13,843	13,941
Effect of dilutive shares	129	66	178	114
Weighted average shares common outstanding — diluted	14,008	13,884	14,021	14,055
Earnings per common share - basic	$ 1.24	$ 1.21	$ 2.21	$ 1.97
Earnings per common share - diluted	$ 1.23	$ 1.21	$ 2.19	$ 1.95

10. STOCKHOLDERS' EQUITY

Share Repurchase Plan

On August 15, 2017, our board of directors authorized the repurchase up to 500,000 shares of our outstanding common stock over a 12-month period beginning on August 19, 2017 through August 18, 2018. The plan authorized purchases to be made from time to time in the open market, or in privately negotiated transactions, subject to availability. Any repurchased shares will have the status of treasury shares and may be used, when needed, for general corporate purposes. The former repurchase plan expired on August 18, 2017.

During the six months ended September 30, 2017, we did not purchase any shares of our outstanding common stock under the share repurchase plan; however, we acquired 57,725 shares of common stock at a value of $4.4 million to satisfy tax withholding obligations relating to the vesting of employees' restricted stock.

During the six months ended September 30, 2016, we purchased 656,962 shares of our outstanding common stock at an average cost of $40.81 per share for a total purchase price of $26.8 million under the share repurchase plan. We also purchased 59,472 shares of common stock at a value of $2.6 million to satisfy tax withholding obligations relating to the vesting of employees' restricted stock.

11. SHARE-BASED COMPENSATION

Share-Based Plans

As of September 30, 2017, we had share-based awards outstanding under the following plans: (1) the 2008 Non-Employee Director Long-Term Incentive Plan ("2008 Director LTIP"), (2) the 2017 Non-Employee Director Long-Term Incentive Plan ("2017 Director LTIP") and (3) the 2012 Employee Long-Term Incentive Plan ("2012 Employee LTIP"). Both of the share-based plans define fair market value as the previous trading day's closing price when the grant date falls on a date the stock was not traded.

Restricted Stock Activity

For the six months ended September 30, 2017, we granted 535 restricted shares under the 2008 Director LTIP, 5,112 restricted shares under the 2017 Director LTIP, and 66,530 restricted shares under the 2012 Employee LTIP. For the six months ended September 30, 2016, we granted 10,990 restricted shares under the 2008 Director LTIP, and 134,538 restricted shares under the 2012 Employee LTIP. A summary of the restricted shares is as follows:

	Number of Shares	Weighted Average Grant-date Fair Value
Nonvested April 1, 2017	371,689	$ 40.45
Granted	72,177	$ 80.21
Vested	(155,811)	$ 38.51
Forfeited	(4,108)	$ 39.37
Nonvested September 30, 2017	283,947	$ 51.64

Upon each vesting period of the restricted stock awards, employees are subject to minimum tax withholding obligations. Under the 2012 Employee LTIP, we may purchase a sufficient number of shares due to the participant to satisfy their minimum tax withholding on employee stock awards. For the six months ended September 30, 2017, the Company had acquired 57,725 shares of common stock at a value of $4.4 million to satisfy tax withholding obligations relating to the vesting of employees' restricted stock, which was included in treasury stock.

Compensation Expense

We recognize compensation cost for awards of restricted stock with graded vesting on a straight line basis over the requisite service period. There are no additional conditions for vesting other than service conditions. During the three months ended September 30, 2017 and 2016, we recognized $1.5 million and $1.4 million, respectively, of total share-based compensation expense. During the six months ended September 30, 2017 and 2016, we recognized $3.0 million and $2.9 million, respectively, of total share-based compensation expense. Unrecognized compensation expense related to nonvested restricted stock was $12.7 million as of September 30, 2017, which will be fully recognized over the next thirty-three (33) months.

We also provide our employees with a contributory 401(k) profit sharing plan. We may make contributions to the plan. These contributions are not required and whether or not we choose to make them is entirely within our discretion. Our employer contributions to the plan are fully vested at all times. For the three months ended September 30, 2017 and 2016, our estimated contribution expense for the plan was $0.5 million and $0.4 million, respectively. For the six months ended September 30, 2017 and 2016, our estimated contribution expense for the plan was $1.1 million and $0.8 million, respectively.

12. INCOME TAXES

We account for our tax positions in accordance with Codification Topic 740, Income Taxes. Under the guidance, we evaluate uncertain tax positions based on the two-step approach. The first step is to evaluate each uncertain tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained in an audit, including resolution of related appeals or litigation processes, if any. For tax positions that are not likely of being sustained upon audit, the second step requires us to estimate and measure the tax benefit as the largest amount that is more than 50 percent likely of being realized upon ultimate settlement.

Our total gross unrecognized tax benefits recorded for uncertain income tax, and interest and penalties thereon, were negligible as of September 30, 2017, and September 30, 2016. We had no additions or reductions to our gross

unrecognized tax benefits during the three and six months ended September 30, 2017. We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense.

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13. FAIR VALUE OF FINANCIAL INSTRUMENTS

We account for the fair values of our assets and liabilities in accordance with ASC Topic 820, Fair Value Measurement and Disclosure. The following table summarizes the fair value hierarchy of our financial instruments as of September 30, 2017 and March 31, 2017 (in thousands):

	Recorded Amount	Fair Value Measurement Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2017				
Assets:				
Money market funds	$ 2,560	$ 2,560	$ -	$ -
Liabilities:				
Contingent consideration	$ 12,650	$ -	$ -	$ 12,650
March 31, 2017				
Assets:				
Money market funds	$ 50,866	$ 50,866	$ -	$ -
Liabilities:				
Contingent consideration	$ 554	$ -	$ -	$ 554

For the three and six months ended September 30, 2017, we recorded adjustments that increased the fair value of our liability for contingent consideration by $10.3 million, and $12.4 million due to business acquisitions. For the six months ended September 30, 2017, we made $0.3 million in payments to satisfy the current obligations of the contingent consideration arrangement from our earlier acquisition of Consolidated IT Services.

14. SEGMENT REPORTING

Our operations are conducted through two operating segments that are also both reportable segments. Our technology segment includes sales of information technology products, third-party software, third-party maintenance, advanced professional and managed services and our proprietary software to commercial enterprises, state and local governments, and government contractors. Our financing segment consists of the financing of IT equipment, software and related services to commercial enterprises, state and local governments, and government contractors. We measure the performance of the segments based on operating income.

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Our reportable segment information was as follows (in thousands):

	Three Months Ended					
	September 30, 2017			September 30, 2016		
	Technology	Financing	Total	Technology	Financing	Total
Sales of product and services	$357,759	$-	$357,759	$361,227	$-	$361,227
Financing revenue	-	12,035	12,035	-	8,722	8,722
Fee and other income	1,043	8	1,051	1,488	25	1,513
Net sales	358,802	12,043	370,845	362,715	8,747	371,462
Cost of sales, product and services	281,953	-	281,953	288,204	-	288,204
Direct lease costs	-	1,321	1,321	-	1,325	1,325
Cost of sales	281,953	1,321	283,274	288,204	1,325	289,529
Selling, general, and administrative expenses	53,503	2,837	56,340	48,302	3,305	51,607
Depreciation and amortization	2,128	1	2,129	1,721	2	1,723
Interest and financing costs	-	274	274	-	400	400
Operating expenses	55,631	3,112	58,743	50,023	3,707	53,730
Operating income	$21,218	$7,610	$28,828	$24,488	$3,715	$28,203
Selected Financial Data - Statement of Cash Flow						
Depreciation and amortization	$2,161	$1,359	$3,520	$1,765	$1,292	$3,057
Purchases of property, equipment and operating lease equipment	$955	$610	$1,565	$912	$1,367	$2,279
Selected Financial Data - Balance Sheet						
Total assets	$568,355	$170,641	$738,996	$484,178	$196,716	$680,894

	Six Months Ended					
	September 30, 2017			September 30, 2016		
	Technology	Financing	Total	Technology	Financing	Total
Sales of product and services	$714,839	$-	$714,839	$651,408	$-	$651,408
Financing revenue	-	21,106	21,106	-	15,709	15,709
Fee and other income	2,029	28	2,057	2,764	84	2,848
Net sales	716,868	21,134	738,002	654,172	15,793	669,965
Cost of sales, product and services	570,386	-	570,386	518,051	-	518,051
Direct lease costs	-	2,452	2,452	-	2,317	2,317
Cost of sales	570,386	2,452	572,838	518,051	2,317	520,368
Selling, general, and administrative expenses	105,004	6,000	111,004	93,515	6,146	99,661
Depreciation and amortization	4,190	2	4,192	3,492	6	3,498
Interest and financing costs	-	633	633	-	749	749
Operating expenses	109,194	6,635	115,829	97,007	6,901	103,908
Operating income	$37,288	$12,047	$49,335	$39,114	$6,575	$45,689

Selected Financial Data - Statement of Cash Flow						
Depreciation and amortization	$4,256	$2,489	$6,745	$3,553	$2,279	$5,832
Purchases of property, equipment and operating lease equipment	$2,046	$1,390	$3,436	$1,564	$1,605	$3,169
Selected Financial Data - Balance Sheet						
Total assets	$568,355	$170,641	$738,996	$484,178	$196,716	$680,894

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15. BUSINESS COMBINATIONS

Integrated Data Storage, LLC acquisition

On September 15, 2017, our subsidiary ePlus Technology, inc. acquired certain assets and assumed certain liabilities of Integrated Data Storage, LLC (“IDS”) though an asset purchase agreement. Headquartered in Oak Brook, IL and with offices in downtown Chicago and Indianapolis, IDS is an advanced data center solutions provider focused on cloud enablement and managed services, including its proprietary IDS Cloud, which features enterprise-class technology infrastructure coupled with consulting services to support private, hybrid, and public cloud deployments. The acquisition expands ePlus’ footprint in the Midwest and enhances its sales and engineering capabilities in cloud services, disaster recovery and backup as a service, storage, data center, and professional services.

Our preliminary sum of total consideration transferred is $38.4 million, consisting of $29.8 million paid in cash at closing, less $1.4 million in receivables due to us as a working capital adjustment, plus an additional $10.0 million equal to the preliminary fair value of consideration, contingent on the acquiree’s business operations future gross profit. The contingent consideration was calculated using the Monte Carlo simulation model based on our projections of future gross profits. The maximum payout of the contingent consideration is $15.0 million paid over 3 years. Our preliminary allocation of the purchase consideration to the assets acquired and liabilities assumed is presented below (in thousands):

	Acquisition Date Amount
Accounts receivable and other assets	$ 14,176
Property and equipment	2,062
Identified intangible assets	13,610
Accounts payable and other current liabilities	(12,483)
Total identifiable net assets	17,365
Goodwill	21,033
Total purchase consideration	$ 38,398

Our sum for consideration transferred and our allocation of the purchase consideration is preliminary and subject to revision as additional information related to the fair value of assets and liabilities becomes available.

The identified intangible assets of $13.6 million consist of customer relationships with an estimated useful life of 8 years. The fair value of acquired receivables equals the gross contractual amounts receivable. We expect to collect all acquired receivables.

We recognized goodwill related to this transaction of $21.0 million, which was assigned to our technology reporting unit. The goodwill recognized in the acquisition is attributable to the acquired assembled workforce and expected synergies, none of which qualify for recognition as a separate intangible asset. The total amount of goodwill is expected to be deductible for tax purposes. The amount of revenues and earnings of the acquiree since the acquisition date are not material. Likewise, the impact to the revenue and earnings of the combined entity for the current reporting period through the acquisition date had the acquisition date been April 1, 2017, is not material.

OneCloud Consulting Inc. acquisition

On May 17, 2017, our subsidiary ePlus Technology, inc., acquired 100% of the stock of OneCloud Consulting, Inc. (“OneCloud”). Based in Milpitas, CA, OneCloud is a versatile team of highly trained technology consultants, architects, developers and instructors. OneCloud enables its customers’ cloud and application strategy via professional services, technical education and software development. The acquisition provides us with additional ability to address

customers’ needs in cloud-based solutions and infrastructure, including DevOps, OpenStack, and other emerging technologies, to our broad customer base.

Our preliminary sum of total consideration we transferred was $10.0 million consisting of $7.9 million paid in cash at closing, net of cash acquired, and $2.1 million equal to the fair value of contingent consideration, calculated using the Monte Carlo simulation model. The maximum payout of the contingent consideration is $4.5 million paid over 3 years.

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Our preliminary allocation of the purchase consideration to the assets acquired and liabilities assumed is presented below (in thousands):

	Acquisition Date Amount
Accounts receivable and other assets	$ 488
Identified intangible assets	4,130
Accounts payable and other current liabilities	(1,822)
Total identifiable net assets	2,796
Goodwill	7,189
Total purchase consideration	$ 9,985

The identified intangible assets of $4.1 million consist of customer relationships of $1.7 million with an estimated useful life of 8 years, and internally developed processes of $2.4 million with an estimated useful life of 5 years.

We recognized goodwill related to this transaction of $7.2 million, which was assigned to our technology reporting unit. The goodwill recognized in the acquisition is attributable to the acquired assembled workforce and expected synergies, none of which qualify for recognition as a separate intangible asset. The total amount of goodwill is expected to be deductible for tax purposes. The amount of revenues and earnings of the acquiree since the acquisition date are not material. Likewise, the impact to the revenue and earnings of the combined entity for the current reporting period through the acquisition date had the acquisition date been April 1, 2017, is not material.

Consolidated IT Services acquisition

On December 6, 2016, our subsidiary ePlus Technology, inc., acquired certain assets and assumed certain liabilities of Consolidated IT Services. Consolidated IT Services' business provides data center, unified communications, networking, and security solutions to a diverse set of domestic and international customers including commercial, enterprise, and state, local, and education (SLED) organizations in the upper Midwest. Acquiring Consolidated IT Services expanded our reach to the upper Midwest, a new geography for ePlus, and enables us to market our advanced technology solutions to their long-standing customer base.

The total purchase price is $13.1 million including $9.5 million paid in cash at closing and $4.0 million that will be paid in cash in equal quarterly installments over 2 years, less $0.4 million paid back to us as part of the final working capital adjustment. Our allocation of the purchase consideration to the assets acquired and liabilities is presented below (in thousands):

	Acquisition Date Amount
Accounts receivable and other current assets	$ 7,491
Property and equipment	1,045
Identified intangible assets	4,090
Accounts payable and other current liabilities	(5,786)
Total identifiable net assets	6,840
Goodwill	6,227
Total purchase consideration	$ 13,067

In the six months ended September 30, 2017, we increased identified intangible assets and decreased goodwill by $280 thousand from the provisional amounts recorded as of March 31, 2017.

The identified intangible assets of $4.1 million consist entirely of customer relationships with an estimated useful life of 7 years.

We recognized goodwill related to this transaction of $6.2 million, which was assigned to our technology reporting unit. The goodwill recognized in the acquisition is attributable to the acquired assembled workforce and expected synergies, none of which qualify for recognition as a separate intangible asset. The total amount of goodwill is expected to be deductible for tax purposes. The amount of revenues and earnings of the acquiree since the acquisition date are not material. Likewise, the impact to the revenue and earnings of the combined entity for the prior reporting period through the acquisition date had the acquisition date been April 1, 2016 is not material.

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

This discussion is intended to further the reader's understanding of our consolidated financial condition and results of operations. It should be read in conjunction with the financial statements included in this quarterly report on Form 10-Q and our annual report on Form 10-K for the fiscal year ended March 31, 2017 ("2017 Annual Report"). These historical financial statements may not be indicative of our future performance. This Management's Discussion and Analysis of Financial Condition and Results of Operations may contain forward-looking statements, all of which are based on our current expectations and could be affected by the uncertainties and risks described in Part I, Item 1A, "Risk Factors," in our 2017 Annual Report.

EXECUTIVE OVERVIEW

Business Description

We are a leading solutions provider that delivers actionable outcomes for organizations by utilizing information technology (IT) and consulting solutions to drive business agility and innovation. Leveraging world-class engineering talent, we assess, plan, deliver, and secure solutions comprised of leading technologies and consumption models aligned with customers' needs. Our expertise and experience enables ePlus to craft optimized solutions that take advantage of the cost, scale and efficiency of private, public and hybrid cloud in an evolving market. We also provide consulting, professional, managed and complete lifecycle management services including flexible financing solutions. We have been in the business of selling, leasing, financing, and managing information technology and other assets for more than 27 years.

Our primary focus is to deliver integrated technology solutions that address our customers' Cloud, Security and Digital Infrastructure needs, for both on-premise and in the cloud. Our Hybrid IT framework is a lifecycle approach that includes consulting, assessment, architecture, testing, implementation, managed services, maintenance and periodic consultative reviews. In addition to cloud, our portfolio of expertise includes software defined, security, IoT, data and analytics, mobility, hyper-converged infrastructure, and other advanced technologies. We design, implement and manage an array of IT solutions from multiple leading IT vendors. We are an authorized reseller from over 1,000 vendors, but primarily from approximately 100 vendors, including Artista Networks, Check Point, Cisco Systems, Citrix, Commvault, Dell EMC, F5 Networks, Gigamon, HP Inc., HPE, Juniper Networks, Lenovo, NetApp, Nimble Storage, Oracle, Palo Alto Networks, Pure Storage, Quantum, Splunk, and VMware, among many others. We possess top-level engineering certifications with a broad range of leading IT vendors that enable us to offer multi-vendor IT solutions that are optimized for each of our customers' specific requirements. Our hosted, proprietary software solutions are focused on giving our customers more control over their IT supply chain, by automating and optimizing the procurement and management of their owned, leased, and consumption-based assets.

Our scale and financial resources have enabled us to continue investing in engineering and technology resources and stay current with emerging technology trends. By delivering leading edge Hybrid IT solutions, ePlus has become a trusted advisor to our customers. Our integrated technology solutions incorporate hardware, software, security and both managed and professional services. In addition, we offer a wide range of consumption options including leasing and financing for technology and other capital assets. We believe our lifecycle approach offering of integrated solutions, services, financing, and our proprietary supply chain software, is unique in the industry. This broad portfolio enables us to deliver a unique customer experience that spans the continuum from fast delivery of competitively priced products, services, subsequent management and upkeep, through to end-of-life disposal services. This approach also permits us to accommodate our customers' business requirements and deliver ever-more-sophisticated hybrid IT solutions, thus solidifying our relationships and value.

Our go-to-market strategy focuses primarily on diverse end-markets for middle market to large enterprises. For the twelve months ended September 30, 2017, the percentage of revenue by customer end market within our technology

segment includes technology industry 24%, state and local government, and educational institutions 18%, telecommunications, media and entertainment 15%, financial services 14%, and healthcare 12%. The majority of our sales were generated within the United States; however, we have the ability to support our customers nationally and internationally including a presence in the United Kingdom (“U.K.”), India and Singapore. Our technology segment accounted for 97% of our net sales, and 74% of our operating income, while our financing segment accounted for 3% of our net sales, and 26% of our operating income for the six months ended September 30, 2017.

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Key Business Metrics

Our management monitors a number of financial and non-financial measures and ratios on a regular basis in order to track the progress of our business. We believe that the most important of these measures and ratios include gross margin, gross margin on product and services, operating income margin, net earnings, net earnings per common share, Adjusted EBITDA, Adjusted EBITDA margin, Adjusted gross billings of product and services, and non-GAAP net earnings per share. We use a variety of operating and other information to evaluate the operating performance of our business, develop financial forecasts, make strategic decisions, and prepare and approve annual budgets.

These key indicators include financial information that is prepared in accordance with US GAAP and presented in our unaudited condensed consolidated financial statements as well as non-GAAP performance measurement tools. Generally, a non-GAAP financial measure is a numerical measure of a company's performance or financial position that either excludes or includes amounts that are not normally included in the most directly comparable measure calculated and presented in accordance with US GAAP. Non-GAAP measures used by management may differ from similar measures used by other companies, even when similar terms are used to identify such measures.

Our key business metrics and results from those metrics are as follows, (dollars in thousands):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2017	2016	2017	2016
Sales of products and services	$357,759	$361,227	$714,839	$651,408
Adjusted gross billings of product and services (1)	$503,581	$487,308	$985,266	$884,781
Gross margin	23.6 %	22.1 %	22.4 %	22.3 %
Gross margin, product and services	21.2 %	20.2 %	20.2 %	20.5 %
Operating income margin	7.8 %	7.6 %	6.7 %	6.8 %
Net earnings	$17,221	$16,775	$30,644	$27,446
Net earnings margin	4.6 %	4.5 %	4.2 %	4.1 %
Net earnings per common share - diluted	$1.23	$1.21	$2.19	$1.95
Non-GAAP: Net earnings (2)	$17,835	$17,130	$30,439	$28,089
Non-GAAP: Net earnings per common share - diluted (2)	$1.27	$1.23	$2.17	$2.00
Adjusted EBITDA (3)	$30,957	$29,926	$53,527	$49,187
Adjusted EBITDA margin (3)	8.3 %	8.1 %	7.3 %	7.3 %
Purchases of property and equipment used internally	$955	$912	$2,046	$1,564
Purchases of equipment under operating leases	610	1,367	1,390	1,605
Total capital expenditures	$1,565	$2,279	$3,436	$3,169

(1) We define Adjusted gross billings of product and services as our sales of product and services calculated in accordance with US GAAP, adjusted to exclude the costs incurred related to sales of third party software assurance, subscription licenses, maintenance and services. We have provided below a reconciliation of Adjusted gross billings of product and services to Sales of product and services, which is the most directly comparable financial measure to this non-GAAP financial measure.

We use Adjusted gross billings of product and services as a supplemental measure of our performance to gain insight into the volume of business generated by our technology segment, and to analyze the changes to our accounts receivable and accounts payable. Our use of Adjusted gross billings of product and services as analytical tools has limitations, and you should not consider them in isolation or as substitutes for analysis of our financial results as reported under US GAAP. In addition, other companies, including companies in our industry, might calculate Adjusted gross billings of product and services or similarly titled measures differently, which may reduce their usefulness as comparative measures.

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	Three Months Ended September 30,		Six Months Ended September 30,	
	2017	2016	2017	2016
Sales of products and services	$357,759	$361,227	$714,839	$651,408
Costs incurred related to sales of third party software assurance, maintenance and services	145,822	126,081	270,427	233,373
Adjusted gross billings of product and services	$503,581	$487,308	$985,266	$884,781

(2) Non-GAAP net earnings per common share are based on net earnings calculated in accordance with US GAAP, adjusted to exclude other income and acquisition related amortization expense, and related effects on income tax, and the tax (benefit) expense recognized due to the vesting of shared based compensation. We use non-GAAP net earnings per common share as a supplemental measure of our performance to gain insight into our operating performance. We believe that the exclusion of these items in calculating non-GAAP net earnings per common share provides management and investors a useful measure for period-to-period comparisons of our business and operating results by excluding items that management believes are not reflective of our underlying operating performance. Accordingly, we believe that non-GAAP net earnings per common share provide useful information to investors and others in understanding and evaluating our operating results. However, our use of non-GAAP net earnings per common share as analytical tools has limitations, and you should not consider them in isolation or as substitutes for analysis of our financial results as reported under US GAAP. In addition, other companies, including companies in our industry, might calculate non-GAAP net earnings per common share or similarly titled measures differently, which may reduce their usefulness as comparative measures.

	Three Months Ended September 30,		Six Months Ended September 30,	
	2017	2016	2017	2016
GAAP: Earnings before tax	$ 28,687	$ 28,583	$49,465	$46,069
Acquisition related amortization expense	1,186	974	2,307	2,063
Other (income) expense	141	(380)	(130)	(380)
Non-GAAP: Earnings before provision for income taxes	30,014	29,177	51,642	47,752
GAAP: Provision for income taxes	11,466	11,808	18,821	18,623
Acquisition related amortization expense	450	324	874	689
Other (income) expense	59	(157)	(55)	(157)
Tax benefit on restricted stock	204	72	1,563	508
Non-GAAP: Provision for income taxes	12,179	12,047	21,203	19,663
Non-GAAP: Net earnings	$ 17,835	$ 17,130	$30,439	$28,089
GAAP: Net earnings per common share - diluted	$ 1.23	$ 1.21	$2.19	$1.95
Non-GAAP: Net earnings per common share - diluted	$ 1.27	$ 1.23	$2.17	$2.00

(3) We define Adjusted EBITDA as net earnings calculated in accordance with US GAAP, adjusted for the following: interest expense, depreciation and amortization, provision for income taxes, and other income. We consider the interest on notes payable from our financing segment and depreciation expense presented within cost of sales, which includes depreciation on assets financed as operating leases, to be operating expenses. As such, they are not included in the amounts added back to net earnings in the Adjusted EBITDA calculation. We provide below a reconciliation of Adjusted EBITDA to net earnings, which is the most directly comparable financial measure to this non-GAAP financial measure. Adjusted EBITDA margin is our calculation of Adjusted EBITDA divided by net sales.

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We use Adjusted EBITDA as a supplemental measure of our performance to gain insight into our operating performance. We believe that the exclusion of other income in calculating Adjusted EBITDA and Adjusted EBITDA margin provides management and investors a useful measure for period-to-period comparisons of our business and operating results by excluding items that management believes are not reflective of our underlying operating performance. Accordingly, we believe that Adjusted EBITDA and Adjusted EBITDA margin provide useful information to investors and others in understanding and evaluating our operating results. However, our use of Adjusted EBITDA and Adjusted EBITDA margin as analytical tools has limitations, and you should not consider them in isolation or as substitutes for analysis of our financial results as reported under US GAAP. In addition, other companies, including companies in our industry, might calculate Adjusted EBITDA and Adjusted EBITDA margin or similarly titled measures differently, which may reduce their usefulness as comparative measures.

	Three Months Ended September 30,		Six Months Ended September 30,	
Consolidated	2017	2016	2017	2016
Net earnings	$ 17,221	$ 16,775	$ 30,644	$ 27,446
Provision for income taxes	11,466	11,808	18,821	18,623
Depreciation and amortization	2,129	1,723	4,192	3,498
Other (income) expense	141	(380)	(130)	(380)
Adjusted EBITDA	$ 30,957	$ 29,926	$ 53,527	$ 49,187
Technology Segment				
Operating income	$ 21,218	$ 24,488	$ 37,288	$ 39,114
Depreciation and amortization	2,128	1,721	4,190	3,492
Adjusted EBITDA	$ 23,346	$ 26,209	$ 41,478	$ 42,606
Financing Segment				
Operating income	$ 7,610	$ 3,715	$ 12,047	$ 6,575
Depreciation and amortization	1	2	2	6
Adjusted EBITDA	$ 7,611	$ 3,717	$ 12,049	$ 6,581

Consolidated Results of Operations

During the three months ended September 30, 2017, net sales decreased 0.2%, or $0.6 million to $370.8 million, compared to $371.5 million for the same period in the prior fiscal year. For the six months ended September 30, 2017, net sales increased 10.2%, or $68.0 million to $738.0 million, compared to $670.0 million for the same period in the prior fiscal year.

Adjusted gross billings of product and services increased 3.3%, or $16.3 million to $503.6 million, for the three months ended September 30, 2017 from $487.3 million for the same period in the prior fiscal year. For the six months ended September 30, 2017, adjusted gross billings of product and services increased 11.4%, or $100.5 million to $985.3 million, from $884.8 million for the same period in the prior fiscal year. Both the three month and six month increase in demand was from commercial customers primarily in the technology industry.

Consolidated gross profit rose 6.9% to $87.6 million, compared with $81.9 million for the three months ended September 30, 2016. Consolidated gross margins were 23.6% for the three months ended September 30, 2017 an increase of 150 basis points compared to 22.1% for the same period in the prior fiscal year, due to a shift in product mix, as we sold a higher proportion of third party software assurance, maintenance and services for which the revenues are presented on a net basis, and an increase in revenues from our services. For the six months ended September 30, 2017, consolidated gross profit rose 10.4% to $165.2 million, compared with $149.6 million for the same period in the prior fiscal year.

Consolidated gross margins were 22.4% for the six months ended September 30, 2017 an increase of 10 basis points compared to 22.3% for the same period in the prior fiscal year. The smaller increase in margins for the six month periods is due to a shift in product mix sold to a higher proportion of third party software assurance, maintenance and services in the current quarter mostly offset by a large competitively bid project which partially shipped during the six month period. Also contributing to the lower margins was a decrease in vendor incentives earned.

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Our operating expenses increased 9.3% to $58.7 million, or 67.1% of gross profits for the three months ended September 30, 2017 as compared to $53.7 million, representing 65.6% of gross profits in the same period prior year. For the six months ended September 30, 2017, our operating expenses increased 11.5% to $115.8 million, or 70.1% of gross profits as compared to $103.9 million, representing 69.5% of gross profits in the same prior year period. The majority of this increase reflects increased variable compensation as a result of the increase in gross profit, as well as additional employees, and an increase in employee healthcare costs. Our headcount increased by 186 employees or 17.0% to 1,282 from 1,096 a year ago, 155 of which were from the acquisitions of Consolidated IT Services, OneCloud, and IDS. The net additions in personnel compared to the prior year include 162 sales and engineering positions, with the remaining additions being administrative, IT, and finance positions.

Operating income for the three months ended September 30, 2017 increased 2.2% to $28.8 million, as compared to $28.2 million for the same period in the prior year. For the three months ended September 30, 2017, the operating income margin increased 20 basis points to 7.8% from 7.6% for the same period in the prior year. Operating income for the six months ended September 30, 2017 increased 8.0% to $49.3 million, as compared to $45.7 million for the same period in the prior year. For the six months ended September 30, 2017, the operating income margin decreased 10 basis points to 6.7% from 6.8% for the same period in the prior year.

Consolidated net earnings for the three months ended September 30, 2017 were $17.2 million, an increase of 2.7%, or $0.4 million, compared to the prior year's results. For the six months ended September 30, 2017, consolidated net earnings were $30.6 million, an increase of 11.7%, or $3.2 million, compared to the prior year's results.

Adjusted EBITDA increased $1.0 million, or 3.4% to $31.0 million and Adjusted EBITDA margin increased 20 basis points to 8.3% for the three months ended September 30, 2017, as compared to the prior period of 8.1%. For the six months ended September 30, 2017, Adjusted EBITDA increased $4.3 million, or 8.8% to $53.5 million and Adjusted EBITDA margin remained stable at 7.3% for the six months ended September 30, 2017 and 2016.

Diluted earnings per share increased 1.7%, or $0.02 to $1.23 per share for the three months ended September 30, 2017, as compared to $1.21 per share for the three months ended September 30, 2016. Our effective tax rate for the three months ended September 30, 2017 was 40.0%, which includes a tax benefit of $0.2 million related to the vesting of share based compensation during the quarter. Non-GAAP diluted earnings per share increased 3.3% to $1.27 for the three months ended September 30, 2017, as compared to $1.23 for the three months ended September 30, 2016.

For the six months ended September 30, 2017, diluted earnings per share increased 12.3%, or $0.24 to $2.19 per share, as compared to $1.95 per share for the three months ended September 30, 2016. Our effective tax rate for the six months ended September 30, 2017 was 38.0%, which includes a tax benefit of $1.6 million related to the vesting of share based compensation during the quarter. Non-GAAP diluted earnings per share increased 8.5% to $2.17 for the six months ended September 30, 2017, as compared to $2.00 for the six months ended September 30, 2016.

Cash and cash equivalents decreased $49.6 million or 45.2% to $60.2 million at September 30, 2017 compared with $109.8 million, as of March 31, 2017. The decrease is primarily the result of investments in our financing portfolio, working capital required for the growth in our technology segment, $28.4 million paid in cash at closing of our acquisition of IDS and $7.9 million paid in cash at closing for our acquisition of OneCloud. Our cash on hand, funds generated from operations, amounts available under our credit facility and the possible monetization of our investment portfolio provide sufficient liquidity for our business.

Segment Overview

Our operations are conducted through two segments: technology and financing.

Technology Segment

The technology segment sells IT equipment and software and related services primarily to corporate customers, state and local governments, and higher education institutions on a nationwide basis, with geographic concentrations relating to our physical locations. The technology segment also provides Internet-based business-to-business supply chain management solutions for information technology products.

Our technology segment derives revenue from the sales of new equipment and service engagements. Included in the sales of product and services are revenues derived from performing advanced IT professional and managed services that may be sold together with and integral to third-party products and software. Our service engagements are generally governed by statements of work, and are primarily fixed price (with allowance for changes); however, some service agreements are based on time and materials.

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Customers who purchase IT equipment and services from us may have customer master agreements, or CMAs, with our company, which stipulate the terms and conditions of the relationship. Some CMAs contain pricing arrangements, and most contain mutual voluntary termination clauses. Our other customers place orders using purchase orders without a CMA in place or with other documentation customary for the business. Often, our work with state and local governments is based on public bids and our written bid responses

We endeavor to minimize our cost of sales through incentive programs provided by vendors and distributors. The programs we qualify for are generally set by our reseller authorization level with the vendor. The authorization level we achieve and maintain governs the types of products we can resell as well as such items as pricing received, funds provided for the marketing of these products and other special promotions. These authorization levels are achieved by us through purchase volume, certifications held by sales executives or engineers and/or contractual commitments by us. The authorization levels are costly to maintain and these programs continually change and, therefore, there is no guarantee of future reductions of costs provided by these vendor consideration programs.

Financing Segment

Our financing segment offers financing solutions to corporations, governmental entities, and educational institutions nationwide and also in the United Kingdom, Canada and Iceland. The financing segment derives revenue from leasing IT and medical equipment and the disposition of that equipment at the end of the lease. The financing segment also derives revenues from the financing of third-party software licenses, software assurance, maintenance and other services.

Financing revenue generally falls into the following three categories:

- Portfolio income: Interest income from financing receivables and rents due under operating leases;
- Transactional gains: Net gains or losses on the sale of financial assets; and
- Post-contract earnings: Month-to-month rents; early termination, prepayment, make-whole, or buyout fees; and net gains on the sale of off-lease (used) equipment.

Our financing segment sells the equipment underlying a lease to the lessee or a third-party other than the lessee. These sales occur at the end of the lease term and revenues from the sales of such equipment are recognized at the date of sale. We also recognize revenue from events that occur after the initial sale of a financial asset and remarketing fees from certain residual value investments.

Fluctuations in Revenues

Our results of operations are susceptible to fluctuations for a number of reasons, including, without limitation, customer demand for our products and services, supplier costs, changes in vendor incentive programs, interest rate fluctuations, general economic conditions, and differences between estimated residual values and actual amounts realized related to the equipment we lease. Operating results could also fluctuate as a result of a sale prior to the expiration of the lease term to the lessee or to a third-party or from post-term events.

We expect to continue to expand by opening new sales locations and hiring additional staff for specific targeted market areas in the near future whenever we can find both experienced personnel and desirable geographic areas. These investments may reduce our results from operations in the short term.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with US GAAP requires management to use judgment in the application of accounting policies, including making estimates and assumptions. If our judgment or interpretation of

the facts and circumstances relating to various transactions had been different, or different assumptions were made, it is possible that alternative accounting policies would have been applied, resulting in a change in financial results. On an ongoing basis, we reevaluate our estimates, including those related to revenue recognition, residual values, vendor incentives, lease classification, goodwill and intangibles, reserves for credit losses and income taxes specifically relating to uncertain tax positions. We base estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. For all such estimates, we caution that future events rarely develop exactly as forecasted, and therefore, these estimates may require adjustment.

Our critical accounting estimates have not changed from those reported in Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our 2017Annual Report.

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SEGMENT RESULTS OF OPERATIONS

The three and six months ended September 30, 2017 compared to the three and six months ended September 30, 2016

Technology Segment

The results of operations for our technology segment for the three and six months ended September 30, 2017 and 2016 were as follows (dollars in thousands):

	Three Months Ended September 30,				Six Months Ended September 30,			
	2017	2016	Change		2017	2016	Change	
Sales of product and services	$357,759	$361,227	$(3,468)	(1.0 %)	$714,839	$651,408	$63,431	9.7 %
Fee and other income	1,043	1,488	(445)	(29.9%)	2,029	2,764	(735)	(26.6%)
Net sales	358,802	362,715	(3,913)	(1.1 %)	716,868	654,172	62,696	9.6 %
Cost of sales, product and services	281,953	288,204	(6,251)	(2.2 %)	570,386	518,051	52,335	10.1 %
Gross profit	76,849	74,511	2,338	3.1 %	146,482	136,121	10,361	7.6 %
Selling, general, and administrative expenses	53,503	48,302	5,201	10.8 %	105,004	93,515	11,489	12.3 %
Depreciation and amortization	2,128	1,721	407	23.6 %	4,190	3,492	698	20.0 %
Operating expenses	55,631	50,023	5,608	11.2 %	109,194	97,007	12,187	12.6 %
Operating income	$21,218	$24,488	$(3,270)	(13.4%)	$37,288	$39,114	$(1,826)	(4.7 %)
Key business metrics								
Adjusted gross billings of product and services	$503,581	$487,308	$16,273	3.3 %	$985,266	$884,781	$100,485	11.4 %
Adjusted EBITDA	$23,346	$26,209	$(2,863)	(10.9%)	$41,478	$42,606	$(1,128)	(2.6 %)

Net sales: Net sales for the three months ended September 30, 2017 were $358.8 million compared to $362.7 million during the three months ended September 30, 2016, a decrease of 1.1%, or $3.9 million. For the six months ended September 30, 2017, net sales were $716.9 million compared to $654.2 million during the same period in the prior year, an increase of 9.6%, or $62.7 million.

Adjusted gross billings of product and services for the three months ended September 30, 2017 were $503.6 million compared to $487.3 million during the three months ended September 30, 2016, an increase of 3.3%, or $16.3 million. Sales of product and services for the three months ended September 30, 2017 were $357.8 million compared to $361.2 million during the same period in the prior year, a decrease of 1.0%, or $3.5 million. The decrease in sales of product and services is due to a shift in product mix, as we sold a higher proportion of third party software assurance, maintenance and services for which the revenues are presented on a net basis.

The decrease in net sales of product and services during the three months ended September 30, 2017 was also due, in part, to an increase in demand for products and services from customers in the health care and financial services industries, more than offset by reductions in sales to state and local government and educational customers (“SLED”), technology, and telecom, media and entertainment customers.

For the six months ended September 30, 2017, adjusted gross billings of product and services were $985.3 million compared to $884.8 million during the six months ended September 30, 2016, an increase of 11.4%, or $100.5 million. For the six months ended September 30, 2017, sales of product and services were $714.8 million compared to $651.4 million during the same period in the prior year, an increase of 9.7%, or $63.4 million. The increase in net sales of product and services during the six month period was due, in part, to an increase in demand for products and services from customers in the financial services industries, technology, health care, and telecom, media and entertainment industries, which include sales relating to several large projects by major customers.

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Summarized below are the sequential and year-over-year changes in net sales of product and services:

Quarter Ended	Sequential		Year over Year	
September 30, 2017	0.2	%	(1.0	%)
June 30, 2017	11.1	%	23.1	%
March 31, 2017	1.3	%	10.3	%
December 31, 2016	(12.1	%)	10.3	%
September 30, 2016	24.5	%	11.4	%

We rely on our vendors to fulfill a large majority of shipments to our customers. As of September 30, 2017, we had open orders of $152.7 million and deferred revenue of $52.8 million. As of September 30, 2016, we had open orders of $166.6 million and deferred revenues of $23.9 million.

We analyze sales of products and services by customer end market and by manufacturer, as opposed to discrete product and service categories. The percentage of sales of product and services by industry and vendor are summarized below:

	Twelve Months Ended September 30,					
	2017		2016		Change	
Revenue by customer end market:						
Technology	24	%	23	%	1	%
SLED	18	%	22	%	(4	%)
Telecom, Media & Entertainment	15	%	15	%	-	
Financial Services	14	%	12	%	2	%
Healthcare	12	%	10	%	2	%
Other	17	%	18	%	(1	%)
Total	100	%	100	%		
Revenue by vendor:						
Cisco Systems	48	%	49	%	(1	%)
HP Inc. & HPE	5	%	6	%	(1	%)
NetApp	6	%	5	%	1	%
Sub-total	59	%	60	%	(1	%)
Other	41	%	40	%	1	%
Total	100	%	100	%		

Our revenues by customer end market have remained consistent over the year with over 80% of our revenues generated from customers within the five end markets identified above. During the trailing twelve months ended September 30, 2017 we had an increase in the percentage total revenues from customers in the technology, financial services, and health care industries, which were partially offset by decreases in the percentage of total revenues from SLED compared to the prior year period. These changes were driven by changes in customer buying cycles and specific IT related initiatives, rather than the acquisition or loss of a customer or set of customers.

The majority of our revenues by vendor are derived from Cisco Systems, a combined HP Inc. and HPE, and NetApp, which in total, declined to 59% for the twelve months ended September 30, 2017 from approximately 60% in the prior year trailing twelve month period, with the greatest decline in the proportional percentage of total revenues in Cisco product sales. The decrease in the percentage of revenues from the top three vendors is due in part to substantial competition and rapid developments in the IT industry. None of the vendors included within the “other” category exceeded 4% of total revenues.

Cost of sales, product and services: Cost of sales, product and services decreased 2.2% for the three months ended September 30, 2017 as compared to the prior year period, due to the 1.0% decrease in sales of product and services, and an increase in the sales of higher margin products during the quarter. For the six months ended September 30, 2017, cost of sales, product and services increased 10.1% was due to the increase in sales of product and services. Our gross margin on the sales of product and services increased 100 basis points to 21.2% for the three months ended September 30, 2017, from 20.2% in the same period in the prior year due to a shift in product mix, as we sold a higher proportion of third party software assurance, maintenance and services for which the revenues are presented on a net basis, and an increase in revenues from our services.

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For the six months ended September 30, 2017, our gross margin on the sales of product and services decreased 30 basis points to 20.2%, from 20.5%, due to lower product margins from a large competitively bid project which partially shipped during the six month period as well as reduction in vendor incentives earned as a percentage of sales of product services. Vendor incentives earned as a percentage of sales of product services remained stable for the three months, while decreasing 20 basis points for the six months ended September 30, 2017, as compared to same periods in the prior year.

There are ongoing changes to the incentive programs offered to us by our vendors. Accordingly, if we are unable to maintain the level of vendor incentives we are currently receiving, gross margins may decrease.

Selling, general, and administrative expenses: Selling, general, and administrative expenses were $53.5 million for the three months ended September 30, 2017, an increase of $5.2 million, or 10.8% compared to $48.3 million for the prior year period. Salaries and benefits increased $2.8 million, or 7.0% to $43.0 million, compared to $40.2 million during the prior year. All most all the increase was due to higher salaries and benefits expenses related to the increase in the number of employees from both acquisitions and internal growth.

Selling, general, and administrative expenses were $105.0 million for the six months ended September 30, 2017, an increase of $11.5 million, or 12.3% compared to $93.5 million for the prior year period. Salaries and benefits increased $8.4 million, or 10.9% to $86.1 million, compared to $77.7 million during the prior year. Approximately 20.7% of this increase was due to higher variable compensation due to the increase in gross profit, 25.5% of the increase was due to higher employee benefits, and the remaining increase was primarily due salary expense related to an increase in the number of employees. Our technology segment had 1,233 employees as of September 30, 2017, an increase of 186, or 17.8%, from 1,047 at September 30, 2016, of which the acquisitions of Consolidated IT Services, OneCloud, and IDS accounted for 155 of the added positions. There were 162 positions added in the past year related to sales, marketing, and professional services personnel.

General and administrative expenses increased $2.0 million, or 30.0% to $8.7 million during the three months ended September 30, 2017 compared to $6.7 million the prior year, due to higher advertising and marketing expense, travel expense, including travel expense related to acquisitions, and software license and maintenance expense. Professional and other fees increased 25.9% to $1.8 million, primarily due to acquisition related expenses. For the six months ended September 30, 2017, general and administrative expenses increased $2.4 million, or 18.5% to $15.3 million compared to $12.9 million the prior year, due to higher travel expense, including travel expense related to acquisitions, and software license and maintenance expense. Professional and other fees increased $0.7 million, or 22.3% to $3.6 million primarily due to legal fees related to the IDS and OneCloud acquisitions.

Depreciation and amortization expense increased $0.4 million, or 23.6% to $2.1 million during the three months ended September 30, 2017 compared to $1.7 million in the prior year. For the six months ended September 30, 2017, depreciation and amortization expense increased $0.7 million, or 20.0% to $4.2 million compared to $3.5 million in the prior year. The increase in depreciation and amortization expense is related to the acquisitions of Consolidated IT Services in December 2016, OneCloud in May 2017, and IDS in September 2017.

Segment operating income: As a result of the foregoing, operating income was $21.2 million, a decrease of $3.3 million, or 13.4% for the three months ended September 30, 2017 compared to $24.5 million in the prior year period. For the three months ended September 30, 2017, Adjusted EBITDA was $23.3 million, a decrease of $2.9 million, or 10.9% compared to $26.2 million in the prior year period. For the six months ended September 30, 2017, operating income was $37.3 million, a decrease of $1.8 million, or 4.7% compared to $39.1 million in the prior year period. The Adjusted EBITDA for the six months ended September 30, 2017, was $41.5 million, a decrease of $1.1 million, or 2.6% compared to $42.6 million in the prior year period.

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Financing Segment

The results of operations for our financing segment for the three and six months ended September 30, 2017 and 2016 were as follows (dollars in thousands):

	Three Months Ended September 30,				Six Months Ended September 30,			
	2017	2016	Change		2017	2016	Change	
Financing revenue	$ 12,035	$ 8,722	$ 3,313	38.0 %	$ 21,106	$ 15,709	$ 5,397	34.4 %
Fee and other income	8	25	(17)	(68.0 %)	28	84	(56)	(66.7 %)
Net sales	12,043	8,747	3,296	37.7 %	21,134	15,793	5,341	33.8 %
Direct lease costs	1,321	1,325	(4)	(0.3 %)	2,452	2,317	135	5.8 %
Gross profit	10,722	7,422	3,300	44.5 %	18,682	13,476	5,206	38.6 %
Selling, general, and administrative expenses	2,837	3,305	(468)	(14.2 %)	6,000	6,146	(146)	(2.4 %)
Depreciation and amortization	1	2	(1)	(50.0 %)	2	6	(4)	(66.7 %)
Interest and financing costs	274	400	(126)	(31.5 %)	633	749	(116)	(15.5 %)
Operating expenses	3,112	3,707	(595)	(16.1 %)	6,635	6,901	(266)	(3.9 %)
Operating income	$ 7,610	$ 3,715	$ 3,895	104.8 %	$ 12,047	$ 6,575	$ 5,472	83.2 %
Key business metrics								
Adjusted EBITDA	$ 7,611	$ 3,717	$ 3,894	104.8 %	$ 12,049	$ 6,581	$ 5,468	83.1 %

Net sales: Net sales increased by $3.3 million, or 37.7% to $12.0 million for the three months ended September 30, 2017, as compared to $8.7 million prior year results due to higher post-contract earnings and other financing revenues. During the quarters ended September 30, 2017 and 2016, we recognized net gains on sales of financial assets of $1.2 million and $1.7 million, respectively, and the fair value of assets received from these sales were $48.3 million and $75.4 million, respectively. Post contract earnings increased $3.4 million due to early terminations of several large leases, and other financing revenues increased $0.4 million mainly due to earnings on consumption based financing arrangements.

For the six months ended September 30, 2017, net sales increased by $5.3 million, or 33.8% to $21.1 million as compared to $15.8 million prior year results due to higher transactional gains and other financing revenues. During the six months ended September 30, 2017 and 2016, we recognized net gains on sales of financial assets of $3.5 million and $3.2 million, respectively, and the fair value of assets received from these sales were $134.1 million and $129.6 million, respectively. Post contract earnings increased $3.5 million due to early terminations of several large leases, and other financing revenues increased $1.2 million mainly due to earnings on consumption based financing arrangements.

At September 30, 2017, we had $131.8 million in financing receivables and operating leases, compared to $150.7 million as of September 30, 2016, a decrease of $18.9 million or 12.6%.

Gross Profit: Gross profit increased by $3.3 million, or 44.5% to $10.7 million for the three months ended September 30, 2017, compared to the same period in the prior year. For the six months ended September 30, 2017, gross profit increased $5.2 million, or 38.6% to $18.7 million compared to the same period of the prior year, as a result of higher revenues. Direct lease costs remained constant for the three months ended September 30, 2017 and 2016, while direct lease costs increased $0.1 million for the six months ended September 30, 2017, which consists of depreciation expense from operating leases

Selling, general, and administrative expenses: For the three months ended September 30, 2017 selling, general, and administrative expenses decreased by $0.5 million or 14.2%, which was due primarily to a decrease in our reserves for credit losses expense of $0.4 million. Selling, general, and administrative expenses decreased by $0.1 million or 2.4% for the six months ended September 30, 2017, compared to the prior year period. Our financing segment had 49 employees as of both September 30, 2017 and 2016.

Interest and financing costs decreased $0.1 million to $0.3 million for the three months ended September 30, 2017, compared to the prior year, due to a decrease in the average total notes payable outstanding compared to the three months ended September 30, 2017. For the six months ended September 30, 2017, interest and financing costs decreased by $0.1 million to $0.6 million, or 15.5%. Total notes payable were $37.1 million as of September 30, 2017, a decrease of $20.3 million or 35.3% compared to $57.4 million as of September 30, 2016. Our weighted average interest rate for non-recourse notes payable was 3.62% and 2.94%, as of September 30, 2017 and September 30, 2016, respectively.

Segment operating income: As a result of the foregoing, operating income and Adjusted EBITDA each increased $3.9 million or 104.8%, to $7.6 million for both the three months ended September 30, 2017 and 2016. For the six months ended September 30, 2017, operating income and Adjusted EBITDA increased $5.5 million or 83.2% and 83.1%, respectively.

Consolidated

Other income: Other income and expense during the three months ended September 30, 2017, was a net expense of $0.1 million, which consists of interest income on cash and cash equivalents, more than offset by foreign currency transaction losses. For the six months ended September 30, 2017, other income and expense was $0.1 million in net income, as a result of interest income on cash and cash equivalents partially offset by foreign currency transaction losses.

Income taxes: Our provision for income tax expense was $11.5 million and $18.8 million for the three and six months ended September 30, 2017, as compared to $11.8 million and $18.6 million for the same periods in the prior year. Our effective income tax rate for the three and six months ended September 30, 2017, was 40.0% and 38.0%, compared to 41.3% and 40.4% for the three and six months ended September 30, 2016. The favorable change in our effective income tax rate was due primarily to a tax benefit on the vesting of restricted stock of $0.2 and $1.6 million in the three and six months ended September 30, 2017, respectively, compared to a tax benefit of $0.1 and $0.5 million in the three and six months ended September 30, 2016 respectively.

Net earnings: The foregoing resulted in net earnings of $17.2 million and $30.6 million for the three and six months ended September 30, 2017, an increase of 2.7% and 11.7%, as compared to $16.8 million and $27.4 million during the three and six months ended September 30, 2016, respectively.

Basic and fully diluted earnings per common share were $1.24 and $1.23, for the three months ended September 30, 2017, an increase of 2.5% and 1.7% as compared to $1.21 and $1.21, respectively, for the three months ended September 30, 2016. For the six months ended September 30, 2017, basic and fully diluted earnings per common share were $2.21 and $2.19, an increase of 12.2% and 12.3% as compared to $1.97 and $1.95, respectively, for the same period in the prior year.

Weighted average common shares outstanding used in the calculation of basic and diluted earnings per common share for the three months ended September 30, 2017 was 13.9 million and 14.0 million, respectively. Weighted average common shares outstanding used in the calculation of the basic and diluted earnings per common share for the three months ended September 30, 2016 was 13.8 million and 13.9 million, respectively.

Weighted average common shares outstanding used in the calculation of basic and diluted earnings per common share for the six months ended September 30, 2017 was 13.8 million and 14.0 million, respectively. Weighted average common shares outstanding used in the calculation of the basic and diluted earnings per common share for the six months ended September 30, 2016 was 13.9 million and 14.1 million, respectively.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity Overview

Our primary sources of liquidity have historically been cash and cash equivalents, internally generated funds from operations, and borrowings, both non-recourse and recourse. We have used those funds to meet our capital requirements, which have historically consisted primarily of working capital for operational needs, capital expenditures, purchases of equipment for lease, payments of principal and interest on indebtedness outstanding, acquisitions and the repurchase of shares of our common stock.

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Our subsidiary ePlus Technology, inc., part of our technology segment, finances its operations with funds generated from operations, and with a credit facility with Wells Fargo Commercial Distribution Finance, LLC ("WFCDF"). ePlus Technology, inc's agreement with WFCDF has an aggregate credit limit of $325 million as of September 30, 2017. There are two components of this facility: (1) a floor plan component; and (2) an accounts receivable component. After a customer places a purchase order with us and we have completed our credit check, we place an order for the equipment with one of our vendors. Generally, most purchase orders from us to our vendors are first financed under the floor plan component and reflected in "accounts payable—floor plan" in our consolidated balance sheets. Payments on the floor plan component are due on three specified dates each month, generally 30-60 days from the invoice date. On the due date of the invoices financed by the floor plan component, the invoices are paid by the accounts receivable component of the credit facility. The balance of the accounts receivable component is then reduced by payments from our available cash. The outstanding balance under the accounts receivable component is recorded as recourse notes payable on our consolidated balance sheets. There was no outstanding balance at September 30, 2017 or March 31, 2017, while the maximum credit limit was $30.0 million for both periods. The borrowings and repayments under the floor plan component are reflected as "net borrowings on floor plan facility" in the cash flows from financing activities section of our consolidated statements of cash flows.

Most customer payments in our technology segment are remitted to our lockboxes. Once payments are cleared, the monies in the lockbox accounts are automatically transferred to our operating account on a daily basis. On the due dates of the floor plan component, we make cash payments to WFCDF. These payments from the accounts receivable component to the floor plan component and repayments from our cash are reflected as "net borrowings on floor plan facility" in the cash flows from financing activities section of our consolidated statements of cash flows. We engage in this payment structure in order to minimize our interest expense and bank fees in connection with financing the operations of our technology segment.

We believe that cash on hand, and funds generated from operations, together with available credit under our credit facility, will be sufficient to finance our working capital, capital expenditures and other requirements for at least the next twelve calendar months.

Our ability to continue to fund our planned growth, both internally and externally, is dependent upon our ability to generate sufficient cash flow from operations or to obtain additional funds through equity or debt financing, or from other sources of financing, as may be required. While at this time we do not anticipate requiring any additional sources of financing to fund operations, if demand for IT products declines, our cash flows from operations may be substantially affected.

Cash Flows

The following table summarizes our sources and uses of cash over the periods indicated (in thousands):

	Six Months Ended September 30,	
	2017	2016
Net cash provided by (used in) operating activities	$ 13,330	$ (43,806)
Net cash used in investing activities	(52,891)	(18,648)
Net cash provided by (used in) financing activities	(10,046)	15,330
Effect of exchange rate changes on cash	32	393
Net Decrease in Cash and Cash Equivalents	$ (49,575)	$ (46,731)

Cash flows from operating activities. Cash provided by operating activities totaled $13.3 million during the six months ended September 30, 2017. Net earnings adjusted for the impact of non-cash items was $30.7 million. Net changes in assets and liabilities resulted in a decrease of cash and cash equivalents of $17.4 million, primarily due to

net additions to accounts receivables of $21.7 million, salaries and commissions payable and deferred revenues and other liabilities of $21.6 million, deferred costs, other intangible assets and other assets of $13.0 million, and accounts payable of $6.9 million, partially offset by reductions in inventories of $43.0 million and financing receivables of $2.7 million.

Cash used in operating activities totaled $43.7 million during the six months ended September 30, 2016. Net earnings adjusted for the impact of non-cash items was $30.9 million. Net changes in assets and liabilities resulted in a decrease of cash and cash equivalents of $74.6 million, primarily due to additions to accounts receivables of $61.8 million, inventories of $47.3 million, partially offset by increases accounts payable of $14.8 million.

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In order to manage our working capital, we monitor our cash conversion cycle for our Technology segment, which is defined as days sales outstanding ("DSO") in accounts receivable plus days of supply in inventory ("DIO") minus days of purchases outstanding in accounts payable ("DPO"). The following table presents the components of the cash conversion cycle for our Technology segment:

	As of September 30,	
	2017	2016
(DSO) Days sales outstanding (1)	52	54
(DIO) Days inventory outstanding (2)	15	13
(DPO) Days payable outstanding (3)	(44)	(51)
Cash conversion cycle	23	16

(1) Represents the rolling three-month average of the balance of trade accounts receivable-trade, net for our Technology segment at the end of the period divided by Adjusted gross billings of product and services for the same three-month period.

(2) Represents the rolling three-month average of the balance of inventory, net for our Technology segment at the end of the period divided by Cost of adjusted gross billings of product and services for the same three-month period.

(3) Represents the rolling three-month average of the combined balance of accounts payable-trade and accounts payable-floor plan for our Technology segment at the end of the period divided by Cost of adjusted gross billings of product and services for the same three-month period.

Our cash conversion cycle increased to 23 days at September 30, 2017, compared to 16 days at September 30, 2016, primarily driven by an increase in DPO of 7 days due to DPO timing of payments.

Cash flows related to investing activities. Cash used in investing activities was $52.9 million during the six months ended September 30, 2017. Cash used in investing activities during the six months ended September 30, 2017 was primarily driven by acquisitions of $37.7 million, net issuance and repayment of financing receivables of $59.7 million, purchases of assets to be leased or financed of $3.8 million, and purchases of property, equipment, software, and operating lease equipment of $3.4 million, which was partially offset by the sale of financing receivables of $43.8 million, and proceeds from sale of property, equipment and operating leases of $8.0 million.

Cash used in investing activities was $18.6 million during the six months ended September 30, 2016. Cash used in investing activities during the six months ended September 30, 2016 was primarily driven by issuance of financing receivables of $64.0 million, and purchases of assets to be leased or financed of $4.5 million, which was partially offset by cash proceeds from the sale of financing receivables of $25.4 million, the repayment financing receivable of $24.0 million, and proceeds from the sale of property, equipment and operating lease equipment of $3.6 million.

Cash flows from financing activities. Cash used in financing activities was $10.0 million during the six months ended September 30, 2017, which was primarily due to net borrowing on floor plan facility of $12.4 million, cash used for the repurchase of common stock of $4.4 million, and repayment of financing of acquisitions of $1.1 million, partially offset by net borrowings of non-recourse and recourse notes payable of $7.8 million. Cash provided by financing activities was $15.2 million during the six months ended September 30, 2016, which was primarily due to net borrowings on the floor plan facility of $28.2 million and net borrowings of non-recourse and recourse notes payable of $17.5 million, which was offset by $30.5 million in cash used for the repurchase of common stock.

Non-Cash Activities

We assign contractual payments due under lease and financing agreements to third-party financial institutions, which are accounted for as non-recourse notes payable. As a condition to the assignment agreement, certain financial

institutions may request that the customer remit their contractual payments to a trust; rather than to us, and the trust pays the financial institution. Alternatively, if the structure of the agreement does not require a trustee, the customer will continue to make payments to us, and we will remit the payment to the financial institution. The economic impact to us under either assignment structure is similar, in that the assigned contractual payments are paid by the customer and remitted to the lender to pay down the corresponding non-recourse notes payable. However, these assignment structures are classified differently within our consolidated statements of cash flows. More specifically, we are required to exclude non-cash transactions from our consolidated statement of cash flows, so certain contractual payments made by the customer to the trust are excluded from our operating cash receipts and the corresponding repayment of the non-recourse notes payable from the trust to the third-party financial institution are excluded from our cash flows from financing activities. Contractual payments received by the trust and paid to the lender on our behalf are disclosed as a non-cash financing activity.

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Liquidity and Capital Resources

We may utilize non-recourse notes payable to finance approximately 80% to 100% of the purchase price of the assets being leased or financed by our customers. Any balance of the purchase price remaining after non-recourse funding and any upfront payments received from the customer (our equity investment in the equipment) must generally be financed by cash flows from our operations, the sale of the equipment leased to third parties, or other internal means. Although we expect that the credit quality of our financing arrangements and our residual return history will continue to allow us to obtain such financing, such financing may not be available on acceptable terms, or at all.

The financing necessary to support our lease and financing activities has been provided by our cash and non-recourse borrowings. We monitor our exposure closely. We are able to obtain financing through our traditional lending sources which is primarily non-recourse borrowings from third party banks and finance companies. Non-recourse financings are loans whose repayment is the responsibility of a specific customer, although we may make representations and warranties to the lender regarding the specific contract or have ongoing loan servicing obligations. Under a non-recourse loan, we borrow from a lender an amount based on the present value of the contractually committed payments at a fixed rate of interest, and the lender secures a lien on the financed assets. When the lender is fully repaid, the lien is released and all further proceeds are ours. We are not liable for the repayment of non-recourse loans unless we breach our representations and warranties in the loan agreements. The lender assumes the credit risk, and the lender's only recourse, upon default, is against the customer and the specific equipment.

At September 30, 2017, our non-recourse notes payable decreased 0.2% to $36.4 million, as compared to $36.5 million at March 31, 2017. Recourse notes payable decreased 24.2% to $0.7 million as of September 30, 2017 compared to $0.9 million as of March 31, 2017.

Whenever desirable, we arrange for equity investment financing, which includes selling lease payments, including the residual portions, to third parties and financing the equity investment on a non-recourse basis. We generally retain customer control and operational services, and have minimal residual risk. We usually reserve the right to share in remarketing proceeds of the equipment on a subordinated basis after the investor has received an agreed-to return on its investment.

Credit Facility — Technology

Our subsidiary, ePlus Technology, inc., has a financing facility from WFCDF to finance its working capital requirements for inventories and accounts receivable. There are two components of this facility: (1) a floor plan component; and (2) an accounts receivable component. This facility has full recourse to ePlus Technology, inc. and is secured by a blanket lien against all its assets, such as chattel paper, receivables and inventory. As of September 30, 2017, the facility had an aggregate limit of the two components of $325.0 million with an accounts receivable sub-limit of $30.0 million.

Availability under the facility may be limited by the asset value of equipment we purchase or accounts receivable, and may be further limited by certain covenants and terms and conditions of the facility. These covenants include but are not limited to a minimum excess availability of the facility and minimum earnings before interest, taxes, depreciation and amortization of ePlus Technology, inc. We were in compliance with these covenants as of September 30, 2017. Interest on the facility is assessed at a rate of the One Month LIBOR plus two and one half percent if the payments are not made on the three specified dates each month. The facility also requires that financial statements of ePlus Technology, inc. be provided within 45 days of each quarter and 90 days of each fiscal year end and also requires other operational reports be provided on a regular basis. Either party may terminate the facility with 90 days advance written notice.

We are not, and do not believe that we are reasonably likely to be, in breach of the WFCDF credit facility. In addition, we do not believe that the covenants of the WFCDF credit facility materially limit our ability to undertake financing. In this regard, the covenants apply only to our subsidiary, ePlus Technology, inc. This credit facility is secured by the assets of only ePlus Technology, inc. and the guaranty as described below.

The facility provided by WFCDF requires a guaranty of $10.5 million by ePlus inc. The guaranty requires ePlus inc. to deliver its annual audited financial statements by a certain date. We have delivered the annual audited financial statements for the year ended March 31, 2017, as required. The loss of the WFCDF credit facility could have a material adverse effect on our future results as we currently rely on this facility and its components for daily working capital and liquidity for our technology segment and as an operational function of our accounts payable process.

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On July 27, 2017, we executed an amendment to the WFCDF credit facility which temporarily increased the aggregate limit of the two components from $250.0 million to $325.0 million from the date of the agreement through October 31, 2017, and provides us an election beginning July 1 in each subsequent year to similarly temporarily increase the aggregate limit of the two components to $325.0 million ending the earlier of 90 days following the date of election and October 31 of that same year.

Floor Plan Component

Purchases by ePlus Technology, inc. including computer technology products, software, maintenance and services, are in part financed through a floor plan component in which interest expense for the first thirty to sixty days, in general, is not charged. The floor plan liabilities are recorded as accounts payable—floor plan on our consolidated balance sheets, as they are normally repaid within the fifteen to sixty-day time frame and represent assigned accounts payable originally generated with the manufacturer/distributor. In some cases we are able to pay invoices early and receive a discount, but if the fifteen to sixty-day obligation is not paid timely, interest is then assessed at stated contractual rates.

The respective floor plan component credit limits and actual outstanding balance payables for the dates indicated were as follows (in thousands):

Maximum Credit Limit at September 30, 2017	Balance as of September 30, 2017	Maximum Credit Limit at March 31, 2017	Balance as of March 31, 2017
$ 325,000	$ 120,217	$ 250,000	$ 132,612

Accounts Receivable Component

Included within the credit facility, ePlus Technology, inc. has an accounts receivable component from WFCDF, which has a revolving line of credit. On the due date of the invoices financed by the floor plan component, the invoices are paid by the accounts receivable component of the credit facility. The balance of the accounts receivable component is then reduced by payments from our available cash. The outstanding balance under the accounts receivable component is recorded as recourse notes payable on our consolidated balance sheets. There was no balance outstanding for the accounts receivable component at September 30, 2017 or March 31, 2017, while the maximum credit limit was $30.0 million for both periods.

Performance Guarantees

In the normal course of business, we may provide certain customers with performance guarantees, which are generally backed by surety bonds. In general, we would only be liable for the amount of these guarantees in the event of default in the performance of our obligations. We are in compliance with the performance obligations under all service contracts for which there is a performance guarantee, and we believe that any liability incurred in connection with these guarantees would not have a material adverse effect on our consolidated statements of operations.

Off-Balance Sheet Arrangements

As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements as defined in Item 303(a) (4) (ii) of Regulation S-K or other contractually narrow or limited purposes. As of September 30, 2017, we were not involved in any unconsolidated special purpose entity transactions.

Adequacy of Capital Resources

The continued implementation of our business strategy will require a significant investment in both resources and managerial focus. In addition, we may selectively acquire other companies that have attractive customer relationships and skilled sales and/or engineering forces. We may also start offices in new geographic areas, which may require a significant investment of cash. We may also acquire technology companies to expand and enhance the platform of bundled solutions to provide additional functionality and value-added services. We may continue to use our internally generated funds to finance investments in leased assets or investments in notes receivables due from our customers. These actions may result in increased working capital needs as the business expands. As a result, we may require additional financing to fund our strategy, implementation, potential future acquisitions, and working capital needs which may include additional debt and equity financing.

Inflation

For the periods presented herein, inflation has been relatively low and we believe that inflation has not had a material effect on our results of operations.

Potential Fluctuations in Quarterly Operating Results

Our future quarterly operating results and the market price of our common stock may fluctuate. In the event our revenues or earnings for any quarter are less than the level expected by securities analysts or the market in general, such shortfall could have an immediate and significant adverse impact on the market price of our common stock. Any such adverse impact could be greater if any such shortfall occurs near the time of any material decrease in any widely followed stock index or in the market price of the stock of one or more public equipment leasing and financing companies, IT resellers, software competitors, major customers or vendors of ours.

Our quarterly results of operations are susceptible to fluctuations for a number of reasons, including, but not limited to currency fluctuations, reduction in IT spending, any reduction of expected residual values related to the equipment under our leases, the timing and mix of specific transactions, the reduction of manufacturer incentive programs, and other factors. Quarterly operating results could also fluctuate as a result of our sale of equipment in our lease portfolio at the expiration of a lease term or prior to such expiration, to a lessee or to a third party and the transfer of financial assets. Sales of equipment and transfers of financial assets may have the effect of increasing revenues and net income during the quarter in which the sale occurs, and reducing revenues and net income otherwise expected in subsequent quarters. See Part I, Item 1A, “Risk Factors,” in our 2017 Annual Report.

We believe that comparisons of quarterly results of our operations are not necessarily meaningful and that results for one quarter should not be relied upon as an indication of future performance.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in our quantitative and qualitative disclosures about market risk during the six months ended September 30, 2017 from our Annual Report on Form 10-K for the fiscal year ended March 31, 2017. For a discussion of the Company's exposure to market risk, reference is made to disclosures set forth in Part II, Item 7A of our above-mentioned 2017 Annual Report on Form 10-K.

Although a substantial portion of our liabilities are non-recourse, fixed-interest-rate instruments, we utilize our lines of credit and other financing facilities which are subject to fluctuations in short-term interest rates. These instruments, which are denominated in U.S. dollars, were entered into for other than trading purposes and, with the exception of amounts drawn under the WFCDF facility, bear interest at a fixed rate. Because the interest rate on these instruments is fixed, changes in interest rates will not directly impact our cash flows. Borrowings under the WFCDF facility bear interest at a market-based variable rate. As of September 30, 2017, the aggregate fair value of our recourse and non-recourse borrowings approximated their carrying value.

We have transactions in foreign currencies, primarily in British Pounds and in Euros. There is a potential for exposure to fluctuations in foreign currency rates resulting primarily from the translation exposure associated with the preparation of our consolidated financial statements. In addition, we have foreign currency exposure when transactions are not denominated in the subsidiary’s functional currency. To date, our foreign operations are insignificant in relation to total consolidated operations and we believe that potential fluctuations in currency exchange rates will not have a material effect on our financial position.

The UK referendum (“Brexit”) on whether to remain in, or leave, the European Union, could impact revenue items, cost items, tax, goodwill impairments and liquidity, among others. The most obvious immediate impact is the effect of

foreign exchange fluctuations on revenue and cost items. We have determined that our foreign currency exposure for our United Kingdom operations is insignificant in relation to total consolidated operations and we believe those potential fluctuations in currency exchange rates and other Brexit related economic and operational risks will not have a material effect on our results of operations and financial position.

We evaluate Brexit-related developments on a regular basis to determine if such developments are anticipated to have a material impact on the Company's results on operations and financial position.

We have assets in Canada and Iceland. As a lessor, we have entered into lease contracts and non-recourse, fixed-interest-rate financing denominated in Canadian dollars and in Icelandic krona. In our fiscal year beginning April 1, 2016, we began entering in financing transactions and non-recourse, fixed-interest-rate financing denominated in British Pounds in the United Kingdom. To date, our foreign operations have been insignificant and we believe that potential fluctuations in currency exchange rates will not have a material effect on our financial position.

Item 4. Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer ("CEO") and our Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of our disclosure controls and procedures, or "disclosure controls," as defined in the Exchange Act Rule 13a-15(e). Disclosure controls are controls and procedures designed to reasonably ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this quarterly report, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to our management, including our CEO and CFO, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. Our disclosure controls include some, but not all, components of our internal control over financial reporting. Based upon that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of September 30, 2017.

Changes in Internal Controls

There have not been any changes in our internal control over financial reporting during the quarter ended September 30, 2017, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on the Effectiveness of Controls

Our management, including our CEO and CFO, does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect all errors and all fraud. A control system cannot provide absolute assurance due to its inherent limitations; it is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. A control system also can be circumvented by collusion or improper management override. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of such limitations, disclosure controls and internal control over financial reporting cannot prevent or detect all misstatements, whether unintentional errors or fraud. However, these inherent limitations are known features of the financial reporting process; therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently a party to any legal proceedings with loss contingencies that are expected to be material. From time to time, we may be a plaintiff or a defendant in legal actions arising from our normal business activities, none of which has had a material effect on our business, results of operations or financial condition. Legal proceedings which may arise in the ordinary course of business include preference payment claims asserted in customer bankruptcy proceedings, tax audits, claims of alleged infringement of patents, trademarks, copyrights and other intellectual property rights, claims of alleged non-compliance with contract provisions, employment-related claims, claims by

competitors, vendors or customers, claims related to alleged violations of laws and regulations, and claims relating to alleged security or privacy breaches. We attempt to ameliorate the effect of potential litigation through insurance coverage and contractual protections such as rights to indemnifications and limitations of liability. We do not expect that the outcome in any of these matters, individually or collectively, will have a material adverse effect on our financial condition or results of operations, however, litigation is inherently unpredictable. Therefore, judgments could be rendered or settlements entered that could adversely affect our results of operations or cash flows in a particular period. We provide for costs related to contingencies when a loss is probable and the amount is reasonably determinable.

Item 1A. Risk Factors

There has not been any material change in the risk factors previously disclosed in Part I, Item 1A of our 2017 Annual Report.

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

The following table provides information regarding our purchases of ePlus inc. common stock during the six months ended September 30, 2017.

Period	Total number of shares purchased (1)	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs	
April 1, 2017 through April 30, 2017	-	$ -	-	1,000,000	(2)
May 1, 2017 through May 31, 2017	-	$ -	-	1,000,000	(3)
June 1, 2017 through June 30, 2017	54,546	$ 75.72	-	1,000,000	(4)
July 1, 2017 through July 31, 2017	3,179	$ 79.50	-	1,000,000	(5)
August 1, 2017 through August 18, 2017	-	$ -	-	1,000,000	(6)
August 19, 2017 through August 31, 2017	-	$ -	-	500,000	(7)
September 1, 2017 through September 30, 2017	-	$ -	-	500,000	(8)

(1) Any shares acquired were in open-market purchases, except for 54,546 shares, which were repurchased in June 2017, and 3,179 shares which were repurchased in July 2017, to satisfy tax withholding obligations that arose due to the vesting of shares of restricted stock.

(2) The share purchase authorization in place for the month ended April 30, 2017 had purchase limitations on the number of shares of up to 1,000,000 shares. As of April 30, 2017, the remaining authorized shares to be purchased were 1,000,000.

(3) The share purchase authorization in place for the month ended May 31, 2017 had purchase limitations on the number of shares of up to 1,000,000 shares. As of May 31, 2017, the remaining authorized shares to be purchased were 1,000,000.

(4) The share purchase authorization in place for the month ended June 30, 2017 had purchase limitations on the number of shares of up to 1,000,000 shares. As of June 30, 2017, the remaining authorized shares to be purchased were 1,000,000.

(5) The share purchase authorization in place for the month ended July 31, 2017 had purchase limitations on the number of shares of up to 1,000,000 shares. As of July 31, 2017, the remaining authorized shares to be purchased were 1,000,000.

(6) As of August 18, 2017 the authorization under the then existing share purchase plan expired.

(7) On August 15, 2017, the board of directors authorized the company to repurchase up to 500,000 shares of our outstanding common stock commencing on August 19, 2017 through August 18, 2018. As of August 31, 2017, the remaining authorized shares to be purchased were 500,000.

(8) The share purchase authorization in place for the month ended September 30, 2017 had purchase limitations on the number of shares of up to 500,000 shares. As of September 30, 2017, the remaining authorized shares to be purchased were 500,000.

The timing and expiration date of the current stock repurchase authorizations are included in Note 10, “Stockholders’ Equity” to our unaudited condensed consolidated financial statements included elsewhere in this report.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

None.

Item 6. Exhibits

10.1	Amended and Restated Employment Agreement effective September 6, 2017 , by and between ePlus inc. and Mark P. Marron, (Incorporated herein by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on September 7, 2017).
10.2	Amended and Restated Employment Agreement effective September 6, 2017, by and between ePlus inc. and Phillip G. Norton, (Incorporated herein by reference to Exhibit 10.2 to our Current Report on Form 8-K filed on September 7, 2017).
10.3	Amended and Restated Employment Agreement effective September 6, 2017, by and between ePlus inc. and Elaine D. Marion, (Incorporated herein by reference to Exhibit 10.3 to our Current Report on Form 8-K filed on September 7, 2017).
10.4	Amendment No. 5, dated July 27, 2017, to Amended and Restated Agreement for Wholesale Financing between ePlus Technology, inc. and Wells Fargo Commercial Distribution Finance, LLC (Incorporated herein by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on August 3, 2017).
10.5	Amendment No. 5, dated July 27, 2017, to Amended and Restated Agreement for Business Financing between ePlus Technology, inc. and Wells Fargo Commercial Distribution Finance, LLC (Incorporated herein by reference to Exhibit 10.2 to our Current Report on Form 8-K filed on August 3, 2017).
10.6	2017 Non-Employee Director Long-Term Incentive Plan (Incorporated herein by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on September 14, 2017).
31.1	Certification of the Chief Executive Officer of ePlus inc. pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a).
31.2	Certification of the Chief Financial Officer of ePlus inc. pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a).
32	Certification of the Chief Executive Officer and Chief Financial Officer of ePlus inc. pursuant to 18 U.S.C. § 1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

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

		ePlus inc.
Date:	November 2, 2017	/s/ MARK P. MARRON By: Mark P. Marron, Chief Executive Officer and President (Principal Executive Officer)
Date:	November 2, 2017	/s/ ELAINE D. MARION By: Elaine D. Marion Chief Financial Officer (Principal Financial Officer)

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