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

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended **June 30, 2014**

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 **33-16820-D**

ARÊTE INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

Colorado
(State or Other Jurisdiction of
Incorporation or Organization)

84-1508638
(I.R.S. Employer
Identification No.)

7260 Osceola Street, Westminster, Colorado
(Address of Principal Executive Offices)

80030
(Zip Code)

303-427-8688
(Registrant's Telephone Number, Including Area Code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

As of August 13, 2014, the Registrant had 12,408,459 shares of common stock issued and outstanding.

- (1) Explanatory Note: The Company is a voluntary filer with the Securities & Exchange Commission but it has filed all Exchange Act reports for the preceding 12 months.

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ARÊTE INDUSTRIES, INC.

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UNAUDITED CONSOLIDATED BALANCE SHEETS
December 31, 2013 and June 30, 2014**

	<u>2013</u>	<u>2014</u>
<u>ASSETS</u>		
Current Assets:		
Cash and equivalents	\$ 476,323	\$ 16,109
Receivable from DNR Oil & Gas, Inc.:		
Oil and gas sales, net of production costs	230,029	484,048
Other	2,368	2,368
Prepaid expenses and other	38,177	42,650
Total Current Assets	<u>746,897</u>	<u>545,175</u>
Property and Equipment:		
Oil and gas properties, at cost, successful efforts method:		
Proved properties	9,555,897	10,176,355
Unevaluated properties	314,336	314,336
Natural gas gathering system	442,195	442,195
Furniture and equipment	22,522	22,522
Total property and equipment	10,334,950	10,955,408
Less accumulated depreciation, depletion and amortization	<u>(2,094,337)</u>	<u>(2,375,447)</u>
Net Property and Equipment	<u>8,240,613</u>	<u>8,579,961</u>
TOTAL ASSETS	<u>\$ 8,987,510</u>	<u>\$ 9,125,136</u>

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ARÊTE INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS
December 31, 2013 and June 30, 2014

	<u>2013</u>	<u>2014</u>
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
Current Liabilities:		
Accounts payable:		
Payable to DNR Oil & Gas, Inc.:		
Operator fees and other	36,000	36,000
Unrelated parties	17,806	375,738
Notes and advances payable - current portion:		
Directors and affiliates	717,833	178,273
Unrelated parties	325,000	950,641
Accrued interest expense	52,242	12,998
Accrued consulting - related party	—	67,500
Director fees payable in common stock	450	900
Current portion of asset retirement obligations	159,782	162,672
Other accrued costs and expenses	57,210	88,425
Total Current Liabilities	<u>1,366,323</u>	<u>1,873,147</u>
Long-Term Liabilities:		
Contingent acquisition costs payable to DNR Oil & Gas, Inc.	250,000	250,000
Notes and advances payable, net of current portion:		
DNR Oil & Gas, Inc.	792,151	792,151
Directors and affiliates	246,639	226,750
Unrelated parties	425,000	—
Asset retirement obligations, net of current portion	522,421	552,661
Total Long-Term Liabilities	<u>2,236,211</u>	<u>1,821,562</u>
Total Liabilities	<u>3,602,534</u>	<u>3,694,709</u>
Commitments and Contingencies		
Stockholders' Equity:		
Convertible Class A preferred stock; \$10,000 face value per share, authorized 1,000,000 shares:		
Series 1; authorized 30,000 shares, issued and outstanding 10 shares in 2013 and 2014, liquidation preference of \$111,250 in 2013 and of \$118,750 in 2014	95,451	95,451
Series 2; authorized 2,500 shares, no shares issued and outstanding in 2013 and 2014	—	—
Common stock, no par value; authorized 499,000,000 shares, issued and outstanding 13,608,459 in 2013 and 12,408,459 in 2014	21,488,387	21,260,387
Accumulated deficit	<u>(16,198,862)</u>	<u>(15,925,411)</u>
Total Stockholders' Equity	<u>5,384,976</u>	<u>5,430,427</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 8,987,510</u>	<u>\$ 9,125,136</u>

The Accompanying Notes are an Integral Part of These Financial Statements.

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ARÊTE INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
Three Month and Six Months Ended June 30, 2013 and 2014

	<u>Quarter Ended June 30:</u>		<u>Six-Months Ended June 30</u>	
	<u>2013</u>	<u>2014</u>	<u>2013</u>	<u>2014</u>
Revenues:				
Oil and natural gas sales	\$ 516,267	669,488	\$ 973,992	\$ 1,165,239
Sale of oil and natural gas properties	—	78,815	949	242,472
Royalty revenue	—	963	—	1,770
Total revenues	<u>516,267</u>	<u>749,266</u>	<u>974,941</u>	<u>1,409,481</u>
Operating Expenses:				
Oil and gas producing activities:				
Lease operating expenses	153,593	208,566	341,400	369,934
Production taxes	41,028	58,589	76,865	91,646
Depreciation, depletion, amortization and accretion	150,733	162,182	323,335	291,845
Gas gathering:				
Operating expenses	4,142	3,385	7,685	7,370
Depreciation	11,055	11,055	22,110	22,110
General and administrative expenses:				
Director fees	900	450	1,350	450
Investor relations	44,530	29,621	75,427	35,186
Legal, auditing and professional services	66,300	34,596	96,890	78,644
Consulting and executive services:				
Related parties	30,750	97,500	61,500	127,500
Other administrative expenses	19,192	19,307	40,562	41,082
Depreciation	—	142	285	285
Total operating expenses	<u>522,223</u>	<u>625,393</u>	<u>1,047,409</u>	<u>1,066,052</u>
Operating income (loss)	(5,956)	123,873	(72,468)	343,429
Other income (expense):				
Interest income	—	—	1	—
Interest expense	(36,304)	(34,808)	(61,800)	(69,978)
Income (loss) before income taxes	(42,260)	89,065	(134,267)	273,451
Income tax benefit (expense)				
Net income (loss)	<u>\$ (42,260)</u>	<u>\$ 89,065</u>	<u>\$ (134,267)</u>	<u>\$ 273,451</u>
Net Income (Loss) Applicable to Common Stockholders:				
Net income (loss)	\$ (42,260)	\$ 89,065	\$ (134,267)	\$ 273,451
Redemption of preferred stock	3,053,365	—	3,053,365	—
Accrued preferred stock dividends	(9,375)	(3,750)	(205,313)	(7,500)
Net income (loss) applicable to common stockholders	<u>\$ 3,001,730</u>	<u>\$ 85,315</u>	<u>\$ 2,713,785</u>	<u>\$ 265,951</u>
Earnings (Loss) Per Share Applicable to Common Stockholders:				
Basic	<u>\$ 0.37</u>	<u>\$ 0.01</u>	<u>\$ 0.34</u>	<u>\$ 0.02</u>
Diluted	<u>\$ 0.23</u>	<u>\$ 0.01</u>	<u>\$ 0.20</u>	<u>\$ 0.02</u>
Weighted Average Number of Common Shares Outstanding:				
Basic	<u>8,125,000</u>	<u>12,408,000</u>	<u>8,055,000</u>	<u>12,607,000</u>
Diluted	<u>13,251,466</u>	<u>12,408,000</u>	<u>13,251,466</u>	<u>12,607,000</u>

The Accompanying Notes are an Integral Part of These Financial Statements.

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ARÊTE INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
Six Months Ended June 30, 2014

	<u>Class A Preferred Stock</u>		<u>Common Stock</u>		<u>Accumulated</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Deficit</u>	
Balances, December 31, 2013	10	\$ 95,451	13,608,459	\$21,488,387	\$(16,198,862)	\$5,384,976
Redemption of common stock			(1,200,000)	\$ (228,000)		(228,000)
Net income	—	—	—	—	273,451	273,451
Balances, June 30, 2014	<u>10</u>	<u>\$ 95,451</u>	<u>12,408,459</u>	<u>\$21,260,387</u>	<u>\$(15,925,411)</u>	<u>\$5,430,427</u>

The Accompanying Notes are an Integral Part of These Financial Statements.

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ARÊTE INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
Six Months Ended June 30, 2013 and 2014

	<u>2013</u>	<u>2014</u>
Cash Flows from Operating Activities:		
Net income (loss)	\$ (134,267)	\$ 273,451
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation, depletion and amortization	312,670	281,110
Accretion of discount on asset retirement obligations	33,060	33,130
Gain on sale of oil and gas properties	(949)	(242,472)
Common stock issued in exchange for services	18,000	—
Changes in operating assets and liabilities:		
Accounts receivable	(152,499)	(202,735)
Prepaid expenses and other	36,617	(4,473)
Accounts payable	(18,758)	357,932
Directors fees and officers services payable	—	67,950
Accrued costs and expenses	(161,141)	36,487
Net cash provided by (used in) operating activities	<u>(67,267)</u>	<u>600,380</u>
Cash Flows from Investing Activities:		
Capital expenditures for property and equipment	(189,110)	(620,458)
Proceeds from sale of oil and gas properties	949	191,189
Net cash provided by (used in) investing activities	<u>(188,161)</u>	<u>(429,269)</u>
Cash Flows from Financing Activities:		
Proceeds from notes and advance payable	1,040,935	532,641
Principal payments on notes payable	(350,135)	(935,966)
Payment of dividends on preferred stock	(391,875)	—
Redemption of common stock	—	(228,000)
Redemption of preferred stock	(50,000)	—
Net cash provided by (used in) financing activities	<u>248,925</u>	<u>(631,325)</u>
Net decrease in cash and equivalents	(6,503)	(460,214)
Cash and equivalents, beginning of period	<u>6,921</u>	<u>476,323</u>
Cash and equivalents, end of period	<u>\$ 418</u>	<u>\$ 16,109</u>
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	<u>\$ 51,045</u>	<u>\$ 55,651</u>
Cash paid for income taxes	<u>\$ —</u>	<u>\$ —</u>
Supplemental Disclosure of Non-cash Investing and Financing Activities:		
Preferred stock dividends declared	<u>\$ —</u>	<u>\$ —</u>

The Accompanying Notes are an Integral Part of These Financial Statements.

ARÊTE INDUSTRIES, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2014

1. Organization and Nature of Operations

Arête Industries, Inc. (“Arête” or the “Company”), is a Colorado corporation that was incorporated on July 21, 1987. The Company owns 100% of Arete Energy, Inc. which is an inactive subsidiary which has no assets, liabilities or operations. Arête has operated a natural gas gathering system in Wyoming since 2006 and on July 29, 2011 the Company purchased oil & natural gas properties in Colorado, Montana, Kansas, and Wyoming.

The Company seeks to focus on acquiring interests in traditional oil and gas ventures, and seek properties that offer profit potential from overlooked and by-passed reserves of oil and natural gas, which may include shut-in wells, in-field development, stripper wells, re-completion and re-working projects. In addition, the Company’s strategy includes purchase and sale of acreage prospective for oil and natural gas and seeking to obtain cash flow from the sale and farm out of such prospects.

2. Summary of Significant Accounting Policies

Basis of presentation

The accompanying unaudited consolidated financial statements have been prepared by the Company. In the opinion of management, the accompanying unaudited financial statements contain all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation of the financial position as of December 31, 2013 and June 30, 2014, and the results of operations, changes in stockholders’ equity, and cash flows for the quarters ended June 30, 2013 and 2014. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for a full year. The Company’s 2013 Annual Report on Form 10-K includes certain definitions and a summary of significant accounting policies and should be read in conjunction with this Form 10-Q. Except as disclosed herein, there have been no material changes to the information disclosed in the notes to the consolidated financial statements included in the Company’s 2013 Annual Report on Form 10-K.

Use of Estimates

Preparation of the Company’s financial statements in accordance with GAAP requires management to make various assumptions, judgments and estimates that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Changes in these assumptions, judgments and estimates will occur as a result of the passage of time and the occurrence of future events and, accordingly, actual results could differ from amounts initially established.

The most significant areas requiring the use of assumptions, judgments and estimates relate to the volumes of natural gas and oil reserves used in calculating depreciation, depletion and amortization (“DD&A”), the amount of expected future cash flows used in determining possible impairments of oil and gas properties and the amount of future capital costs used in these calculations. Assumptions, judgments and estimates also are required in determining future asset retirement obligations, impairments of undeveloped properties, and in valuing stock-based payment awards.

During the quarter ended June 30, 2014, the Company changed the estimate of revenue receivable from its three new wells in Wyoming by reducing net revenue by \$54,974.

The only component of comprehensive income that is applicable to the Company is net income (loss). Accordingly, a separate statement of comprehensive income (loss) is not included in these financial statements.

Principles of Consolidation

The consolidated financial statements of the Company include the accounts of Arête and its inactive subsidiary, Arete Energy, Inc. All intercompany accounts and transactions have been eliminated in consolidation.

Earnings per share

Basic net income (loss) per share of common stock is calculated by dividing net income (loss) attributable to common stockholders by the weighted average number of common shares outstanding during each period. Diluted net income (loss) attributable to common stockholders is calculated by dividing net income (loss) attributable to common stockholders by the weighted average number of common shares outstanding and other dilutive securities. The only potentially dilutive securities for the diluted earnings per share calculations consist of Series 1 preferred stock that is

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convertible into common stock at an exchange price of \$3.30 per common share. As of June 30, 2014, the convertible preferred stock had an aggregate liquidation preference of \$118,750 and was convertible to 35,985 shares of common stock. These shares were excluded from the earnings per share calculation because it was anti-dilutive to assume conversion at the beginning of the quarter, which would have eliminated preferred dividends from the earnings per share calculation.

New Accounting Pronouncements

In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*. The objective of ASU 2013-11 is to provide guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. ASU 2013-11 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this standard will not have an impact on the Company's consolidated financial statements.

Other accounting standards that have been issued or proposed by the FASB, or other standards-setting bodies, that do not require adoption until a future date are not expected to have a material impact on the Company's financial statements upon adoption.

3. Disposition of Oil and Gas Properties

In December 2013, we sold one of our producing properties, which resulted in gross proceeds of approximately \$1,004,000. This property was sold to an unrelated purchaser and pursuant to our amended purchase agreement entered into in September 2013, we were required to pay the related party sellers approximately \$554,000 of the proceeds due to their contingent interest and, as a result our net proceeds were \$450,000. After deducting the net book value of the property of \$163,000, plus the asset retirement obligation assumed by the unrelated purchaser of \$31,000, we recognized a gain of approximately \$318,000. The Company retained a 1.57% overriding royalty interest in this property. This sale comprised approximately 1.1% of the Company's barrels of oil equivalent ("BOE") of oil and gas reserve quantities, and approximately 2.2% of the Company's discounted future net revenues prior to the sale. The Company determined that this sale did not qualify for discontinued operations reporting.

The Company has participated as a working interest owner in four horizontal wells to be drilled in Campbell County, Wyoming in the Turner zone. The following is a description of the wells:

- 1) The Thielen #1-21 is in Section 21 Township 43N. This well is currently being drilled to a total depth of approximately 15,350 including the lateral. The Company will have an approximate 1.06% working interest.
- 2) The Thielen #2-21 is in Section 21 Township 43N. This well is scheduled to be drilled in the summer of 2014 and is planned to be drilled to a total depth of approximately 15,330 feet including the lateral. The Company will have an approximate 1.06% working interest.
- 3) The Starlight Federal 28H is located in Section 7, Township 43N. This well is scheduled to be drilled in the first quarter of 2014 and is planned to be drilled to a total depth of approximately 15,310 including the lateral. The Company will have an approximate 0.7025% working interest.
- 4) The Starlight Federal 30H is located in Section 7, Township 43N. This well is scheduled to be drilled in the first quarter of 2014 and is planned to be drilled to a total depth of approximately 15,310 including the lateral. The Company will have an approximate 1.405% working interest.

The Company has received the results on three of the wells and these results have been included in this filing. We do not have results on the fourth well other than the drilling has been completed and the information is being evaluated.

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4. Income taxes

The book to tax temporary differences resulting in deferred tax assets and liabilities are primarily net operating loss carry forwards of approximately \$7.7 million which expire in 2015 through 2032. A 100% valuation allowance has been established against the deferred tax assets, as utilization of the loss carry forwards and realization of other deferred tax assets cannot be reasonably assured. For the six months ended June 30, 2014, the Company did not recognize any income tax benefit due to the valuation allowance.

5. Stock transactions and preferred stock dividends

During the quarter ended June 30, 2014, the Company did not issue any common stock for compensation or services. The Board of Directors has not declared the semi-annual dividend payable to preferred shareholders of record as of June 30, 2014.

The Company agreed to repurchase 1,200,000 shares of its Common Stock. The following are the details of the transaction:

On December 10, 2013, Burlingame Equity Investors Master Fund LP (“Burlingame”), a significant stockholder of Arête Industries, Inc. (the “Company”) entered into conditional stock option agreements with Nicholas L. Scheidt, the Company’s Chief Executive Officer and Director, pursuant to which Mr. Scheidt was granted options to purchase up to 1,460,000 shares of Company common stock at \$0.19 per share. Mr. Scheidt subsequently assigned the right to purchase 1,200,000 shares to the Company on January 27, 2014. On January 30, 2014, the Company entered into a Direct Stock Purchase Agreement with Burlingame pursuant to which the Company has purchased the 1,200,000 shares of its common stock from Burlingame at a price of \$0.19 per share for total consideration of \$228,000. In addition, Mr. Scheidt assigned an additional 141,873 shares of Company common stock underlying his option from Burlingame to Donald W. Prosser, the Company’s Chief Financial Officer and Director. Pursuant to this assignment, Mr. Prosser agreed to purchase the entire 141,873 shares of Company common stock from Burlingame at a price of US \$0.19 per share for total consideration of \$26,956. Furthermore, of these 141,873 shares, Mr. Prosser agreed to transfer 57,895 shares to William W. Stewart, a Director of the Company, for \$11,000 or \$0.19 per share and 13,158 shares to Apex Financial Services Corp, a company controlled by Mr. Scheidt, for \$2,500 or \$0.19 per share. Finally, Mr. Scheidt agreed to exercise the remaining 118,127 shares of Company common stock under his option from Burlingame at a price of \$0.19 per share for total consideration of \$22,444.

6. Contracts Payable

The Company entered into a consulting contract for financing, structure, and investor services on March 2, 2010 for 800,000 shares of Common Stock valued at \$500,000. The contract was for a period of three years and the fair value of the services were amortized ratably over the service period. Accordingly, the Company recognized a charge to investor relations expense of \$27,778 and \$0 for the six months ended June 30, 2013 and 2014, respectively.

7. Notes and advances payable

Notes payable consist of the following as of December 31, 2013 and June 30, 2014:

	2013	2014
Officers, directors and affiliates:		
Notes and advances payable, interest at 8.0%, due on demand	\$ 14,984	\$ —
Notes and advances payable, interest at 9.7%, due on demand	85,000	—
Note payable, interest at 7.0%, due March 2015	150,000	150,000
Notes payable, interest 7.0%, due January 2017	—	134,295
Notes payable, interest varies (see explanation below)	—	792,151
Collateralized note payable (see below)	714,488	120,728
Total officers, directors and affiliates	964,472	1,197,174

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Less: Current portion of officers, directors, and affiliates	<u>717,833</u>	<u>178,273</u>
Long-term portion of officers, directors, and affiliates	<u>\$246,639</u>	<u>\$1,018,901</u>
Unrelated parties:		
Notes payable, interest at 7.5%, due March 2015	200,000	150,000
Note payable, interest variable (see below)	—	532,641
Notes payable, interest at 7.0%, due January 2015	44,000	—
Notes payable, interest at 7.0%, due January 2015	<u>506,000</u>	<u>268,000</u>
Total unrelated parties	750,000	950,641
Less: Current portion of unrelated parties	<u>325,000</u>	<u>950,641</u>
Long-term portion of unrelated parties	<u>\$425,000</u>	<u>\$ —</u>

On April 29, 2013, the Company executed a promissory note under which the Company agreed to pay Apex Financial Services Corp, a Colorado corporation, (“Apex”) the principal sum of \$1,000,000, with interest accruing at an annual rate of 7.5%, with principal and interest due on May 31, 2014. The Company also agreed to assign 75% of its operating income from its oil and gas operations and any lease or well sale or any other assets sales to Apex to secure the debt. Apex is 100% owned by the CEO, director, and shareholder of the Company, Nicholas L. Scheidt. The Company borrowed the full amount of principal on the note, and also paid a loan fee of \$10,000. In the event of default on the note and failure to cure the default in ten days, Apex may accelerate payment and the annual interest rate on the note will accrue at 18%. Default includes failure to pay the note when due or if the Company borrows any other monies or offers security in the Company or in the collateral securing the note prior to the note being paid in full. The outstanding principal balance as of June 30, 2014 was \$120,728.

On January 28, 2014, we entered into a line of credit loan agreement for \$1,500,000 due January 15, 2015. The terms of the note are as follows: 1) the accrued interest is payable monthly starting February 28, 2014, 2) the interest rate is variable based on an index calculated based on a prime rate as published by the Wall Street Journal index (currently 3.25%) plus an add on index with the current and minimum rate of 6.5%, the note has draw provisions, with the first draw of \$479,701, 4) the note is secured by seven wells and leases owned by the Company, a certificate of deposit for \$500,000 at CityWide Bank pledged by a third party, and 5) the personal guarantee of the Nicholas Scheidt, Chief Executive Officer. The amount eligible for borrowing on the Credit Facility is limited to the lesser of (i) 65% of the Company’s PV10 value of its carbon reserves based upon the most current engineering reserve report or (ii) 48 month cumulative cash flow based upon the most current engineering reserve report. In addition to the borrowing base limitation, the Company is required to maintain and meet certain affirmative and negative covenants and conditions in order to draw advances on the Credit Facility. The Credit Facility contains certain representations, warranties, and affirmative and negative covenants applicable to the Company, which are customarily applicable to senior secured loan facilities. Key covenants include limitations on indebtedness, restricted payments, creation of liens on oil and gas properties, hedging transactions, mergers and consolidations, sales of assets, use of loan proceeds, change in business, and change in control. The above-referenced promissory notes contain customary default and acceleration provisions and provide for a default interest rate of 21% per annum. In addition, the Credit Facility contains customary events of default, including: (a) failure to pay any obligations when due; (b) failure to comply with certain restrictive covenants; (c) false or misleading representations or warranties; (d) defaults of other indebtedness; (e) specified events of bankruptcy, insolvency or similar proceedings; (f) one or more final, non-appealable judgments in excess of \$50,000 that is not covered by insurance; (g) change in control (25% threshold); (h) negative events affecting the Guarantor; and (i) lender in good faith believes itself insecure. In an event of default arising from the specified events, the Credit Facility provides that the commitments thereunder will terminate and the Lender may take such other actions as permitted including, declaring any principal and accrued interest owed on the line of credit to become immediately due and payable. The Credit Facility is secured by a security interest in substantially all of the assets of the Company, pursuant to a Security Agreement, Deed of Trust and Assignment of As-Extracted Collateral entered into between the Company and Citywide Banks. The outstanding principal balance as of June 30, 2014 was \$532,641.

On January 1, 2014, we memorialized our short-term liabilities into formal promissory notes. These certain outstanding advances and other notes payable are now included in single promissory notes, all have been reported previously in our financial statements. Information concerning these promissory notes is set forth in the table below.

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<u>Name of Holder</u>	<u>Position</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>Monthly P&I Payment Amount</u>	<u>Number of Monthly Payments</u>
Donald W. Prosser	CFO & Director	\$28,500	7.00%	\$ 564.33	60
Charles B. Davis	COO & Director	\$66,500	7.00%	\$ 1,316.78	60
William Stewart	Director	\$49,500	7.00%	\$ 980.16	36

The above-referenced promissory notes contain customary default and acceleration provisions and provide for a default interest rate of 18% per annum. The outstanding principal balances as of June 30, 2014 was \$134,295.

In addition, we also issued an unsecured promissory note in the amount of \$792,151 on January 1, 2014 to DNR Oil & Gas, Inc. (“DNR”). DNR is a company controlled by one of our directors, Charles B. Davis. The DNR note accrues interest at the rate of 2.50% for the calendar years 2014 and 2015, 4.00% for the calendar year 2016, 6.00% for the calendar year 2017 and 8.00% for the remainder of the term of the DNR note. The DNR note matures on January 1, 2019. The DNR note requires payments as follows:

- One payment of \$250,000 in 2016;
- One payment of \$250,000 in 2017;
- One payment of \$250,000 in 2018; and
- The balance of principal and accrued interest on or before January 1, 2019.

The DNR note contains customary default and acceleration provisions and provides for a default interest rate of 18% per annum. The outstanding principal balance as of June 30, 2014 was \$792,151.

In June 2013, in connection with the conversions of Series A1 Preferred Stock by Burlingame Equity Investors II, LP and Burlingame Equity Investors Master Fund, LP, the Company issued unsecured promissory notes in the original principal amounts of \$48,000 and \$552,000, respectively, with interest at 7% per annum payable quarterly and all unpaid interest and principal due on July 23, 2014. In connection with our new line of credit, we have agreed with the holders of these two existing notes to make a partial prepayment on the principal balance of the Notes in exchange for an extension of the maturity date to January 27, 2015. Information concerning the principal pay down and new maturity date is set forth in the following table.

<u>Name of Holder</u>	<u>Principal Balance Before Pay down</u>	<u>Principal Pay down</u>	<u>Remaining Principal Balance</u>
Burlingame Equity Investors II, LP	\$ 44,000	\$ 44,000	\$ —
Burlingame Equity Investors Master Fund, LP	\$ 506,000	\$238,000	\$ 268,000

All of the notes payable shown above are unsecured, except the Apex note. Accrued interest on notes and advances payable amounted to \$52,242 as of December 31, 2013 and \$12,998 as of June 30, 2014.

8. Asset retirement obligations (ARO)

A reconciliation of the Company’s asset retirement obligations for the quarter ended June 30, 2014, is as follows:

Balance, December 31, 2013	\$ 682,203
Liabilities incurred	—
Accretion expense	33,130
Revisions to estimate	—
Balance, June 30, 2014	715,333
Less current asset retirement obligations	(162,672)
Long-term asset retirement obligations	<u>\$ 552,661</u>

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

Forward-looking information

This report contains certain "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act of 1934, as amended, that are based on management's exercise of business judgment as well as assumptions made by, and information currently available to, management. When used in this document, the words "may", "will", "anticipate", "believe", "estimate", "expect", "intend", and words of similar import, are intended to identify any forward-looking statements. You should not place undue reliance on these forward-looking statements. These statements reflect our current view of future events and are subject to certain risks and uncertainties as noted below. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, our actual results could differ materially from those anticipated in these forward-looking statements. Although we believe that our expectations are based on reasonable assumptions, we can give no assurance that our expectations will materialize.

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read together with our audited financial statements and related notes included in our Annual Report on Form 10-K and the financial statements and footnotes included in this Quarterly Report on Form 10-Q. This Quarterly Report on Form 10-Q, including the following discussion, contains trend analysis and other forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Any statements in this Quarterly Report on Form 10-Q that are not statements of historical facts are forward-looking statements. These forward-looking statements made herein are based on our current expectations, involve a number of risks and uncertainties and should not be considered as guarantees of future performance. The factors that could cause actual results to differ materially include without limitation:

- unsuccessful drilling and completion activities and the possibility of resulting write-downs;
- capital requirements and uncertainty of obtaining additional funding on terms acceptable to us;
- price volatility of oil and natural gas prices, and the effect that lower prices may have on our earnings and stockholders' equity;
- a decline in oil or natural gas production or oil or natural gas prices, and the impact of general economic conditions on the demand for oil and natural gas and the availability of capital;
- geographical concentration of our operations;
- increases in the cost of drilling, completion and gas gathering or other costs of production and operations;
- our ability to successfully drill wells that produce oil or natural gas in commercially viable quantities;
- failure to meet our proposed drilling schedule;
- adverse variations from estimates of reserves, production, production prices and expenditure requirements, and our inability to replace our reserves through acquisition, exploration and development activities;
- our current level of indebtedness and the effect of any increase in our level of indebtedness;
- limited control over non-operated properties;
- reliance on limited number of customers;
- title defects to our properties and inability to retain our leases;
- our ability to retain key members of our senior management and key consulting resources;
- federal, and state regulations and laws;

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- impact of environmental, health and safety, and other governmental regulations, and of current or pending legislation;
- federal and state legislation and regulatory initiatives relating to hydraulic fracturing;
- risks in connection with evaluating potential acquisitions, integration of significant acquisitions, and difficulty managing our growth and the related demands on our resources;
- developments in the global economy;
- financing and interest rate exposure;
- effects of competition;
- effect of seasonal factors;
- lack of availability of drilling rigs, equipment, supplies, insurance, personnel and oil field services; and
- further sales or issuances of common stock.

Finally, our future results will depend upon various other risks and uncertainties, including, but not limited to, those detailed in the section entitled "Risk Factors" included in our Annual Report on Form 10-K. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements in this section and elsewhere in this report. Other than as required under securities laws, we do not assume a duty to update these forward-looking statements, whether as a result of new information, subsequent events or circumstances, changes in expectations or otherwise

General Overview

It is our desire to provide an understanding of the Company's past performance, its financial condition and its prospects for the future. Accordingly, we will discuss and provide our analysis of the following:

- Critical accounting policies;
- Results of operations;
- Liquidity and capital resources;
- Contractual obligations;
- Off-Balance sheet arrangements;
- New accounting pronouncements.

In the third quarter of 2011, we completed an acquisition of producing oil and natural gas properties in Montana, Wyoming, Colorado and Kansas. These properties include several proved undeveloped and probable drilling opportunities. While we have made progress to implement our business strategy over the past year, we believe our primary challenge over the next few months is to obtain additional financing to exploit existing drilling opportunities and to possibly acquire additional properties. We have sold some of our properties while retaining overriding royalty interests for future upside upon further development of the properties. In addition, we are in the process of reviewing opportunities for the purchase of production and undeveloped oil and gas leases for future development. However, in order to purchase properties or begin substantive drilling activities we must obtain additional financing, which cannot be assured. We rely heavily on the skills of our board members in the fields of business development, capital acquisition, corporate visibility, oil and gas development, geology and operations.

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Critical Accounting Policies

The following discussion and analysis of the results of operations and financial condition are based on the our consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in the United States of America. Our significant accounting policies are more fully described in Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended, December 31, 2013, as supplemented by the Unaudited Notes to Consolidated Financial Statements included herein. However, certain accounting policies and estimates are particularly important to the understanding of our financial position and results of operations and require the application of significant judgment by our management or can be materially affected by changes from period to period in economic factors or conditions that are outside of our control. As a result, they are subject to uncertainty. In applying these policies, our management uses its judgment to determine the appropriate assumptions to be used in the determination of certain estimates. Those estimates are based on our historical experience, our future business plans and projected financial results, the terms of existing contracts, our observance of trends in the oil and gas industry, information provided by our customers and information available from other outside sources, as appropriate. Actual results may differ from these estimates. We believe the following critical accounting policies affect our most significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

We record revenue from the sale of natural gas, natural gas liquids (“NGL”) and crude oil when delivery to the purchaser has occurred and title has transferred. We use the sales method to account for gas imbalances. Under this method, revenue is recorded on the basis of gas actually sold by us. In addition, we will record revenue for our share of gas sold by other owners that cannot be volumetrically balanced in the future due to insufficient remaining reserves. We also reduce revenue for other owners’ gas sold by us that cannot be volumetrically balanced in the future due to insufficient remaining reserves. Our remaining over- and under-produced gas balancing positions are considered in our proved oil and gas reserves. Gas imbalances at June 30, 2014 were not material.

Property and equipment

In January 2010, the Financial Accounting Standards Board (“FASB”) issued authoritative oil and gas reserve estimation and disclosure guidance that was effective for the Company beginning in 2010. This guidance was issued to align the accounting oil and gas reserve estimation and disclosure requirements with the requirements in the SEC final rule, “Modernization of Oil and Gas Reporting”, which was also effective in 2010.

Our oil and gas exploration and production activities are accounted for using the successful efforts method. Under this method, all property acquisition costs and costs of exploratory and development wells are capitalized when incurred, pending determination of whether the well has found proved reserves. If an exploratory well does not find proved reserves, the costs of drilling the well are charged to expense and included within cash flows from investing activities in the consolidated statements of cash flows. The costs of development wells are capitalized whether productive or nonproductive. Oil and gas lease acquisition costs are also capitalized.

Other exploration costs, including certain geological and geophysical expenses and delay rentals for oil and gas leases, are charged to expense as incurred. The sale of a partial interest in a proved property is accounted for as a cost recovery and no gain or loss is recognized as long as this treatment does not significantly affect the unit-of-production DD&A rate. A gain or loss is recognized for all other sales of proved properties and is classified in other operating revenues. Maintenance and repairs are charged to expense, and renewals and betterments are capitalized to the appropriate property and equipment accounts.

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Unevaluated oil and gas property costs are transferred to proved oil and gas properties if the properties are subsequently determined to be productive. Proceeds from sales of partial interests in unproved leases are accounted for as a recovery of cost without recognizing any gain until all costs are recovered. Unevaluated oil and gas properties are assessed periodically for impairment on a property-by-property basis based on remaining lease terms, drilling results, reservoir performance, commodity price outlooks or future plans to develop acreage.

We review our proved oil and gas properties and our gas gathering system for impairment whenever events and circumstances indicate that a decline in the recoverability of their carrying value may have occurred. We estimate the expected undiscounted future cash flows of assets evaluated for impairment and compare such undiscounted future cash flows to the carrying amount of the respective asset to determine if the carrying amount is recoverable. If the carrying amount exceeds the estimated undiscounted future cash flows, we will adjust the carrying amount of the asset to fair value. The factors used to determine fair value include, but are not limited to, recent sales prices of comparable properties, the present value of estimated future cash flows, net of estimated operating and development costs using estimates of reserves, future commodity pricing, future production estimates, anticipated capital expenditures and various discount rates commensurate with the risk and current market conditions associated with realizing the expected cash flows projected.

The provision for DD&A of oil and gas properties is calculated on a field-by-field basis using the unit-of-production method. Natural gas is converted to barrel of oil equivalents ("BOE") at the rate of six Mcf of natural gas to one barrel of oil. Estimated future dismantlement, restoration and abandonment costs, which are net of estimated salvage values, are taken into consideration.

Asset Retirement Obligations

The estimated fair value of the future costs associated with dismantlement, abandonment and restoration of oil and gas properties is recorded generally upon acquisition or completion of a well. The net estimated costs are discounted to present values using a credit-adjusted, risk-free rate over the estimated economic life of the oil and gas properties. Such costs are capitalized as part of the related asset. The asset is depleted on the units-of-production method on a field-by-field basis. The associated liability is classified in current and long-term liabilities in the consolidated balance sheets. The liability is periodically adjusted to reflect (1) new liabilities incurred, (2) liabilities settled during the period, (3) accretion expense and (4) revisions to estimated future cash flow requirements. The accretion expense is recorded as a component of depreciation, depletion and amortization expense in the consolidated statements of operations.

Stock-based Compensation

We have not granted any stock options or warrants during the quarters ended June 30, 2013 and 2014, and no options or warrants were outstanding at any time during 2013 and 2014. We issued shares of common stock for services performed by officers, directors and unrelated parties during 2013 and we expect to issue shares for services in the future. We recorded these transactions based on the value of the services or the value of the common stock, whichever was more readily determinable.

Results of Operations for the Quarters Ended June 30, 2013 and 2014

To date, inflation has not had a material impact on our operations. Presented below is a discussion of our results of operations for the Quarters Ended June 30, 2013 and 2014.

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Oil and Gas Producing Activities

The results of our producing oil and gas properties in Wyoming, Colorado, Kansas and Montana are presented below is a summary of our oil and gas operations for the quarters ended June 30, 2013 and 2014:

	2013	2014
Oil Sales	\$ 398,084	\$ 565,472
Natural Gas Sales	<u>118,183</u>	<u>104,016</u>
Total Revenue	516,267	669,488
Production Taxes	(41,028)	(58,589)
Lease Operating Expense	(153,593)	(208,566)
Depreciation, depletion, amortization and accretion	<u>(150,733)</u>	<u>(162,182)</u>
Net	<u>\$ 170,913</u>	<u>\$ 240,151</u>
Net barrels of oil sold	4,991	6,323
Net mcf of gas sold	21,785	18,168
Average price for oil	<u>\$ 79.76</u>	<u>\$ 89.43</u>
Average price for gas	<u>\$ 5.43</u>	<u>\$ 5.73</u>
Lease operating expense per BOE	<u>\$ 17.81</u>	<u>\$ 22.30</u>
DD&A per BOE	<u>\$ 17.48</u>	<u>\$ 17.34</u>

Our oil sales are primarily attributable to our properties in Kansas and Wyoming. The average oil price for the second quarter of 2013 was \$79.76 per barrel but ranged from a low of \$77.79 for April and a high of \$83.28 for June. The average oil price for the second quarter of 2014 was \$89.94 per barrel but ranged from a low of \$84.68 for April to a high of \$95.36 for May. The average natural gas prices, including proceeds from sales of natural gas liquids, amounted to \$5.43 per Mcf for the second quarter of 2013 and was \$5.73 per Mcf for the second quarter of 2014.

Production taxes were approximately 8% of our oil and gas sales for the second quarters of 2013 and 2014. Lease operating expense averaged \$17.81 per Barrel of Oil Equivalent ("BOE"), whereby six Mcf of gas are equal to one barrel of oil, for the second quarter of 2013. Lease operating expense averaged \$22.30 per Barrel of Oil Equivalent ("BOE") for the same period of 2014. Many of the wells included in our acquisition have been producing for a decade or longer and the cost of workovers and normal maintenance are charged to expense in the period the costs are incurred. For the second quarter of 2013, we incurred approximately \$8,000 for workovers, well service units and repairs which accounted for approximately \$0.96 per BOE of our lease operating expenses that was capitalized based on increased production the wells. For the second quarter of 2014, we incurred approximately \$26,000 for workovers, well service units and repairs which accounted for approximately \$2.78 per BOE that were capitalized.

Under successful efforts accounting, DD&A expense is separately computed for each producing field based on geologic and reservoir delineation. The capital expenditures for proved properties for each field compared to the proved reserves corresponding to each producing field determine a weighted average DD&A rate for current production. Future DD&A rates will be adjusted to reflect future capital expenditures and proved reserve changes in specific areas.

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During the second quarter of 2014 we sold our share of the four new wells in which we participated as a small working interest owner for a promote fee of \$78,815 and we are still participating in a part of each of the well. We expect to periodically evaluate our portfolio of properties and sell additional properties if we believe a sale can be completed on terms that provide attractive returns.

Gas Gathering Activities

We have owned and operated a natural gas gathering system (pipeline and compressor station) for coal bed methane properties in the Powder River Basin of Wyoming since 2006. We had no revenues for the second quarters of 2013 and 2014, due to low natural gas prices which resulted in all wells in the field being shut-in since June 2011.

Presented below is a summary of operating costs for the quarters ended June 30, 2013 and 2014:

	<u>2013</u>	<u>2014</u>
Related party- cost of production	\$ —	\$ —
Unrelated parties:		
Compressor rental	—	—
Pumper costs	—	—
Transportation	—	—
Property taxes	1,275	1,117
Land rent, utilities, repairs and other	<u>2,887</u>	<u>2,268</u>
Total unrelated party costs	<u>4,142</u>	<u>3,385</u>
Total	<u>\$4,142</u>	<u>\$3,385</u>

Depreciation expense related to the gas gathering system was \$11,055 for the second quarter of both 2013 and 2014.

In July 2011, we acquired the entire field of coal bed methane wells as part of our \$11 million acquisition. While these wells are not economic at current prices being received for natural gas related to the production capability from the existing geologic formation, we have geologic and engineering data that suggest substantial gas reserves exist on these properties by drilling new wells and/or recompleting the existing wells to several new geologic formations. We expect to further evaluate these properties and, if warranted, execute our development plans within the next three years in seeking to exploit the value of the properties and the gas gathering system. As of June 30, 2014, the capitalized cost of the coal bed methane leases is \$248,295 and the net capitalized cost of the gas gathering system is \$122,977.

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General and Administrative

Presented below is a summary of general and administrative expenses for the quarters ended June 30, 2013 and 2014:

	<u>2013</u>	<u>2014</u>	<u>Change</u>
Director fees	\$ 900	\$ 450	\$ (450)
Investor relations	44,530	29,621	(14,909)
Legal, auditing and transfer agent	66,300	34,596	(31,704)
Accounting, financial reporting and rent- related party	750	—	(750)
Consulting fees:			
Related parties	30,000	97,500	67,500
Unrelated parties	—	—	—
Other administrative expense	19,192	19,307	115
Depreciation	—	143	143
Total general and administrative expenses	<u>\$161,672</u>	<u>\$181,616</u>	<u>\$(19,944)</u>

General and administrative expenses increased by \$19,944 in 2014 compared to 2013. The management has provided accounting services and all needed administrative services for compliance with regulatory agencies and no cost to the Company. The increase is due to payment of consulting to the CEO, Nicholas Scheidt.

We incur a monthly charge of \$10,000 under an agreement with DNR, whereby executive level expertise is provided for our existing and prospective oil and properties. The total monthly charge under the operating agreement is \$18,000, of which \$8,000 is allocated to lease operating expense. DNR is an affiliate of Charles B. Davis, an executive officer and director of the Company.

The Company in the second quarter of 2014 the board of directors voted to pay Nicholas Scheidt \$90,000 for consulting and management of the Company through December 31, 2014. The Company accrued \$67,500 during the three months ended June 30, 2014.

Income (loss) from operations

Income from operations for the second quarter of 2014 was \$123,873 compared to a loss of \$(5,956) for the second quarter of 2013. The increase in income was primarily due to the gain on sale of oil and gas properties of \$78,815, as well as the items discussed above relating to the oil and natural gas operations, gas gathering activities, and general and administrative expenses.

Interest Expense

Interest expense decreased by \$1,496 in the second quarter of 2014 to \$34,808 from \$36,304 in the second quarter of 2013.

Results of Operations for the Six-Months Ended June 30, 2013 and 2014

To date, inflation has not had a material impact on our operations. Presented below is a discussion of our results of operations for the six-months ended June 30, 2013 and 2014.

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Oil and Gas Producing Activities

Presented below is a summary of our oil and gas operations for the six months ended June 30, 2013 and 2014:

	2013	2014
Oil Sales	\$ 757,878	\$ 950,544
Natural Gas Sales	<u>216,114</u>	<u>214,695</u>
Total Revenue	973,992	1,165,239
Production Taxes	(76,865)	(91,646)
Lease Operating Expense	(341,400)	(369,934)
Depreciation, depletion, amortization and accretion	<u>(323,335)</u>	<u>(291,845)</u>
Net	<u>\$ 232,392</u>	<u>\$ 411,814</u>
Net barrels of oil sold	9,380	11,298
Net mcf of gas sold	42,405	36,234
Average price for oil	<u>\$ 80.80</u>	<u>\$ 84.18</u>
Average price for gas	<u>\$ 5.09</u>	<u>\$ 5.92</u>
Lease operating expense per BOE	<u>\$ 20.83</u>	<u>\$ 21.34</u>
DD&A per BOE	<u>\$ 19.66</u>	<u>\$ 16.84</u>

Our oil sales are primarily attributable to our properties in Kansas and Wyoming. The average oil price for the six months ended June 30, 2013 was \$80.80 per barrel but ranged from a low of \$77.79 for May and a high of \$85.82 for February. The average oil price for the six months ended June 30, 2014 was \$84.18 per barrel but ranged from a low of \$72.68 for January to a high of \$95.36 for May. The average natural gas prices, including proceeds from sales of natural gas liquids, amounted to \$5.09 per Mcf for the six months ended June 30, 2013. Our average natural gas prices, including proceeds from sales of natural gas liquids, amounted to \$5.92 per Mcf for the six months ended June 30, 2014.

Production taxes were approximately 8% of our oil and gas sales for the six months ended June 30, 2013 and 2014. Lease operating expense averaged \$20.83 per Barrel of Oil Equivalent (“BOE”), whereby six Mcf of gas are equal to one barrel of oil, for the six months ended June 30, 2013. Lease operating expense averaged \$21.34 per Barrel of Oil Equivalent (“BOE”) for the same period 2014. Many of the wells included in our acquisition have been producing for a decade or longer and the cost of workovers and normal maintenance are charged to expense in the period the costs are incurred. For the six months ended June 30, 2013, we incurred approximately \$79,000 for workovers, well service units and repairs which accounted for approximately \$4.80 per BOE of our lease operating expenses that was capitalized based on increased production the wells. For the six months ended June 30, 2014, we incurred approximately \$124,000 for workovers, well service units and repairs which accounted for approximately \$7.15 per BOE that were capitalized.

Under successful efforts accounting, DD&A expense is separately computed for each producing field based on geologic and reservoir delineation. The capital expenditures for proved properties for each field compared to the proved reserves corresponding to each producing field determine a weighted average DD&A rate for current production. Future DD&A rates will be adjusted to reflect future capital expenditures and proved reserve changes in specific areas.

During the six months ended June 30, 2014 we sold our share of the four new wells in which we participated as a small working interest owner for a promote fee of \$242,472. We expect to periodically evaluate our portfolio of properties and sell additional properties if we believe sales can be completed on terms that provide attractive returns.

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Gas Gathering Activities

We have owned and operated a natural gas gathering system (pipeline and compressor station) for coal bed methane properties in the Powder River Basin of Wyoming since 2006. We had no revenues for the six months ended June 30, 2013 and 2014, due to low natural gas prices which resulted in all wells in the field being shut-in since June 2011.

Presented below is a summary of operating costs for the six months ended June 30, 2013 and 2014:

	<u>2013</u>	<u>2014</u>
Related party- cost of production	\$ —	\$ —
Unrelated parties:		
Compressor rental	—	—
Pumper costs	—	—
Transportation	—	—
Property taxes	2,550	2,235
Land rent, utilities, repairs and other	5,135	5,135
Total unrelated party costs	7,185	7,370
Total	<u>\$9,685</u>	<u>\$7,370</u>

Depreciation expense related to the gas gathering system was \$22,110 for the six months ended June 30, 2013 and 2014.

In July 2011, we acquired the entire field of coal bed methane wells as part of our \$11 million acquisition. While these wells are not economic at current prices being received for natural gas related to the production capability from the existing geologic formation, we have geologic and engineering data that suggest substantial gas reserves exist on these properties by drilling new wells and/or recompleting the existing wells to several new geologic formations. We expect to further evaluate these properties and, if warranted, execute our development plans within the next three years in seeking to exploit the value of the properties and the gas gathering system. As of June 30, 2014, the capitalized cost of the coal bed methane leases is \$248,295 and the net capitalized cost of the gas gathering system is \$122,977.

General and Administrative

Presented below is a summary of general and administrative expenses for the quarters ended June 30, 2013 and 2014:

	<u>2013</u>	<u>2014</u>	<u>Change</u>
Director fees	\$ 1,350	\$ 450	\$ (900)
Investor relations	75,427	35,186	(40,241)
Legal, auditing and transfer agent	96,890	78,644	(18,246)
Accounting, financial reporting and rent- related party	1,500	—	(1,500)
Consulting fees:			
Related parties	60,000	127,500	67,500
Unrelated parties	—	—	—
Other administrative expense	40,562	41,082	520
Depreciation	285	285	—
Total general and administrative expenses	<u>\$276,014</u>	<u>\$151,617</u>	<u>\$ 7,133</u>

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General and administrative expenses increased by \$7,133 in 2014 compared to 2013. The management has provided accounting services and all needed administrative services for compliance with regulatory agencies and no cost to the Company.

We incur a monthly charge of \$10,000 under an agreement with DNR, whereby executive level expertise is provided for our existing and prospective oil and properties. The total monthly charge under the operating agreement is \$18,000, of which \$8,000 is allocated to lease operating expense. DNR is an affiliate of Charles B. Davis, an executive officer and director of the Company.

In the second quarter of 2014 the board of directors voted to pay Nicholas Scheidt \$90,000 for consulting and management of the Company through December 31, 2014. The Company accrued \$67,500 during the three months ended June 30, 2014.

Income (loss) from operations

Income from operations for the six months ended June 30, 2014 was \$343,429 compared to a loss of \$(72,468) for the six months ended June 30, 2013 primarily due to the gain on sale of oil and gas properties of \$242,472, as well as the items discussed above relating to the oil and natural gas operations, gas gathering activities, and general and administrative expenses.

Interest Expense

Interest expense increased by \$8,178 for the six months ended June 30, 2014 to \$69,978, from \$61,800 for the six months ended June 30, 2013 due to increased borrowing.

Liquidity and Capital Resources

We had a working capital deficit as of June 30, 2014 of \$1,295,732, compared to a working capital deficit of \$619,426 at December 31, 2013. The approximate \$700,000 increase in our working capital deficit resulted from a decrease in cash from redeeming common stocks capital expenditures, an increase in current liabilities after restructure the Company's debt, reduced by operating profits.

We generated positive operating cash flow of \$600,381 for the six months ended June 30, 2014 compared to operating cash flow (used in) of \$(67,267) for the six months ended June 30, 2013.

For the six months ended June 30, 2014, we (used) \$(429,269) of cash flows related to investing activities for capital expenditures. For the six months ended June 30, 2013, we (used) \$(188,161) of cash flows related to investing activities for capital expenditures.

For the six months ended June 30, 2013, the financing activities provided net cash flow of \$248,925. For the six months ended June 30, 2014, we had net cash financing activities that (used) \$(631,125) as we borrowed \$532,641, repaid borrowings of \$935,766 and redeemed common stock for \$228,000.

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Part of our strategy is to monitor the current production of our properties, seek to develop them with infield drilling, and explore sales and purchases of additional leases and operating wells with upside. We are currently evaluating several opportunities for drilling in Wyoming and Colorado. In 2014 we entered into participating agreements for four wells in Wyoming. The Company has participated as a working interest owner in four horizontal wells to be drilled in Campbell County, Wyoming in the Turner zone. The following is a description of the wells:

- 1) The Thielen #1-21 is in Section 21 Township 43N. This well was drilled to a total depth of approximately 15,350 feet including the lateral. The Company has an approximate 1.06% working interest.
- 2) The Thielen #2-21 is in Section 21 Township 43N. This well was drilled to a total depth of approximately 15,330 feet including the lateral. The Company will has an approximate 1.06% working interest.
- 3) The Starlight Federal 28H is located in Section 7, Township 43N. This well was drilled to a total depth of approximately 15,310 feet including the lateral. The Company will has an approximate 0.7025% working interest.
- 4) The Starlight Federal 30H is located in Section 7, Township 43N. This well was drilled to a total depth of approximately 15,310 feet including the lateral. The Company has an approximate 1.45% working interest

Three of these wells have begun producing. The fourth well has been completed, the information is being evaluated and we are not certain when production will commence.

As of June 30, 2014, we had cash and equivalents of approximately \$16,000 and approximately \$490,000 in receivables due from oil and natural gas operations in the next 60 days. We have a working capital loan for \$1,500,000 and we have borrowed \$550,000 and have a \$950,000 available to use for growth. We also expect to evaluate acquisitions that are consistent with our business objective of acquiring interests in traditional oil and gas ventures, and seeking properties that offer profit potential from overlooked and by-passed reserves of oil and natural gas.

In order to execute our plan to acquire additional interests in oil and gas properties that meet our objectives, we need additional financing in addition to our working capital loan above. From the time we acquired our existing properties in the third quarter of 2011, we have sold our interests in some of those properties, which resulted in aggregate net proceeds from three sales of \$6,377,000, which was used to repay acquisition indebtedness. We intend to only sell properties that can be liquidated for an attractive premium and there can be no assurance that we will continue to generate any proceeds from the sale of our properties.

If oil and gas prices decrease materially from current levels and additional debt or equity funding is unavailable on acceptable terms, or at all, our strategy would include some or all of the following: (i) defer drilling on our existing properties, (ii) forego additional oil and gas property acquisitions, (iii) shut-in any marginal or uneconomic wells, (iv) attempt to negotiate the issuance of common stock in exchange for services, and (v) review and implement other opportunities to reduce general, administrative and operating expenses.

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Contractual Obligations and Commercial Commitments

As of June 30, 2014, we have future minimum lease payments of approximately \$6,000. This amount is payable during the years ending June 30, 2015, 2016, 2017, 2018 and after 2019 in the amounts of \$1,000 each year respectively.

Off-Balance Sheet Arrangements

In connection with the related party acquisition of oil and gas properties in the third quarter of 2011, we acquired interests in certain geologic zones of the properties. The Colorado and Kansas properties provide for additional consideration that is payable to the related party sellers if proved producing reserves are increased relating to these properties through drilling or recompletion activities over a period of ten years after the closing date. First to the extent that oil reserves increase, the sellers are entitled to additional consideration of \$250,000 for each increase of 20,000 net barrels. Second, to the extent that oil and gas prices increase, the sellers are entitled to additional consideration as the targeted price thresholds are exceeded for periods of 61 days. The increase in purchase price for the Kansas and Colorado properties is limited to a maximum of \$5 million.

The acquired properties that are located in Wyoming and Montana provide a similar formula as used for the Colorado and Kansas properties that could result in an obligation for additional purchase consideration to the extent that we perform future drilling or recompletion activities in formations that were not producing as of the September 29, 2011 closing date. Furthermore, if we sell properties where reserves have been proved up through drilling or recompletion, the sellers have retained an interest of 70% in the net sales proceeds (after we receive a recovery of 125% of the original purchase allocation in the amended and restated purchase agreement). The increase in purchase price for all properties (Colorado, Kansas, Wyoming and Montana) is limited to a maximum of \$25 million.

Due to consideration retained by the related party sellers from sales of properties through the first quarter of 2012, and \$250,000 of consideration payable in December 2012 due to a sustained increase in oil prices over \$100 per barrel, and the sale of a third property in December the maximum future consideration has been reduced by approximately \$5.8 million to \$19.2 million as of June 30, 2014.

SEC Formal Investigation

The Denver Regional Office of the Securities and Exchange Commission is conducting a non-public, formal, investigation (“SEC Investigation”) to determine whether there have been violations of certain provisions of the federal securities laws relating to the Company, its management and third parties. The principal areas of the SEC Investigation relate to the sale of certain Company securities, possible trading manipulation activities with respect to the Company’s common stock, and potential violations of the federal broker-dealer registration laws by persons or entities in connection with the purchase or sale of the Company’s securities. To date, neither the Company nor any of its directors, officers, or employees have been accused of any wrongdoing by the SEC. We also have been informed by the SEC that the existence of this investigation does not mean that the SEC has concluded that anyone has violated the law or that the SEC has a negative opinion of any person, entity, or security. We have been cooperating fully with the SEC. We cannot reasonably estimate the timing of the SEC Investigation, nor can we predict whether or not it might have a material adverse effect on our business.

New Accounting Pronouncements

In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*. The objective of ASU 2013-11 is to provide guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. ASU 2013-11 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this standard will not have an impact on the Company’s consolidated financial statements.

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Other accounting standards that have been issued or proposed by the FASB, or other standards-setting bodies, that do not require adoption until a future date are not expected to have a material impact on the financial statements upon adoption.

Item 3 - Quantitative and Qualitative Disclosures about Market Risk

The Company is a “Smaller Reporting Company” as defined by Rule 229.10 (f)(1) and is not required to provide or disclose the information required by this item.

Item 4 - Controls and Procedures

As of June 30, 2014, our Chief Executive Officer and Chief Financial Officer (the “Certifying Officers”) conducted evaluations of our disclosure controls and procedures. As defined under Sections 13a-15(e) and 15d-15(e) of the Exchange Act, the term “disclosure controls and procedures” means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer’s management, including the Certifying Officers, to allow timely decisions regarding required disclosure. Based on this evaluation, the Certifying Officers have concluded that our disclosure controls and procedures were not effective to ensure that material information is recorded, processed, summarized and reported by our management on a timely basis in order to comply with our disclosure obligations under the Exchange Act and the rules and regulations promulgated thereunder. As discussed in our Annual Report on Form 10-K for the year ended December 31, 2013, the ineffectiveness of our disclosure controls and procedures is due primarily to (i) our Board of Directors does not currently have any independent members that qualify as an audit committee financial expert, (ii) we have not developed and effectively communicated our accounting policies and procedures, and (iii) our controls over financial statement disclosures were determined to be ineffective.

Further, there were no changes in our internal control over financial reporting during the second fiscal quarter that has materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings.

From time to time, the Company is a party to routine litigation and proceedings that are considered part of the ordinary course of its business. The Company is not aware of any material current, pending, or threatened litigation.

Item 1A - Risk Factors.

There have been no material changes to the risk factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the SEC on April 14, 2014. The risk factors in our Annual Report on Form 10-K for the year ended December 31, 2013, in addition to the other information set forth in this quarterly report, could materially affect our business, financial condition or results of operations. Additional risks and uncertainties not currently known to us or that we deem to be immaterial could also materially adversely affect our business, financial condition or results of operations.

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

None

Item 3 - Defaults upon Senior Securities.

None

Item 4 - Mine Safety Disclosures.

Not Applicable

Item 5 - Other Information.

None

Item 6 - Exhibits

The following documents are filed as exhibits to this report on Form 10-Q or incorporated by reference herein.

- 31.1 Certification of the Principal Executive Officer pursuant to §302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Principal Financial Officer pursuant to §302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Principal Executive Officer pursuant to 18 U.S.C. Section 1350.
- 32.2 Certification of the Principal Financial Officer pursuant to 18 U.S.C. Section 1350.
- 101 The following materials are filed herewith: (i) XBRL Instance, (ii) XBRL Taxonomy Extension Schema, (iii) XBRL Taxonomy Extension Calculation, (iv) XBRL Taxonomy Extension Labels, (v) XBRL Taxonomy Extension Presentation, and (vi) XBRL Taxonomy Extension Definition. In accordance with Rule 406T of Regulation S-T, the information in these exhibits is furnished and deemed not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Exchange Act of 1934, and otherwise is not subject to liability under these sections and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by the specific reference in such filing.

ARÊTE INDUSTRIES, INC.

SIGNATURES

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

By: /s/ Nicholas Scheidt, CEO
Nicholas L Scheidt, Principal Executive Officer
Dated: August 14, 2014

By: /s/ Donald W. Prosser, CFO
Donald W. Prosser, Principal Financial and Accounting Officer
Dated: August 14, 2014

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Nicholas L. Scheidt, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arête Industries, Inc.
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The small business issuer's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the small business issuer and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, including any consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

Dated: August 14, 2014

By: /s/ Nicholas L. Scheidt
Nicholas L. Scheidt, Chief Executive Officer

CERTIFICATION OF PRINCIPAL ACCOUNTING OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Donald W. Prosser, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arête Industries, Inc.
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The small business issuer's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the small business issuer and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the small business issuer, including any consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the small business issuer's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and
5. The small business issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

Dated: August 14, 2014

By: /s/ Donald W. Prosser

Donald W. Prosser, Chief Financial Officer

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Arête Industries, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2014, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Nicholas Scheidt, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Dated: August 14, 2014

By: /s/ Nicholas L. Scheidt

Nicholas L. Scheidt, Chief Executive Officer

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Arête Industries, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2014, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Donald W. Prosser, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Dated: August 14, 2014

By: /s/ Donald W. Prosser

Donald W. Prosser, Chief Financial Officer