

ARENA RESOURCES INC
Form 10-Q/A
February 15, 2006

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

FORM 10-Q/A
Amendment No. 1

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 31, 2005

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES
EXCHANGE ACT OF 1934
OR
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
(Issuer'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 an accelerated filer (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 May 5, 2005, the Company had outstanding 10,332,179 shares of common stock (\$0.001 par value).

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Arena Resources, Inc.
For the Quarter Ended March 31, 2005

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Explanatory Note to Amendment No. 1

The purpose of this Amendment No. 1 to the Quarterly Report on Form 10-Q of Arena Resources, Inc. (the Company) for the three months ended March 31, 2005 (the Original Form 10-Q) is to (i) record an adjusted value (adjusted to market value on the date of issuance) of 40,000 shares of the Company's common stock originally issued as a finders fee in connection with the acquisition of property and capitalized as part of our properties subject to amortization, and (ii) restate our financial statements to reflect a change in how we account for compensation expenses associated with options granted to employees under our stock option plan.

Adjusting the capitalized value of our properties subject to amortization was negligible (\$35,217) and had no impact on our amortization expenses or net income for the quarter ended March 31, 2004 or March 31, 2005 as reported in this Form 10-Q.

The change in how we account for compensation expenses associated with options granted to employees essentially results in our recognition of compensation expense related to the discount amount of the exercise price of the option from the market price of the stock at the date of grant over the vesting period. The discount on all options granted through December 31, 2004 has been 15%, and the vesting period has been five years. The result of these changes is that our general and administrative expenses (which include our current compensation expense) for the quarters ended March 31, 2004 and March 31, 2005 have increased, with a resulting reduction in our net income after taxes. The effect of this change on our net income after taxes is to reduce our net income for the three months ended March 31, 2004 by \$47,244 (from \$309,641 to \$262,397), which results in no change to the basic earnings per share and a reduction of diluted earnings per share from \$0.04 to \$0.03, and for the three months ended March 31, 2005 by \$26,553 (from \$1,313,253 to \$1,286,700) which results in no change to basic earnings per share and a reduction of diluted earnings per share from \$0.12 to \$0.11.

Part I Financial Information

Item I. 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 months ended March 31, 2005 are not necessarily indicative of the results to be expected for the year ending December 31, 2005.

ARENA RESOURCES, INC.
CONDENSED BALANCE SHEETS
(UNAUDITED)
(As Restated Note 2)

| | March 31, 2005 | December 31, 2004 |
|--|----------------------|----------------------|
| ASSETS | | |
| Current Assets | | |
| Cash | \$ 1,764,414 | \$ 1,253,969 |
| Accounts receivable | 1,450,118 | 1,149,513 |
| Joint interest billing receivable | 88,838 | 61,805 |
| Prepaid expenses | 33,136 | 33,136 |
| Total Current Assets | 3,336,506 | 2,498,423 |
| Property and Equipment, Using Full Cost Accounting | | |
| Oil and gas properties subject to amortization | 36,494,723 | 34,457,137 |
| Deposit on property acquisition | 261,600 | - |
| Drilling advances | 272,119 | 900,000 |
| Equipment | 26,687 | 26,687 |
| Office equipment | 71,223 | 60,401 |
| Total Property and Equipment | 37,126,352 | 35,444,225 |
| Less: Accumulated depreciation and amortization | (1,986,723) | (1,565,124) |
| Net Property and Equipment | 35,139,629 | 33,879,101 |
| Total Assets | \$ 38,476,135 | \$ 36,377,524 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Accounts payable | \$ 871,457 | \$ 1,805,865 |
| Accrued liabilities | 102,334 | 34,800 |
| Total Current Liabilities | 973,791 | 1,840,665 |
| Long-Term Liabilities | | |
| Notes payable | 5,000,000 | 10,000,000 |
| Notes payable to related parties | 400,000 | 400,000 |
| Put option | 20,987 | 95,033 |
| Asset retirement liability | 1,290,064 | 1,267,993 |
| Deferred income taxes | 2,726,193 | 1,971,990 |
| Total Long-Term Liabilities | 9,437,244 | 13,735,016 |
| Stockholders' Equity | | |
| 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; 10,316,179 shares and 9,132,910 shares outstanding, respectively | 10,316 | 9,133 |
| Additional paid-in capital | 21,828,815 | 15,258,352 |
| Options and warrants outstanding | 2,575,720 | 3,213,159 |
| Deferred compensation | (191,927) | (234,277) |
| Retained earnings | 3,842,176 | 2,555,476 |

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| | | |
|---|---------------|---------------|
| Total Stockholders' Equity | 28,065,100 | 20,801,843 |
| Total Liabilities and Stockholders' Equity | \$ 38,476,135 | \$ 36,377,524 |

See the accompanying notes to unaudited condensed financial statements.

ARENA RESOURCES, INC.
CONDENSED STATEMENTS OF OPERATIONS
(UNAUDITED)
(As Restated Note 2)

| <i>For the Three Months Ended March 31,</i> | 2005 | 2004 |
|---|--------------|--------------|
| Oil and Gas Revenues | \$ 3,914,735 | \$ 1,200,400 |
| Costs and Operating Expenses | | |
| Oil and gas production costs | 812,237 | 316,290 |
| Oil and gas production taxes | 286,717 | 78,707 |
| Depreciation, depletion and amortization | 421,599 | 111,120 |
| General and administrative expense | 311,855 | 253,552 |
| Total Costs and Operating Expenses | 1,832,408 | 759,669 |
| Other Income (Expense) | | |
| Gain from change in fair value of put options | 74,046 | - |
| Accretion expense | (22,071) | (12,295) |
| Interest expense | (93,399) | (9,113) |
| Net Other Expense | (41,424) | (21,408) |
| Income Before Provision for Income Taxes | 2,040,903 | 419,323 |
| Provision for Deferred Income Taxes | (754,203) | (156,926) |
| Net Income | \$ 1,286,700 | \$ 262,397 |
| Basic Net Income Per Common Share | 0.13 | 0.04 |
| Diluted Net Income Per Common Share | 0.11 | 0.03 |

See the accompanying notes to unaudited condensed financial statements.

ARENA RESOURCES, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(As Restated Note 2)

| <i>For the Three Months Ended March 31,</i> | 2005 | 2004 |
|---|---------------------|---------------------|
| Cash Flows From Operating Activities | | |
| Net income | \$ 1,286,700 | \$ 262,397 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation, depletion and amortization | 421,599 | 111,120 |
| Provision for income taxes | 754,203 | 156,926 |
| Gain from change in fair value of put option | (74,046) | - |
| Amortization of deferred compensation | 42,350 | 75,350 |
| Accretion of discounted liabilities | 22,071 | 12,296 |
| Changes in assets and liabilities: | | |
| Accounts and joint interest receivable | (327,638) | (35,605) |
| Prepaid expenses | - | (3,591) |
| Accounts payable and accrued liabilities | (866,874) | (10,183) |
| Net Cash Provided by Operating Activities | 1,258,365 | 568,710 |
| Cash Flows from Investing Activities | | |
| Purchase and development of oil and gas properties | (1,409,705) | (296,620) |
| Purchase of office equipment | (10,822) | (17,446) |
| Net Cash Used in Investing Activities | (1,420,527) | (314,066) |
| Cash Flows From Financing Activities | | |
| Proceeds from issuance of common stock and warrants, net of offering costs | - | (114,788) |
| Proceeds from exercise of warrants | 5,672,607 | 21,750 |
| Payment of notes payable | (5,000,000) | - |
| Net Cash Provided by (Used in) Financing Activities | 672,607 | (93,038) |
| Net Increase in Cash | 510,445 | 161,606 |
| Cash at Beginning of Period | 1,253,969 | 1,076,676 |
| Cash at End of Period | \$ 1,764,414 | \$ 1,238,282 |
| Supplemental Cash Flow Information | | |
| Cash paid for interest | \$ 131,421 | \$ 9,863 |
| Non-Cash Investing and Financing Activities | | |
| Common stock issued for properties | \$ 261,600 | \$ - |
| See the accompanying notes to unaudited condensed financial statements. | | |

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
MARCH 31, 2005

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-KSB as of December 31, 2004. The financial position and results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results to be expected for the full year ending December 31, 2005.

Nature of Operations 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.

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. If the results of an assessment indicate that the properties are impaired, the amount of the impairment is added to the capitalized costs to be amortized. Amortization expense for the three months ended March 31, 2005 was \$421,599 based on depletion at the rate of \$4.62 per barrel of oil equivalent compared to \$111,120 based on depletion at the rate of \$3.00 per barrel of oil equivalent for the three months ended March 31, 2004. These amounts include \$4,477 and \$3,299 of depreciation on equipment during the three months ended March 31, 2005 and 2004, respectively.

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.

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
MARCH 31, 2005

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 March 31, 2005. During the three months ended March 31, 2005, sales to three customers represented 50%, 18% and 12% of total sales, respectively. At March 31, 2005, these three customers made up 57%, 20% and 6% of accounts receivable, respectively.

Stock-Based Employee Compensation The Company applies the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations in accounting for its stock-based compensation awards to employees. The Company recognizes 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 quarters ended March 31, 2005 and 2004 of \$42,350 and \$75,350, respectively.

Alternately, Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), allows companies to recognize compensation expense over the related service period based on the grant date fair value of the stock option awards. The following table illustrates the effect on net income and basic and diluted income per common share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

| For the Three Months Ended March 31, | 2005 | 2004 |
|---|--------------|-------------|
| Net income, as reported | \$ 1,286,700 | \$ 262,397 |
| Add: Stock based employee compensation expense included in net income, net of related tax effects | 26,553 | 47,244 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects | (152,217) | (127,129) |
| Pro Forma Net Income | \$ 1,161,036 | \$ 182,512 |
| Income per Common Share | | |
| Basic, as reported | \$ 0.13 | \$ 0.04 |
| Basic, pro forma | 0.12 | 0.03 |
| Diluted, as reported | 0.11 | 0.03 |
| Diluted, pro forma | 0.10 | 0.02 |

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
MARCH 31, 2005

NOTE 2 RESTATEMENT OF FINANCIAL STATEMENTS

During 2003, the Company granted nonqualified stock options to directors and employees to purchase 1,000,000 shares of common stock. The exercise price was 85% of the market value of the Company's common stock on the dates issued and the options vest over a five-year period. In reliance upon FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, the Company considered the 15% discount from the market price of the Company's common stock to be reasonable in determining the fair value of the common stock and determined that the time permitted for exercise of the stock options was limited to a reasonable period; therefore, the Company did not recognize any stock-based compensation from the grant of these stock options. However, the Company has recently reevaluated its conclusion with regard to the time permitted for exercise of the stock options and has determined that the five year vesting period is not a reasonable period. As a result, the discount from market value is stock-based compensation. The stock-based compensation is being recognized over the five-year vesting period of the options.

In addition, the Company recently determined that it did not recognize 40,000 shares of common stock that were issued as a finder's fee at their fair value during 2004. The fair value of the common stock has been determined by the market value of the Company's common stock on the date the shares were issued. The fair value of the finder's fee was capitalized as part of the acquisition of oil and gas properties subject to amortization.

The Company has restated its financial statements for the three months ended March 31, 2005 and 2004 to reflect the effects of these adjustments. As a result of the restatement, the Company recognized additional compensation expense of \$42,350 and \$75,350 during the three months ended March 31, 2005 and 2004, respectively. The cost of oil and gas properties subject to amortization was increased by of \$35,217 and stockholders' equity was increased by \$209,017 at March 31, 2005. The following tables summarize the effect of the restatement on the financial statements for the reporting period March 31, 2005:

| | As Previously Stated | Effect of Restatement | As Restated |
|--|-------------------------|--------------------------|-------------|
| For the Three Months Ended March 31, 2005 | | | |
| General and administrative expense | \$ 269,505 | \$ 42,350 | \$ 311,855 |
| Income before provision for income taxes | 2,083,253 | (42,350) | 2,040,903 |
| Provision for deferred income taxes | (770,000) | 15,797 | (754,203) |
| Net income | 1,313,253 | (26,553) | 1,286,700 |
| Basic income per common share | 0.13 | - | 0.13 |
| Diluted income per common share | 0.12 | (0.01) | 0.11 |
| For the Three Months Ended March 31, 2004 | | | |
| General and administrative expense | \$ 178,202 | \$ 75,350 | \$ 253,552 |
| Income before provision for income taxes | 494,673 | (75,350) | 419,323 |
| Provision for deferred income taxes | (185,032) | 28,106 | (156,926) |
| Net income | 309,641 | (47,244) | 262,397 |
| Basic income per common share | 0.04 | - | 0.04 |
| Diluted income per common share | 0.04 | (0.01) | 0.03 |

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
MARCH 31, 2005

| | As Previously Stated | Effect of Restatement | As Restated |
|----------------------------------|-------------------------|--------------------------|---------------|
| As of March 31, 2005 | | | |
| Property and equipment, net | \$ 35,104,412 | \$ 35,217 | \$ 35,139,629 |
| Total assets | 38,440,918 | 35,217 | 38,476,135 |
| Deferred income taxes | 2,899,993 | (173,800) | 2,726,193 |
| Total long-term liabilities | 9,611,044 | (173,800) | 9,437,244 |
| Additional paid-in capital | 21,793,598 | 35,217 | 21,828,815 |
| Options and warrants outstanding | 1,915,720 | 660,000 | 2,575,720 |
| Deferred compensation | - | (191,927) | (191,927) |
| Retained earnings | 4,136,449 | (294,273) | 3,842,176 |
| Total stockholders' equity | 27,856,083 | 209,017 | 28,065,100 |

NOTE 3 EARNINGS PER SHARE INFORMATION

| <i>For the Three Months Ended March 31,</i> | 2005 | 2004 |
|--|--------------|-------------|
| Net Income | \$ 1,286,700 | \$ 262,397 |
| Basic Weighted-Average Common Shares Outstanding | 9,792,744 | 7,163,734 |
| Effect of dilutive securities | | |
| Warrants | 1,021,162 | 429,739 |
| Stock options | 471,033 | 243,441 |
| Diluted Weighted-Average Common Shares Outstanding | 11,284,939 | 7,836,914 |
| Basic Net Income Per Common Share | 0.13 | 0.04 |
| Diluted Net Income Per Common Share | 0.11 | 0.03 |

NOTE 4 ACQUISITION OF OIL AND GAS PROPERTIES

On March 24, 2005, the Company entered into a definitive agreement to acquire approximately 15,000 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 acquisition has not yet been closed, but is anticipated to be closed in May 2005. Upon closing, the Company will pay the balance of approximately \$300,000.

On May 7, 2004, the Company acquired an 82.24% working interest, 67.60% net revenue interest, in the East Hobbs San Andres Property mineral lease (East Hobbs) located in Lea County, New Mexico. Although the Purchase and Sales Agreement transferred the revenue and the related operating costs from East Hobbs to Arena beginning March 1, 2004, Arena did not control the property interests until May 7, 2004. As a result, the acquisition date for accounting purposes was May 7, 2004 and the East Hobbs operations have been included in the results of operations of Arena from May 7, 2004. Revenues and operating costs for the months of March and April were treated as adjustments to the purchase price.

At the date of acquisition, East Hobbs was comprised of 21 operating oil and gas wells that were unitized into one lease prior to the acquisition. The Company purchased East Hobbs for its current production and cash flow, as well as for the drilling and secondary recovery opportunities from the property. The Company paid \$10,008,440 to the sellers, including \$9,008,440 paid directly from borrowings under a credit facility and a bridge financing from a bank described more fully in Note 5. In addition, the Company paid acquisition costs of \$28,000 and issued 40,000 shares of common stock valued at \$239,750, or \$5.99 per share, as a finder's fee on the East Hobbs San Andres Property acquisition.

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
MARCH 31, 2005

On November 18, 2004, Arena Resources, Inc. entered into a binding letter of intent to acquire 100% of the working interest, 75% of the net revenue interest, of the Fuhrman-Mascho Property mineral leases under the terms of Asset Purchase Agreements (the Agreements). Under the terms of the Agreements, the sellers transferred effective control of the property to the Company on December 1, 2004 without restrictions. Accordingly, the acquisition date was December 1, 2004. The results of operations of the Fuhrman-Mascho property have been included in the results of operations of the Company from December 1, 2004.

At the date of acquisition, Fuhrman-Mascho property consisted of 84 leases with a total of 174 operating oil and gas wells. The Company purchased Fuhrman-Mascho for its current production and cash flow, as well as for the drilling and development opportunities from the property. On December 20, 2004, the Company made cash payments to the sellers of \$9,667,381, issued the sellers 150,013 shares of common stock valued at \$1,050,091 or \$7.00 per share based on the market value of the common stock over the 2-day period before and after November 18, 2004, issued the sellers put options entitling the sellers to demand that the Company reacquire the 150,013 shares of common stock at \$7.00 per share from November 1, 2006 through November 30, 2006, and received call options from the sellers entitling the Company to reacquire the 150,013 shares of common stock at \$8.50 per share from the date issued through November 1, 2006. In addition, the Company paid acquisition costs of \$44,421 and issued 30,000 shares of common stock as a consulting and finder's fee, valued at \$210,000, or \$7.00 per share. The consideration paid or issued on December 20, 2004 was discounted to December 1, 2004 at 5% and resulted in recognition of an unamortized discount of \$30,000 at December 1, 2004. The acquisition was funded through the use of cash on hand and a credit facility secured from the Company's principal lender.

The following unaudited pro forma information is presented to reflect the operations of the Company as if the acquisitions of the East Hobbs and the Fuhrman-Mascho properties had been completed on January 1, 2004 and 2003, respectively:

| <i>For the Three Months Ended March 31,</i> | 2005 | 2004 |
|---|--------------|--------------|
| Oil and Gas Revenues | \$ 3,914,735 | \$ 2,457,830 |
| Net Income | 1,286,700 | 419,864 |
| Income Per Common Share | | |
| Basic Net Income Per Common Share | \$ 0.13 | \$ 0.06 |
| Diluted Net Income Per Common Share | 0.11 | 0.05 |

NOTE 5 NOTES PAYABLE

In 2004 the Company established a \$25,000,000 credit facility from a bank with a \$15,000,000 borrowing base. Any increases in the borrowing base are subject to written consent by the financial institution. The interest rate is a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2.25%, currently 5.04% per annum, and is payable monthly. Annual fees for the facility were 1/8 of one percent of the unused portion of the borrowing base. Amounts borrowed under the revolving credit facility are due in April 2007. 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. During the three months ended March 31, 2005, the Company paid a total of \$5,000,000 of the amounts borrowed during 2004, using the proceeds from the exercise of warrants for the Company's common stock. As of March 31, 2005, \$5,000,000 remained outstanding on this credit facility.

ARENA RESOURCES, INC.
NOTES TO UNAUDITED CONDENSED FINANCIAL STATEMENTS
MARCH 31, 2005

As stated in Note 9, effective April 30, 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. At that time, the annual fee for the unused portion of the borrowing base was removed, the tangible net worth the Company must maintain was increased to \$18,000,000 and the maturity date changed to April 30, 2008. All other terms and conditions of the credit facility remained the same.

On February 21, 2005, 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, 2006, under the same terms as the original notes.

NOTE 6 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, 2005 is as follows:

| | |
|--------------------------|--------------|
| Balance, January 1, 2005 | \$ 1,267,993 |
| Accretion expense | 22,071 |
| <hr/> | |
| Balance, March 31, 2005 | \$ 1,290,064 |
| <hr/> | |

NOTE 7 STOCKHOLDERS EQUITY

Warrants exercised During the three months ended March 31, 2005, the Company issued 1,163,269 shares of common stock as a result of warrant holders exercising warrants. Of this total, 76,350 had an exercise price of \$1.75 per share, 1,041,919 had an exercise price of \$5.00 per share and 45,000 had an exercise price of \$7.32 per share. The Company received \$5,672,607 from the exercises.

Shares issued in property acquisition During the three months ended March 31, 2005, the Company issued 20,000 shares of restricted common stock, valued at \$261,600, or \$13.08 per share, as part of the acquisition cost for leasing acreage in Kansas as disclosed in Note 4.

Options issued On January 1, 2005, the Company granted nonqualified stock options to directors and employees to purchase 375,000 shares of common stock at \$8.30 per share through July 1, 2010. The pro forma stock-based employee compensation expense determined under the fair value method for these options, net of related tax effects, for the year ending December 31, 2005 would be \$323,126.

NOTE 8 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 \$299,029 to allow the Company to do business in those states. The standby letters of credit are valid through May 2005 and are collateralized by the revolving credit facility with the bank. 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
MARCH 31, 2005

NOTE 9 SUBSEQUENT EVENTS

Subsequent to March 31, 2005, warrant holders exercised 15,000 warrants with an exercise price of \$1.75 per share and 1,000 warrants with an exercise price of \$5.00 per share.

Subsequent to March 31, 2005 and effective April 30, 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.

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

Results of Operations For the Three Months Ended March 31, 2005

Oil and natural gas sales. For the three months ended March 31, 2005, oil and natural gas sales revenue increased \$2,714,335 to \$3,914,735, compared to \$1,200,400 for the same period during 2004. Oil sales increased \$2,407,975 and natural gas sales increased \$306,360. The increases were the result of increased sales volumes and average realized sales prices. For the three months ended March 31, 2005, oil sales volume increased 43,477 barrels to 77,260 barrels, compared to 33,783 barrels for the same period in 2004. The average realized per barrel oil price increased 37% from \$33.24 for the three months ended March 31, 2004 to \$45.70 for the three months ended March 31, 2005. For the three months ended March 31, 2005, gas sales volume increased 63,992 thousand cubic feet (MCF) to 83,315 MCF, compared to 19,323 MCF for the same period in 2004. The average realized natural gas price per MCF increased 15% from \$4.00 for the three months ended March 31, 2004 to \$4.61 for the three months ended March 31, 2005.

Lease operating expenses. Our lease operating expenses increased from \$316,290 or \$8.54 per barrel of oil equivalent (BOE) for the three months ended March 31, 2004 to \$812,237 or \$8.91 per BOE for the three months ended March 31, 2005. The increase in total was due to properties acquired after the first quarter 2004.

Production taxes. Production taxes as a percentage of oil and natural gas sales were 7% during the three months ended March 31, 2004 and remained steady at 7% for the three months ended March 31, 2005. Production taxes vary from state to state. Therefore, these taxes are likely to 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.

Depreciation, depletion and amortization. Our depreciation, depletion and amortization expense increased by \$310,479 to \$421,599 for the three months ended March 31, 2005, compared to the same period in 2004. The increase was a result of an increase in volume and in the average depreciation, depletion and amortization rate from \$3.00 per BOE during the three months ended March 31, 2004 to \$4.62 per BOE during the three months ended March 31, 2005. The increased depreciation, depletion and amortization rate was the result of a revision to our reserves and increased capitalized costs and development costs from the properties acquired in 2004.

General and administrative expenses. General and administrative expenses increased by \$58,303 to \$311,855 for the three months ended March 31, 2005, compared to the same period in 2004. This 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). Interest expense increased \$84,286 to \$93,399 for the three months ended March 31, 2005 when compared to the same period in 2004. The increase was due to an increase in outstanding debt with the use of our credit facility in our latest acquisition.

Income tax expense. Our effective tax rate was 37% during the three months ended March 31, 2004 and remained steady at 37% for the three months ended March 31, 2005.

Net income. Net income increased from \$262,397 for the three months ended March 31, 2004 to \$1,286,700 for 2005. The primary reasons for this increase include an increase in volumes sold 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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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 | 6,816 BBLs | \$ 323,770 |
| Oklahoma Leases | 14,950 BBLs | \$ 752,925 |
| New Mexico Leases | 55,495 BBLs | \$ 2,457,315 |

GAS

| | Net Production Volume | Net Revenue |
|-------------------|-----------------------|-------------|
| Texas Leases | 2,802 MCF | \$ 9,400 |
| Oklahoma Leases | 9,923 MCF | \$ 33,829 |
| New Mexico Leases | 34,699 MCF | \$ 206,645 |
| Kansas | 35,890 MCF | \$ 130,850 |

Significant Subsequent Events occurring after March 31, 2005:

Subsequent to March 31, 2005 and effective April 30, 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. At that time, the annual fee for the unused portion of the borrowing base was removed, the tangible net worth the Company must maintain was increased to \$18,000,000 and the maturity date changed to April 30, 2008. All other terms and conditions of the credit facility remained the same.

Capital Resources and Liquidity

As shown in the financial statements for the three months ended March 31, 2005, the Company had cash on hand of \$1,764,414, compared to \$1,253,969 as of December 31, 2004. The Company had positive net cash flows from operations for the three months ended March 31, 2005 of \$1,258,365, compared to \$568,710 for the same period 2004. Another significant source of cash inflow was the receipt of \$5,672,607 during the three months ended March 31, 2005 and \$21,750 for the same period in 2004 from the exercise of warrants for the Company's restricted common stock. The most significant cash outflows during the three months ended March 31, 2005 and 2004 were capital expenditures of \$1,420,527 in 2005 and \$314,066 in 2004, repayment of debt on the Company's credit facility of \$5,000,000 in 2005 and payment of deferred offering costs of \$114,788 for the public offering that was completed later in 2004.

On April 14, 2004, the Company established a \$15,000,000 credit facility from a bank with an \$8,500,000 initial borrowing base. In November 2004, the Company entered into an agreement that increased the facility to \$25,000,000, with an increased borrowing base of \$15,000,000. Any increases in the borrowing base are subject to written consent by the financial institution. The interest rate is a floating rate equal to the 30, 60 or 90 day LIBOR rate plus 2.25%, currently 5.04% per annum, and is payable monthly. Annual fees for the facility were 1/8 of one percent of the unused portion of the borrowing base. Amounts borrowed under the revolving credit facility are due in April 2007. 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. During December 2004, the Company drew \$9,000,000 under this revolving credit facility to fund the acquisition of the Fuhrman Mascho leases and \$1,000,000 to help fund development activities. An additional \$299,029 is reserved under the revolving credit facility as collateral for standby letters of credit issued to various states. During the three months ended March 31, 2005, the Company paid a total of \$5,000,000 of the amounts borrowed during 2004, using the proceeds from the exercise of warrants for the Company's common stock. As of March 31, 2005, \$5,000,000 remained outstanding on this credit facility.

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As stated in the Subsequent Events section, effective April 30, 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. At that time, the annual fee for the unused portion of the borrowing base was removed, the tangible net worth the Company must maintain was increased to \$18,000,000 and the maturity date changed to April 30, 2008. All other terms and conditions of the credit facility remained the same.

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.

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

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 believe that:

The Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports it files under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms; and

The Company's disclosure controls and procedures operate such that important information flows to appropriate collection and disclosure points in a timely manner and are effective to ensure that such information is accumulated and communicated to the Company's management, and made known to the Company's Chief Executive Officer and Chief Financial Officer, particularly during the period when this quarterly report was prepared, as appropriate to allow timely decisions regarding the required disclosure.

Changes in Internal Controls Over Financial Reporting

There have been no significant changes in the Company's internal controls over financial reporting or other factors that could significantly affect the Company's internal controls subsequent to their evaluation, nor has there been any need for any corrective actions with regard to significant deficiencies or material weaknesses in internal controls related to financial reporting.

Part II Other Information

Item 1. Legal Proceedings

None.

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

During the three months ended March 31, 2005, the Company issued 1,118,269 shares of common stock as a result of warrant holders exercising warrants. Of this total, 76,350 warrants had an exercise price of \$1.75 per share and 1,041,919 warrants had an exercise price of \$5.00 per share. The Company received \$5,343,207 from the exercises. The shares were issued in transactions not involving a public offering in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933. The persons to whom the shares were issued in exchange for the warrants had access to full information concerning the Company and represented that they acquired the shares for their own account and not for the purpose of distribution. The certificates for the shares contain a restricted legend advising that the shares may not be offered for sale, sold or otherwise transferred without having first been registered under the 1933 Act or pursuant to an exemption from registration under the 1933 Act. There was no underwriter involved in these transactions.

During the three months ended March 31, 2005, the Company issued 20,000 shares of common stock as partial consideration for an acquisition in Kansas that has not yet closed. The shares were valued at \$261,600, or \$13.08 per share. The shares were issued in transactions not involving a public offering in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act of 1933. The persons to whom the shares were issued in exchange for the warrants had access to full information concerning the Company and represented that they acquired the shares for their own account and not for the purpose of distribution. The certificates for the shares contain a restricted legend advising that the shares may not be offered for sale, sold or otherwise transferred without having first been registered under the 1933 Act or pursuant to an exemption from registration under the 1933 Act. There was no underwriter involved in these transactions.

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 |

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: February 15, 2006

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

Dated: February 15, 2006

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

Dated: February 15, 2006

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