

ARENA RESOURCES INC  
Form 10-Q  
August 04, 2006

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 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 001-31657

**ARENA RESOURCES, INC.**

(Exact name of registrant as specified in its charter)

Nevada

(State or other jurisdiction of  
Incorporation or organization)

73-1596109

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

4920 South Lewis Street, Suite 107

Tulsa, Oklahoma 74105

(Address of principal executive offices)

(918) 747-6060

(Registrant's telephone number)

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 past 12 months, and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

☐ Yes ☒ No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date:

As of July 28, 2006, the Company had outstanding 14,601,655 shares of common stock (\$0.001 par value).

**INDEX**

**Arena Resources, Inc.**  
For the Quarter Ended June 30, 2006

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**Part I Financial Information**

**Item 1. Financial Statements:**

The condensed financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading.

In the opinion of the Company, all adjustments, consisting of only normal recurring adjustments, necessary to present fairly the financial position of the Company and the results of its operations and its cash flows have been made. The results of its operations and its cash flows for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the year ending December 31, 2006.

**ARENA RESOURCES, INC.**  
**CONDENSED BALANCE SHEETS**  
**(UNAUDITED)**

	June 30, 2006	December 31, 2005
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash	\$ 17,985,825	\$ 4,317,114
Accounts receivable	5,289,331	3,180,749
Joint interest billing receivable	1,067,253	140,561
Prepaid expenses	258,093	35,436
<b>Total Current Assets</b>	24,600,502	7,673,860
<b>Property and Equipment, Using Full Cost Accounting</b>		
Oil and gas properties subject to amortization	107,406,037	69,770,685
Equipment	55,834	26,687
Drilling rig	2,038,986	1,191,126
Office equipment	114,589	106,177
<b>Total Property and Equipment</b>	109,615,446	71,094,675
Less: Accumulated depreciation and amortization	(6,808,089)	(4,346,628)
<b>Net Property and Equipment</b>	102,807,357	66,748,047
<b>Total Assets</b>	\$ 127,407,859	\$ 74,421,907
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 5,955,510	\$ 6,038,691
Income taxes payable	164,993	329,986
Accrued liabilities	2,181,427	221,519
<b>Total Current Liabilities</b>	8,301,930	6,590,196
<b>Long-Term Liabilities</b>		
Notes payable to related parties	400,000	400,000
Asset retirement liability	1,692,096	1,515,347
Deferred income taxes	11,070,132	7,187,609
<b>Total Long-Term Liabilities</b>	13,162,228	9,102,956
<b>Stockholders' Equity</b>		
Preferred stock - \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock - \$0.001 par value; 100,000,000 shares authorized; 14,601,655 shares and 13,099,702 shares outstanding, respectively	14,602	13,100
Additional paid-in capital	81,470,913	45,331,234
Options and warrants outstanding	2,414,127	1,483,807
Deferred compensation	-	(115,545)
Retained earnings	22,044,059	12,016,159
<b>Total Stockholders' Equity</b>	105,943,701	58,728,755
<b>Total Liabilities and Stockholders' Equity</b>	\$ 127,407,859	\$ 74,421,907

See the accompanying notes to unaudited condensed financial statements.

**ARENA RESOURCES, INC.**  
**CONDENSED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	<b>For the Three Months Ended June 30,</b>		<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Oil and Gas Revenues</b>	\$ 14,690,068	\$ 4,628,554	\$ 25,070,463	\$ 8,543,289
<b>Costs and Operating Expenses</b>				
Oil and gas production costs	1,290,409	626,199	2,668,828	1,438,436
Oil and gas production taxes	909,445	374,397	1,606,654	661,114
Depreciation, depletion and amortization	1,408,999	483,283	2,461,461	904,882
Accretion expense	33,638	27,254	62,942	49,325
General and administrative expense	768,484	300,512	1,472,416	612,367
<b>Total Costs and Operating Expenses</b>	<b>4,410,975</b>	<b>1,811,645</b>	<b>8,272,301</b>	<b>3,666,124</b>
<b>Other Income (Expense)</b>				
Gain (loss) from change in fair value of put options	-	(8,176)	-	65,870
Other financing expense	-	-	(785,598)	-
Interest expense	(48,579)	(76,877)	(95,263)	(170,276)
<b>Net Other Expense</b>	<b>(48,579)</b>	<b>(85,053)</b>	<b>(880,861)</b>	<b>(104,406)</b>
<b>Income Before Provision for Income Taxes</b>	<b>10,230,514</b>	<b>2,731,856</b>	<b>15,917,301</b>	<b>4,772,759</b>
<b>Provision for Deferred Income Taxes</b>	<b>(3,785,290)</b>	<b>(1,016,756)</b>	<b>(5,889,401)</b>	<b>(1,770,959)</b>
<b>Net Income</b>	<b>\$ 6,445,224</b>	<b>\$ 1,715,100</b>	<b>\$ 10,027,900</b>	<b>\$ 3,001,800</b>
<b>Basic Net Income Per Common Share</b>	<b>0.47</b>	<b>0.17</b>	<b>0.74</b>	<b>0.30</b>
<b>Diluted Net Income Per Common Share</b>	<b>0.44</b>	<b>0.15</b>	<b>0.70</b>	<b>0.26</b>

See the accompanying notes to unaudited condensed financial statements.

**ARENA RESOURCES, INC.**  
**CONDENSED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

<i>For the Six Months Ended June 30,</i>	<b>2006</b>	<b>2005</b>
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 10,027,900	\$ 3,001,800
Adjustments to reconcile net income to net cash provided by operating activities:		
Warrants issued for financing expense	785,598	-
Depreciation, depletion and amortization	2,461,461	904,882
Provision for income taxes	5,889,401	1,770,959
Gain from change in fair value of put option	-	(65,870)
Stock based compensation	393,300	69,263
Accretion of discounted liabilities	62,942	49,325
Changes in assets and liabilities:		
Accounts and joint interest receivable	(3,035,274)	(473,100)
Prepaid expenses	(222,657)	-
Income taxes payable and deferred income taxes	(320,058)	-
Excess tax benefits from share-based payment arrangements	(1,851,813)	-
Accounts payable and accrued liabilities	604,634	361,356
<b>Net Cash Provided by Operating Activities</b>	<b>14,795,434</b>	<b>5,618,615</b>
<b>Cash Flows from Investing Activities</b>		
Purchase and development of oil and gas properties	(34,194,713)	(6,453,296)
Purchase of machinery and equipment	(704,379)	(26,793)
<b>Net Cash Used in Investing Activities</b>	<b>(34,899,092)</b>	<b>(6,480,089)</b>
<b>Cash Flows From Financing Activities</b>		
Proceeds from issuance of common stock, net	29,858,463	-
Proceeds from exercise of warrants, net of offering costs	150,000	6,012,673
Proceeds from exercise of options	640,000	-
Excess tax benefits from share-based payment arrangements	1,851,813	-
Funds received and held for call options	1,272,093	-
Proceeds from issuance of notes payable	11,000,000	-
Payment of notes payable	(11,000,000)	(5,000,000)
<b>Net Cash Provided by Financing Activities</b>	<b>33,772,369</b>	<b>1,012,673</b>
<b>Net Increase in Cash</b>	<b>13,668,711</b>	<b>151,199</b>
<b>Cash at Beginning of Period</b>	<b>4,317,114</b>	<b>1,253,969</b>
<b>Cash at End of Period</b>	<b>\$ 17,985,825</b>	<b>\$ 1,405,168</b>
<b>Supplemental Cash Flow Information</b>		
Cash paid for income taxes	\$ 329,986	\$ -
Cash paid for interest	180,702	170,276
<b>Non-Cash Investing and Financing Activities</b>		
Common stock issued for properties and equipment	\$ 3,507,872	\$ 261,645
Asset retirement obligation incurred in property development	113,807	-
See the accompanying notes to unaudited condensed financial statements.		





**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**NOTE 1 BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

**Condensed Financial Statements** The accompanying condensed financial statements have been prepared by the Company and are unaudited. In the opinion of management, the accompanying unaudited financial statements contain all adjustments necessary for fair presentation, consisting of normal recurring adjustments, except as disclosed herein.

The accompanying unaudited interim financial statements have been condensed pursuant to the rules and regulations of the Securities and Exchange Commission; therefore, certain information and disclosures generally included in financial statements have been condensed or omitted. The condensed financial statements should be read in conjunction with the Company's annual financial statements included in its annual report on Form 10-K as of December 31, 2005. The financial position and results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year ending December 31, 2006.

**Nature of Operations** Arena Resources, Inc. (the Company) owns interests in oil and gas properties located in Oklahoma, Texas, Kansas and New Mexico. The Company is engaged primarily in the acquisition, exploration and development of oil and gas properties and the production and sale of oil and gas. In 2006, the Company formed a wholly owned subsidiary, Arena Drilling Co. Arena Drilling Co. was formed to oversee the operation of the Company's drilling rig that began operating in May 2006.

**Consolidation** The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation. The period ending June 30, 2006 is the first period for which the financial statements are consolidated to include Arena Drilling Co.

**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 assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Oil and Gas Properties** The Company uses the full cost method of accounting for oil and gas properties. Under this method, all costs associated with acquisition, exploration, and development of oil and gas reserves are capitalized. Costs capitalized include acquisition costs, geological and geophysical expenditures, lease rentals on undeveloped properties and costs of drilling and equipping productive and non-productive wells. Drilling costs include directly related overhead costs. Capitalized costs are categorized either as being subject to amortization or not subject to amortization.

All capitalized costs of oil and gas properties, including the estimated future costs to develop proved reserves and estimated future costs of abandonment and site restoration, are amortized on the unit-of-production method using estimates of proved reserves as determined by independent engineers. Investments in unproved properties and major development projects are not amortized until proved reserves associated with the projects can be determined. The Company evaluates oil and gas properties for impairment at least quarterly. Amortization expense for the three and six months ended June 30, 2006 was \$1,408,999 and \$2,461,461, respectively, based on depletion at the rate of \$5.59 per barrel of oil equivalent compared to \$483,283 and \$904,882 based on depletion at the rate of \$4.50 per barrel of oil equivalent for the three and six months ended June 30, 2005, respectively. These amounts include \$41,942 and \$4,338 for the three months ended June 30, 2006 and 2005, respectively and \$48,351 and \$8,815 of depreciation on equipment during the six months ended June 30, 2006 and 2005, respectively.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

In addition, capitalized costs are subject to a ceiling test which limits such costs to the estimated present value of future net revenues from proved reserves, discounted at a 10-percent interest rate, based on current economic and operating conditions, plus the lower of cost or fair market value of unproved properties. Consideration received from sales or transfers of oil and gas property is accounted for as a reduction of capitalized costs. Revenue is not recognized in connection with contractual services performed in connection with properties in which the Company holds an ownership interest.

**Income Per Common Share** Basic income per common share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution that could occur if all contracts to issue common stock were converted into common stock, except for those that are anti-dilutive.

**Concentration of Credit Risk and Major Customer** The Company currently has cash in excess of federally insured limits at June 30, 2006. During the six months ended June 30, 2006, sales to one customer represented 80% of oil and gas revenues. At June 30, 2006, this customer made up 81% of accounts receivable.

**Stock-Based Employee Compensation** Effective January 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment (FAS 123(R)), an amendment of SFAS No. 123, Accounting for Stock-Based Compensation, using the modified prospective transition method. Under this transition method, compensation costs are recognized beginning with the effective date: (a) based on the requirements of FAS 123(R) for all share-based awards granted after the effective date and (b) based on the requirements of FAS 123 for all awards granted to employees prior to the effective date of FAS 123(R) that remain unvested on the effective date. Accordingly, we did not restate the results of prior periods. The most notable change with the adoption is that compensation expense associated with stock options is now recognized in our Statements of Operations, rather than being disclosed in a pro forma footnote to our financial statements.

As a result of adopting FAS 123(R), we recognized compensation expense related to unvested options for the three and six months ended June 30, 2006 in the amounts of \$213,533 and \$393,300, respectively. Due to the implementation of FAS 123(R), the remaining \$115,545 in deferred compensation at December 31, 2005, resulting from options issued at a 15% discount, was eliminated against options and warrants outstanding.

Prior to January 1, 2006, the Company accounted for stock options granted under our Stock Option Plan under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations, as permitted by Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). Under these provisions, prior to January 1, 2006, the Company recognized compensation expense related to the 15% discount amount of the exercise price from the market price of the stock at the date of grant over the five year vesting period of the options. The Company recognized compensation expense for the three and six months ended June 30, 2005 of \$26,913 and \$69,263, respectively. Had the Company determined compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, the Company's net income would have been decreased to the pro forma amounts indicated below for the three and six months ended June 30, 2005:

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

	<b>For the Three Months Ended June 30, 2005</b>	<b>For the Six Months Ended June 30, 2005</b>
Net income, as reported	\$ 1,715,100	\$ 3,001,800
Add: Stock based employee compensation expense included in net income, net of related tax effects	16,874	43,427
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(126,216)	(278,433)
Pro Forma Net Income	\$ 1,605,758	\$ 2,766,794
Income per Common Share		
Basic, as reported	\$ 0.17	\$ 0.30
Basic, pro forma	0.15	0.27
Diluted, as reported	0.15	0.26
Diluted, pro forma	0.14	0.24

The fair value of the options granted during the six months ended June 30, 2005 was \$1,128,510, or \$3.01 per share, and was estimated on the dates granted using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield of 0%, expected volatility of 33.47%, risk-free interest rate of 3.64%, and expected lives of 5 years.

**NOTE 2 EARNINGS PER SHARE INFORMATION**

	<b>For the Three Months Ended June 30, 2006</b>	<b>For the Three Months Ended June 30, 2005</b>	<b>For the Six Months Ended June 30, 2006</b>	<b>For the Six Months Ended June 30, 2005</b>
Net Income	\$ 6,445,224	\$ 1,715,100	\$ 10,027,900	\$ 3,001,800
Basic Weighted-Average Common Shares Outstanding	13,779,031	10,361,226	13,478,876	10,078,555
Effect of dilutive securities				
Warrants	252,981	825,567	247,955	912,374
Stock options	680,252	487,371	674,350	472,449
Diluted Weighted-Average Common Shares Outstanding	14,712,264	11,674,164	14,401,181	11,463,378
Basic Income Per Common Share				
Net income	0.47	0.17	0.74	0.30
Diluted Income Per Common Share				
Net Income	0.44	0.15	0.70	0.26

**NOTE 3 ACQUISITION OF OIL AND GAS PROPERTIES**

In January 2006, the Company entered into a definitive agreement to reacquire the working interests and related rights in two different prospects in Comanche and Hamilton Counties, Kansas with combined acreage totaling approximately 20,000 acres. During 2005 the Company sold working interest rights in multiple wells drilled on these prospects, along with rights to participate in additional wells on the acreage. Total consideration provided for the re-acquisitions of these rights and interests was 120,800 shares of common stock, issued in February 2006, valued at \$3,326,832, or \$27.54 per share.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

On March 24, 2005, the Company entered into a definitive agreement to acquire approximately 18,000 acres in Hamilton and Greeley counties, Kansas. On March 16, 2005, the Company issued 20,000 shares, valued at \$261,600 or \$13.08 per share, of restricted common stock as partial payment for this acquisition. The Company has also paid cash in the amount of \$281,054 for the acquisition. The acquisition closed in July 2005.

**NOTE 4 NOTES PAYABLE**

In April 2005, the Company entered into an agreement that increased its credit facility to \$50,000,000, with an increased borrowing base of \$35,000,000. The interest rate was a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2.25%, and is payable monthly. Amounts borrowed under the revolving credit facility are due in May 2009. The revolving credit facility is secured by the Company's principal mineral interests. In order to obtain the revolving credit facility, loans from two officers were subordinated to the position of the bank. The Company is required under the terms of the credit facility to maintain a tangible net worth of \$12,000,000, maintain a 5-to-1 ratio of income before interest, taxes, depreciation, depletion and amortization to interest expense and maintain a current asset to current liability ratio of 1-to-1.

In April 2006, the Company entered into a new credit agreement increasing the Company's credit facility to \$150,000,000 with a \$65,000,000 borrowing base. Additionally, this new agreement adjusted the interest rate to be equal to the 30, 60 or 90 day LIBOR rate plus 2%, removed the requirement to maintain a tangible net worth but added a requirement to a rolling four quarter basis of a maximum leverage ratio of no more than 2.5-to-1. All other conditions of the credit facility remained the same. At June 30, 2006, the Company was in compliance with all covenants and had no amounts outstanding under this credit facility, excluding \$527,500 reserved under the revolving credit facility as collateral for standby letters of credit issued to various states.

On March 31, 2006, two officers of the Company and the Board of Directors agreed to an extension of the \$400,000 notes payable to the two officers to July 1, 2008, under the same terms as the original notes.

**NOTE 5 ASSET RETIREMENT OBLIGATION**

The Company provides for the obligation to plug and abandon oil and gas wells at the dates properties are acquired or the wells are drilled. The asset retirement obligation is adjusted each quarter for any liabilities incurred or settled during the period, accretion expense and any revisions made to the estimated cash flows. The reconciliation of the asset retirement obligation for the three months ended March 31, 2006 is as follows:

Balance, January 1, 2006	\$ 1,515,347
Liabilities incurred	113,807
Accretion expense	62,942
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Balance, June 30, 2006	\$ 1,692,096
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**NOTE 6 STOCKHOLDERS EQUITY**

**Private Placement** In May 2006, the Company issued 1,150,000 shares of common stock in a private placement for \$32,246,000. As of June 30, 2006, the Company had paid \$2,395,037 in offering costs and underwriter's fees resulting in net proceeds from the offering of \$29,858,463. The Company agreed to register these shares and has done so.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

**Warrants exercised** During the six months ended June 30, 2006, the Company issued 50,000 shares of common stock upon the exercise of warrants for proceeds of \$150,000, or \$3.00 per share. Additionally, during the six months ended June 30, 2006, the Company issued 4,953 shares of common stock in a cashless exercise of 2,962 warrants with an exercise price of \$9.00 per share and 3,461 warrants with an exercise price of \$7.49 per share.

**Options exercised** During the six months ended June 30, 2006, the Company issued 170,000 shares of common stock upon the exercise of options for proceeds of \$640,000, or an average of \$3.76 per share. As a result of these exercises, the Company will realize an additional tax benefit in the amount of \$1,851,813, which was recorded against additional paid-in capital.

**Shares issued in property or equipment acquisition** In February 2006, the Company issued 120,800 shares of restricted common stock, valued at \$3,326,832, or \$27.54 per share, as partial consideration for the acquisition of working interests in the Syracuse and Rocky prospects in Comanche and Hamilton Counties, Kansas, as disclosed in Note 3.

Also in February 2006, the Company issued 6,200 shares of restricted common stock, valued at \$181,040, or \$29.20 per share, as part of the cost of a drilling rig that the Company acquired, which was placed in service in April 2006.

**Warrants issued** In connection with the July 2005 private placement of common stock, the Company committed to use its best efforts to register such shares with the Securities and Exchange Commission. The Company was unable to effect the registration within the allotted time and was required to issue warrants to acquire 29,126 shares of common stock in January 2006. The exercise price of these warrants is \$10.30 and the warrants expire in January 2011. The Company recognized an expense equal to the fair value of these warrants of \$785,598 as a result of this issuance. The fair value of the warrants was determined using the Black-Scholes option pricing model with the following assumptions: 4.44% risk-free interest rate; 43.42% expected volatility; five year expected life and 0% dividend yield.

**Options issued** During the six months ended June 30, 2006, the Company issued 50,000 options with an original exercise price of \$34.43 per share under the Company's stock option plan. Also during the six months ended June 30, 2006, the Company amended these options to have an exercise price of \$27.40. The original fair value of the options was \$778,357, calculated using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield of 0%, expected volatility of 43.62%, risk-free interest rate of 4.92%, and expected lives of 5 years. As a result of the amendment the fair value increased by \$98,260, calculated using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield of 0%, expected volatility of 44.27%, risk-free interest rate of 5.03%, and expected lives of 5 years.

**NOTE 7 CONTINGENCIES AND COMMITMENTS**

**Standby Letters of Credit** A commercial bank has issued standby letters of credit on behalf of the Company to the states of Texas, Oklahoma, New Mexico and Kansas totaling \$527,500 to allow the Company to do business in those states. The standby letters of credit are valid until cancelled or matured and are collateralized by the revolving credit facility with the bank. Letter of credit terms range from one to five years. The Company intends to renew the standby letters of credit for as long as the Company does business in those states. No amounts have been drawn under the standby letters of credit.

**ARENA RESOURCES, INC.**  
**NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS**  
**JUNE 30, 2006**

***Funds Held for Call Options*** During the six months ended June 30, 2006, the Company received pass through funds of \$1,272,093 for the call of 149,658 call options with an exercise price of \$8.50 per share. The options were issued in relation to and considered part of the consideration provided in the December 2004 acquisitions of the Fuhrman Mascho properties and were held by the Company. The call options were assigned to third parties as part of the private placement offering closed in July 2005. At that time, the Company agreed to facilitate the exercise of the options. As such, the funds received are being held by the Company to be paid to the shareholders involved as their stock certificates are returned. The full amount being held by the Company has been included in our balance sheet as of June 30, 2006 as an accrued liability.

**NOTE 8 SUBSEQUENT EVENTS**

Subsequent to June 30, 2006, the Company has paid \$1,025,814 of the \$1,272,093 to be paid to shareholders affected by the call option disclosed above.

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

*Results of Operations For the Three Months Ended June 30, 2006*

*Oil and natural gas sales.* For the three months ended June 30, 2006, oil and natural gas sales revenue increased \$10,061,514 to \$14,690,068, compared to \$4,628,554 for the same period during 2005. Oil sales increased \$9,236,350 and natural gas sales increased \$825,164. The increases were the result of our increased volumes due to our development throughout 2005 and 2006 and increased average realized sales prices. For the three months ended June 30, 2006, oil sales volume increased 115,689 barrels to 207,922 barrels, compared to 92,233 barrels for the same period in 2005. The average realized per barrel oil price increased 43% from \$44.97 for the three months ended June 30, 2005 to \$64.37 for the three months ended June 30, 2006. For the three months ended June 30, 2006, gas sales volume increased 113,860 thousand cubic feet (MCF) to 198,828 MCF, compared to 84,968 MCF for the same period in 2005. The average realized natural gas price per MCF increased 16% from \$5.66 for the three months ended June 30, 2005 to \$6.57 for the three months ended June 30, 2006.

*Oil and gas production costs.* Our lease operating expenses (LOE) increased from \$626,199 or \$5.89 per barrel of oil equivalent (BOE) for the three months ended June 30, 2005 to \$1,290,409 or \$5.35 per BOE for the three months ended June 30, 2006. The increase in total LOE was due to our development projects throughout 2005 and 2006. The decrease in the per BOE amounts is a result of increased production as a result of the development of our properties.

*Production taxes.* Production taxes as a percentage of oil and natural gas sales were 8% during the three months ended June 30, 2005 and decreased to 6% for the three months ended June 30, 2006. Production taxes vary from state to state. Therefore, these taxes may vary in the future depending on the mix of production we generate from various states, as well as the possibility that any state may raise its production tax rate.

*Depreciation, depletion and amortization.* Our depreciation, depletion and amortization expense increased by \$925,716 to \$1,408,999 for the three months ended June 30, 2006, compared to the same period in 2005. The increase was primarily a result of an increase in volume and in the average depletion rate from \$4.50 per BOE during the three months ended June 30, 2005 to \$5.59 per BOE during the three months ended June 30, 2006. The increased depletion rate was the result of increased capitalized costs and development costs.

*General and administrative expenses.* General and administrative expenses increased by \$467,972 to \$768,484 for the three months ended June 30, 2006, compared to the same period in 2005. A portion of this increase was due to the adoption of FASB 123(R) which resulted in the recognition of stock-based compensation expense of \$213,533. The remaining increase was primarily related to increases in compensation expense associated with an increase in personnel required to administer our growth.

*Interest expense (net of interest income).* Net interest expense decreased \$28,298 to \$48,579 for the three months ended June 30, 2006 when compared to the same period in 2005. The decrease was due to lower average outstanding debt over the full quarter and being partially offset by interest income on our excess cash.

*Income tax expense.* Our effective tax rate was 37% during the three months ended June 30, 2005 and remained steady at 37% for the three months ended June 30, 2006.

*Net income.* Net income increased from \$1,715,100 for the three months ended June 30, 2005 to \$6,445,224 for the same period in 2006. The primary reasons for this increase include increased volumes as a result of the development of our properties and higher crude oil prices between periods, partially offset by higher lease operating expense, general and administrative expense and income tax expense due to our growth.



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### *Results of Operations For the Six Months Ended June 30, 2006*

*Oil and natural gas sales.* For the six months ended June 30, 2006, oil and natural gas sales revenue increased \$16,527,174 to \$25,070,463, compared to \$8,543,289 for the same period during 2005. Oil sales increased \$15,045,236 and natural gas sales increased \$1,481,938. The increases were the result of our increased volumes due to our development throughout 2005 and 2006 and increased average realized sales prices. For the six months ended June 30, 2006, oil sales volume increased 205,595 barrels to 375,089 barrels, compared to 169,494 barrels for the same period in 2005. The average realized per barrel oil price increased 34% from \$45.32 for the six months ended June 30, 2005 to \$60.59 for the six months ended June 30, 2006. For the six months ended June 30, 2006, gas sales volume increased 172,581 MCF to 340,864 MCF, compared to 168,283 MCF for the same period in 2005. The average realized natural gas price per MCF increased 34% from \$5.12 for the six months ended June 30, 2005 to \$6.88 for the six months ended June 30, 2006.

*Oil and gas production costs.* Our lease operating expenses (LOE) increased from \$1,438,436 or \$7.28 per BOE for the six months ended June 30, 2005 to \$2,668,828 or \$6.18 per BOE for the six months ended June 30, 2006. The increase in total LOE was due to our development projects throughout 2005 and 2006. The decrease in the per BOE amounts is a result of increased production as a result of the development of our properties.

*Production taxes.* Production taxes as a percentage of oil and natural gas sales were 8% during the six months ended June 30, 2005 and decreased to 6% for the six months ended June 30, 2006. Production taxes vary from state to state. Therefore, these taxes may vary in the future depending on the mix of production we generate from various states, as well as the possibility that any state may raise its production tax rate.

*Depreciation, depletion and amortization.* Our depreciation, depletion and amortization expense increased by \$1,556,579 to \$2,461,461 for the six months ended June 30, 2006, compared to the same period in 2005. The increase was primarily a result of an increase in volume and in the average depletion rate from \$4.50 per BOE during the six months ended June 30, 2005 to \$5.59 per BOE during the six months ended June 30, 2006. The increased depletion rate was the result of increased capitalized costs and development costs.

*General and administrative expenses.* General and administrative expenses increased by \$860,049 to \$1,472,416 for the six months ended March 31, 2006, compared to the same period in 2005. A portion of this increase was due to the adoption of FASB 123(R) which resulted in the recognition of stock-based compensation expense of \$393,300. The remaining increase was primarily related to increases in compensation expense associated with an increase in personnel required to administer our growth.

*Other financing expense.* Other financing expense was \$785,598 for the six months ended June 30, 2006, compared to \$0 for the same period in 2005. This financing expense relates to the issuance in the first quarter of 2006 of warrants associated with the 2005 private offering and subsequent registration of common stock.

*Interest expense (net of interest income).* Net interest expense decreased \$75,013 to \$95,263 for the six months ended June 30, 2006 when compared to the same period in 2005. The decrease was due to lower average outstanding debt over the six months and being partially offset by interest income on our excess cash.

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*Income tax expense.* Our effective tax rate was 37% during the six months ended June 30, 2005 and remained steady at 37% for the six months ended June 30, 2006.

*Net income.* Net income increased from \$3,001,800 for the six months ended June 30, 2005 to \$10,027,900 for the same period in 2006. The primary reasons for this increase include increased volumes as a result of the development of our properties and higher crude oil prices between periods, partially offset by higher lease operating expense, general and administrative expense and income tax expense due to our growth.

### *Revenues Year to Date by Geographic section*

Arena reports its net oil and gas revenues for the year to date as applicable to the following geographic sectors:

#### **OIL**

	Net Production Volume	Net Revenue
Texas Leases	238,994 BBLS	\$ 14,440,316
Oklahoma Leases	26,823 BBLS	\$ 1,772,148
New Mexico Leases	109,272 BBLS	\$ 6,526,121

#### **GAS**

	Net Production Volume	Net Revenue
Texas Leases	164,585 MCF	\$ 1,099,295
Oklahoma Leases	13,051 MCF	\$ 49,555
New Mexico Leases	103,248 MCF	\$ 869,019
Kansas	59,980 MCF	\$ 314,009

### *Significant Subsequent Events occurring after June 30, 2006:*

Subsequent to June 30, 2006, the Company has paid \$1,025,814 of the \$1,272,093 to be paid to shareholders affected by the call option disclosed above.

### *Capital Resources and Liquidity*

As shown in the financial statements for the six months ended June 30, 2006, the Company had cash on hand of \$17,985,825, compared to \$4,317,114 as of December 31, 2005. The Company had positive net cash flows from operations for the six months ended June 30, 2006 of \$14,795,434, compared to \$5,618,615 for the same period 2005. Other significant sources of cash inflow were \$11,000,000 drawn down on the Company's credit facility and net proceeds from a private placement of \$29,858,463 in 2006 and \$6,012,673 net proceeds from the exercise of warrants in 2005. The most significant cash outflows during the six months ended June 30, 2006 and 2005 were capital expenditures of \$34,899,092 in 2006 and \$6,480,089 in 2005 and repayment of debt on the Company's credit facility of \$11,000,000 in 2006 and \$5,000,000 in 2005.

In April 2005, the Company entered into an agreement that increased its credit facility to \$50,000,000, with an increased borrowing base of \$35,000,000. The interest rate was a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2.25%, and is payable monthly. Amounts borrowed under the revolving credit facility are due in May 2009. The revolving credit facility is secured by the Company's principal mineral interests. In order to obtain the revolving credit facility, loans from two officers were subordinated to the position of the bank. The Company is required under the terms of the credit facility to maintain a tangible net worth of \$12,000,000, maintain a 5-to-1 ratio of income before interest, taxes, depreciation, depletion and amortization to interest expense and maintain a current asset to current liability ratio of 1-to-1.

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In April 2006, the Company entered into a new credit agreement increasing the Company's credit facility to \$150,000,000 with a \$65,000,000 borrowing base. Additionally, this new agreement adjusted the interest rate to be equal to the 30, 60 or 90 day LIBOR rate plus 2%, removed the requirement to maintain a tangible net worth but added a requirement to a rolling four quarter basis of a maximum leverage ratio of no more than 2.5-to-1. All other conditions of the credit facility remained the same. At June 30, 2006, the Company was in compliance with all covenants and had no amounts outstanding under this credit facility, excluding \$527,500 reserved under the revolving credit facility as collateral for standby letters of credit issued to various states.

### *Disclosures About Market Risks*

Like other natural resource producers, Arena faces certain unique market risks. The two most salient risk factors are the volatile prices of oil and gas and certain environmental concerns and obligations.

#### Oil and Gas Prices

Current competitive factors in the domestic oil and gas industry are unique. The actual price range of crude oil is largely established by major international producers. Pricing for natural gas is more regional. Because domestic demand for oil and gas exceeds supply, there is little risk that all current production will not be sold at relatively fixed prices. To this extent Arena does not see itself as directly competitive with other producers, nor is there any significant risk that the Company could not sell all production at current prices with a reasonable profit margin. The risk of domestic overproduction at current prices is not deemed significant. The primary competitive risks would come from falling international prices which could render current production uneconomical.

Secondarily, Arena is presently committed to use the services of the existing gatherers in its present areas of production. This gives to such gatherers certain short term relative monopolistic powers to set gathering and transportation costs, because obtaining the services of an alternative gathering company would require substantial additional costs since an alternative gatherer would be required to lay new pipeline and/or obtain new rights-of-way in the lease.

It is also significant that more favorable prices can usually be negotiated for larger quantities of oil and/or gas product, such that Arena views itself as having a price disadvantage to larger producers. Large producers also have a competitive advantage to the extent they can devote substantially more resources to acquiring prime leases and resources to better find and develop prospects.

#### Environmental

Oil and gas production is a highly regulated activity which is subject to significant environmental and conservation regulations both on a federal and state level. Historically, most of the environmental regulation of oil and gas production has been left to state regulatory boards or agencies in those jurisdictions where there is significant gas and oil production, with limited direct regulation by such federal agencies as the Environmental Protection Agency. However, while the Company believes this generally to be the case for its production activities in Texas, Oklahoma, Kansas and New Mexico, it should be noticed that there are various Environmental Protection Agency regulations which would govern significant spills, blow-outs, or uncontrolled emissions.

In Oklahoma, Texas, Kansas and New Mexico specific oil and gas regulations exist related to the drilling, completion and operations of wells, as well as disposal of waste oil. There are also procedures incident to the plugging and abandonment of dry holes or other non-operational wells, all as governed by the Oklahoma Corporation Commission, Oil and Gas Division, the Texas Railroad Commission, Oil and Gas Division, the Kansas Corporation Commission, Oil and Gas Division or the New Mexico Oil Conservation Division.

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Compliance with these regulations may constitute a significant cost and effort for Arena. No specific accounting for environmental compliance has been maintained or projected by Arena to date. Arena does not presently know of any environmental demands, claims, or adverse actions, litigation or administrative proceedings in which it or the acquired properties are involved or subject to or arising out of its predecessor operations.

In the event of a breach of environmental regulations, these environmental regulatory agencies have a broad range of alternative or cumulative remedies to include: ordering a clean up of any spills or waste material and restoration of the soil or water to conditions existing prior to the environmental violation; fines; or enjoining further drilling, completion or production activities. In certain egregious situations the agencies may also pursue criminal remedies against the Company or its principals.

### *Forward-Looking Information*

Certain statements in this Section and elsewhere in this report are forward-looking in nature and relate to trends and events that may affect the Company's future financial position and operating results. Such statements are made pursuant to the safe harbor provision of the *Private Securities Litigation Reform Act of 1995*. The terms expect, anticipate, intend, and project and similar words or expressions are intended to identify forward-looking statements. These statements speak only as of the date of this report. The statements are based on current expectations, are inherently uncertain, are subject to risks, and should be viewed with caution. Actual results and experience may differ materially from the forward-looking statements as a result of many factors, including changes in economic conditions in the markets served by the company, increasing competition, fluctuations in raw materials and energy prices, and other unanticipated events and conditions. It is not possible to foresee or identify all such factors. The company makes no commitment to update any forward-looking statement or to disclose any facts, events, or circumstances after the date hereof that may affect the accuracy of any forward-looking statement.

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

#### *Interest Rate Risk*

The Company is subject to interest rate risk on its revolving credit facility, which bears variable interest based upon a LIBOR rate. Changes in interest rates affect the interest earned on the Company's cash and cash equivalents and the interest rate paid on borrowings under its bank credit facility. Currently, the Company does not use interest rate derivative instruments to manage exposure to interest rate changes.

#### *Commodity Price Risk*

The Company's revenues, profitability and future growth depend substantially on prevailing prices for oil and natural gas. Prices also affect the amount of cash flow available for capital expenditures and Arena's ability to borrow and raise additional capital. The amount the Company can borrow under its bank credit facility is subject to periodic redetermination based in part on changing expectations of future prices. Lower prices may also reduce the amount of oil and natural gas that the Company can economically produce. Arena currently sells all of its oil and natural gas production under price sensitive or market price contracts.

Arena does not currently use derivative commodity instruments or similar financial instruments to attempt to hedge commodity price risks associated with future oil and natural gas production.

*Currency Exchange Rate Risk*

Foreign sales accounted for none of the Company's sales; further, the Company accepts payment for its commodity sales only in U.S. dollars; hence, Arena is not exposed to foreign currency exchange rate risk on these sales.

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

The Company maintains controls and procedures designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. At the end of the period covered by this Quarterly Report on Form 10-Q, the Company's management, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that as of the end of such period the Company's disclosure control and procedures are effective in alerting them to material information that is required to be included in the reports the Company files or submits under the Securities Exchange Act of 1934.

*Changes in Internal Controls Over Financial Reporting*

There have been no changes in the Company's internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II Other Information**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

Subsequent to filing our annual report on Form 10-K on March 16, 2006, we filed a registration statement on Form S-3, which contains a risk factor that is in addition to those contained in Item 1A of our Form 10-K. This additional risk factor is set forth below.

**The unavailability or high cost of drilling rigs, equipment, supplies, personnel and oil field services could adversely affect our ability to execute on a timely basis our exploration and development plans within our budget.**

With the recent increase in the prices of oil and natural gas, we have encountered an increase in the cost of securing drilling rigs, equipment and supplies. Shortages or the high cost of drilling rigs, equipment, supplies and personnel are expected to continue in the near-term. In addition, larger producers may be more likely to secure access to such equipment by virtue of offering drilling companies more lucrative terms. If we are unable to acquire access to such resources, or can obtain access only at higher prices, not only would this potentially delay our ability to convert our reserves into cash flow, but could also significantly increase the cost of producing those reserves, thereby negatively impacting anticipated net income.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

- |     |                     |                                   |
|-----|---------------------|-----------------------------------|
| (a) | <u>Exhibit 31.1</u> | Section 302 Certification of CEO  |
|     | <u>Exhibit 31.2</u> | Section 302 Certification of CFO  |
| (b) | <u>Exhibit 32.1</u> | Section 1350 Certification of CEO |
|     | <u>Exhibit 32.2</u> | Section 1350 Certification of CFO |



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**SIGNATURES**

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

REGISTRANT: **ARENA RESOURCES, INC.**

Dated: August 4, 2006

By: /s/ Lloyd Tim Rochford  
Lloyd Tim Rochford  
President, Chief Executive Officer

Dated: August 4, 2006

By: /s/ Stanley McCabe  
Stanley McCabe  
Treasurer, Secretary

Dated: August 4, 2006

By: /s/ William R. Broaddrick  
William R. Broaddrick  
Vice President, Chief Financial Officer