

LOWES COMPANIES INC
Form 10-Q
December 06, 2006

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

FORM 10-Q

x

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

For the quarterly period ended November 3, 2006

Commission file number 1-7898

LOWE'S COMPANIES, INC.

(Exact name of registrant as specified in its charter)

NORTH CAROLINA

(State or other jurisdiction of incorporation or
organization)

56-0578072

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

1000 Lowe's Blvd., Mooresville, NC

(Address of principal executive offices)

28117

(Zip Code)

Registrant's telephone number, including area
code

(704) 758-1000

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.

x Yes o No

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

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

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

o Yes x No

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

| CLASS | OUTSTANDING AT DECEMBER 1, 2006 |
|-------------------------------|--|
| Common Stock, \$.50 par value | 1,522,786,382 |

LOWE'S COMPANIES, INC.

- INDEX -

| PART I - Financial Information | | Page No. |
|--------------------------------|--|----------|
| Item 1. | Financial Statements | |
| | <u>Consolidated Balance Sheets (Unaudited)</u> <u>- November 3, 2006, October 28, 2005, as</u> <u>restated, and February 3, 2006</u> | 3 |
| | <u>Consolidated Statements of Current and</u> <u>Retained Earnings (Unaudited) - Three</u> <u>and nine months ended November 3, 2006</u> <u>and October 28, 2005, as restated</u> | 4 |
| | <u>Consolidated Statements of Cash Flows</u> <u>(Unaudited) - Nine months ended</u> <u>November 3, 2006 and October 28, 2005,</u> <u>as restated</u> | 5 |
| | <u>Notes to Consolidated Financial</u> <u>Statements (Unaudited)</u> | 6-15 |
| | <u>Report of Independent Registered Public</u> <u>Accounting Firm</u> | 16 |
| Item 2. | <u>Management's Discussion and Analysis of</u> <u>Financial Condition and Results of</u> <u>Operations</u> | 17-23 |
| Item 3. | <u>Quantitative and Qualitative Disclosures</u> <u>about Market Risk</u> | 23 |
| Item 4. | <u>Controls and Procedures</u> | 23 |
| PART II - Other Information | | |
| Item 1A. | <u>Risk Factors</u> | 24 |
| Item 2. | <u>Unregistered Sales of Equity Securities and</u> <u>Use of Proceeds</u> | 24 |
| Item 6. | <u>Exhibits</u> | 25 |
| | <u>Signature</u> | 26 |
| | <u>Exhibit Index</u> | 27 |

Part I - FINANCIAL INFORMATION**Item 1. Financial Statements****Lowe's Companies, Inc.****Consolidated Balance****Sheets (Unaudited)**

In Millions, Except Par

Value Data

| | November 3, 2006 | October 28, 2005 As Restated | February 3, 2006 |
|---|---------------------|------------------------------------|---------------------|
| Assets | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ 657 | \$ 1,445 | \$ 423 |
| Short-term investments | 464 | 864 | 453 |
| Merchandise inventory - net | 7,219 | 6,429 | 6,635 |
| Deferred income taxes - net | 157 | 104 | 155 |
| Other current assets | 125 | 200 | 122 |
| Total current assets | 8,622 | 9,042 | 7,788 |
| Property, less accumulated depreciation | 18,188 | 15,410 | 16,354 |
| Long-term investments | 121 | 296 | 294 |
| Other assets | 242 | 205 | 203 |
| Total assets | \$ 27,173 | \$ 24,953 | \$ 24,639 |
| Liabilities and shareholders' equity | | | |
| Current liabilities: | | | |
| Current maturities of long-term debt | \$ 89 | \$ 632 | \$ 32 |
| Accounts payable | 3,416 | 3,201 | 2,832 |
| Accrued salaries and wages | 373 | 369 | 424 |
| Self-insurance liabilities | 616 | 551 | 571 |
| Deferred revenue | 846 | 748 | 709 |
| Other current liabilities | 1,374 | 1,109 | 1,264 |
| Total current liabilities | 6,714 | 6,610 | 5,832 |
| | 4,337 | 3,749 | 3,499 |

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Long-term debt, excluding
current maturities

| | | | |
|--------------------------------|-----|-----|-----|
| Deferred income taxes - net | 683 | 745 | 735 |
| Other long-term liabilities | 353 | 290 | 277 |

| | | | |
|--------------------------|---------------|---------------|---------------|
| Total liabilities | 12,087 | 11,394 | 10,343 |
|--------------------------|---------------|---------------|---------------|

Shareholders' equity:

| | | | |
|---|---|---|---|
| Preferred stock - \$5 par value, none issued | - | - | - |
|---|---|---|---|

Common stock - \$.50 par
value;

| | | | |
|----------------------------------|--|--|--|
| Shares issued and outstanding | | | |
|----------------------------------|--|--|--|

| | | | |
|------------------|-------|--|--|
| November 3, 2006 | 1,520 | | |
|------------------|-------|--|--|

| | | | |
|------------------|-------|--|--|
| October 28, 2005 | 1,560 | | |
|------------------|-------|--|--|

| | | | | |
|------------------|-------|-----|-----|-----|
| February 3, 2006 | 1,568 | 760 | 780 | 784 |
|------------------|-------|-----|-----|-----|

| | | | |
|-----------------------------------|---|-------|-------|
| Capital in excess of par value | - | 1,235 | 1,320 |
|-----------------------------------|---|-------|-------|

| | | | |
|-------------------|--------|--------|--------|
| Retained earnings | 14,323 | 11,544 | 12,191 |
|-------------------|--------|--------|--------|

| | | | |
|---|---|---|---|
| Accumulated other comprehensive income | 3 | - | 1 |
|---|---|---|---|

| | | | |
|---------------------------------------|---------------|---------------|---------------|
| Total shareholders' equity | 15,086 | 13,559 | 14,296 |
|---------------------------------------|---------------|---------------|---------------|

| | | | |
|---|------------------|------------------|------------------|
| Total liabilities and shareholders' equity | \$ 27,173 | \$ 24,953 | \$ 24,639 |
|---|------------------|------------------|------------------|

See accompanying notes to the unaudited consolidated financial statements.

**Lowe's
Companies, Inc.
Consolidated Statements of Current and
Retained Earnings (Unaudited)**

In Millions,
Except Per Share
Data

| | Three Months Ended | | | | Nine Months Ended | | | |
|-------------------------------------|--------------------|----------------|---------------------------------|----------------|-------------------|----------------|---------------------------------|----------------|
| | November 3, 2006 | | October 28, 2005 As Restated | | November 3, 2006 | | October 28, 2005 As Restated | |
| Current Earnings | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent |
| Net sales | \$ 11,211 | 100.00 | \$ 10,592 | 100.00 | \$ 36,522 | 100.00 | \$ 32,435 | 100.00 |
| Cost of sales | 7,346 | 65.53 | 7,012 | 66.20 | 24,011 | 65.74 | 21,430 | 66.07 |
| Gross margin | 3,865 | 34.47 | 3,580 | 33.80 | 12,511 | 34.26 | 11,005 | 33.93 |
| Expenses: | | | | | | | | |
| Selling, general and administrative | 2,320 | 20.70 | 2,212 | 20.88 | 7,404 | 20.27 | 6,711 | 20.69 |
| Store opening costs | 44 | 0.39 | 35 | 0.33 | 97 | 0.27 | 85 | 0.26 |
| Depreciation | 297 | 2.65 | 246 | 2.32 | 854 | 2.34 | 718 | 2.21 |
| Interest - net | 45 | 0.40 | 36 | 0.34 | 110 | 0.30 | 122 | 0.38 |
| Total expenses | 2,706 | 24.14 | 2,529 | 23.87 | 8,465 | 23.18 | 7,636 | 23.54 |
| Pre-tax earnings | 1,159 | 10.33 | 1,051 | 9.93 | 4,046 | 11.08 | 3,369 | 10.39 |
| Income tax provision | 443 | 3.94 | 405 | 3.83 | 1,554 | 4.26 | 1,297 | 4.00 |
| Net earnings | \$ 716 | 6.39 | \$ 646 | 6.10 | \$ 2,492 | 6.82 | \$ 2,072 | 6.39 |
| Weighted average shares outstanding | | | | | | | | |
| - basic | 1,522 | | 1,559 | | 1,540 | | 1,552 | |
| Basic earnings per share | \$ 0.47 | | \$ 0.41 | | \$ 1.62 | | \$ 1.34 | |
| | 1,551 | | 1,608 | | 1,571 | | 1,608 | |

Weighted average
shares outstanding
- diluted

| | | | | |
|---------------------------------------|----------------|----------------|----------------|----------------|
| Diluted earnings per share | \$ 0.46 | \$ 0.40 | \$ 1.59 | \$ 1.29 |
|---------------------------------------|----------------|----------------|----------------|----------------|

| | | | | |
|-------------------------------------|----------------|----------------|----------------|----------------|
| Cash dividends per share | \$ 0.05 | \$ 0.03 | \$ 0.13 | \$ 0.08 |
|-------------------------------------|----------------|----------------|----------------|----------------|

Retained Earnings

| | | | | |
|--------------------------------------|-----------|-----------|-----------|-----------|
| Balance at beginning of period | \$ 13,843 | \$ 10,944 | \$ 12,191 | \$ 9,597 |
| Net earnings | 716 | 646 | 2,492 | 2,072 |
| Cash dividends | (76) | (46) | (200) | (125) |
| Share repurchases | (160) | - | (160) | - |
| Balance at end of period | \$ 14,323 | \$ 11,544 | \$ 14,323 | \$ 11,544 |

See accompanying notes to the unaudited consolidated financial statements.

Lowe's Companies, Inc.
Consolidated Statements of Cash Flows (Unaudited)
In Millions

| | Nine Months Ended | |
|---|--------------------------|--------------------|
| | November 3, | October 28, |
| | 2006 | 2005 |
| | | As Restated |
| Cash flows from operating activities: | | |
| Net earnings | \$ 2,492 | \$ 2,072 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 907 | 771 |
| Deferred income taxes | (54) | 24 |
| Loss on disposition/writedown of fixed and other assets | 35 | 23 |
| Share-based payment expense | 56 | 57 |
| Changes in operating assets and liabilities: | | |
| Merchandise inventory - net | (584) | (579) |
| Other operating assets | (26) | (116) |
| Accounts payable | 584 | 506 |
| Other operating liabilities | 233 | 602 |
| Net cash provided by operating activities | 3,643 | 3,360 |
| Cash flows from investing activities: | | |
| Purchases of short-term investments | (248) | (1,581) |
| Proceeds from sale/maturity of short-term investments | 490 | 1,083 |
| Purchases of long-term investments | (225) | (249) |
| Proceeds from sale/maturity of long-term investments | 141 | 10 |
| Increase in other long-term assets | (8) | (34) |
| Fixed assets acquired | (2,724) | (2,277) |
| Proceeds from the sale of fixed and other long-term assets | 30 | 44 |
| Net cash used in investing activities | (2,544) | (3,004) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of long-term debt | 991 | 987 |
| Repayment of long-term debt | (24) | (23) |
| Proceeds from issuance of common stock under employee stock purchase plan | 36 | 32 |
| Proceeds from issuance of common stock from stock options exercised | 64 | 183 |
| Cash dividend payments | (200) | (125) |
| Repurchase of common stock | (1,737) | (495) |
| Excess tax benefits of share-based payments | 5 | - |
| Net cash (used in) provided by financing activities | (865) | 559 |
| Net increase in cash and cash equivalents | 234 | 915 |
| Cash and cash equivalents, beginning of period | 423 | 530 |
| Cash and cash equivalents, end of period | \$ 657 | \$ 1,445 |

See accompanying notes to the unaudited consolidated financial statements.

Lowe's Companies, Inc.
Notes to Consolidated Financial Statements (Unaudited)

Note 1: Basis of Presentation - The accompanying Consolidated Financial Statements (Unaudited) and notes are presented in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) and do not include all the disclosures normally required in annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America. The Consolidated Financial Statements (Unaudited), in the opinion of management, contain all adjustments necessary to present fairly the financial position as of November 3, 2006 and October 28, 2005, the results of operations for the three and nine months ended November 3, 2006 and October 28, 2005, and cash flows for the nine months ended November 3, 2006 and October 28, 2005.

These interim unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Lowe's Companies, Inc. (the Company) Annual Report on Form 10-K, for the fiscal year ended February 3, 2006, as amended on Form 10-K/A (the Annual Report). The financial results for the interim periods may not be indicative of the financial results for the entire fiscal year.

Certain prior interim period amounts have been reclassified to conform to current classifications. Self-insurance liabilities and deferred revenues are separately presented on the consolidated balance sheets and were reclassified from other current liabilities. The Company also reclassified depreciation expense associated with its distribution network from depreciation expense to cost of sales on the consolidated statements of earnings.

The Company's Board of Directors approved a 2-for-1 stock split of its common shares on May 25, 2006. The stock split was effective June 30, 2006 to shareholders of record on June 16, 2006. The par value of the Company's common stock remained at \$0.50 per share. The par value of the additional shares issued to effect the stock split totaling \$384 million was reclassified from Capital in Excess of Par Value to Common Stock on the Company's consolidated balance sheet. All prior period common share and per common share amounts have been retroactively adjusted to reflect the 2-for-1 stock split.

Note 2: Restatement - During the first quarter of 2006, management reviewed the Company's method of accounting for early payment discounts on merchandise purchases and determined it should recognize these discounts initially as a reduction of inventory cost and then as a reduction to cost of sales when the related inventory is sold in accordance with Emerging Issues Task Force Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor." The Company previously recognized early payment discounts as a financing component of merchandise purchases by reducing cost of sales when the related product was purchased. Prior period financial statements have been restated for the timing of recognition of early payment discounts. The restatement for the timing of recognition of early payment discounts did not affect total operating, investing or financing cash flows.

The following tables summarize the effects of the restatement on the Company's consolidated balance sheet as of October 28, 2005, as well as the related effects on the Company's consolidated statements of earnings for the three and nine month periods ended October 28, 2005.

Consolidated Balance Sheet

| | October 28, 2005 | | October 28, 2005 |
|---|--|----------------|---------------------|
| (In Millions) | As Previously Reported ⁽¹⁾ | Adjustments | As Restated |
| Merchandise inventory - net | \$ 6,499 | \$ (70) | \$ 6,429 |
| Deferred income taxes - net | 76 | 28 | 104 |
| Total current assets | 9,084 | (42) | 9,042 |
| Total assets | \$ 24,995 | \$ (42) | \$ 24,953 |
| Retained earnings | 11,586 | (42) | 11,544 |
| Total shareholders' equity | 13,601 | (42) | 13,559 |
| Total liabilities and shareholders' equity | \$ 24,995 | \$ (42) | \$ 24,953 |

Consolidated Statement of Earnings

| | October 28, 2005 | | October 28, 2005 |
|--------------------------------------|--|------------------|---------------------|
| Three Months Ended | As Previously Reported ⁽¹⁾ | Adjustments | As Restated |
| (In Millions, Except Per Share Data) | | | |
| Cost of sales | \$ 7,008 | \$ 4 | \$ 7,012 |
| Gross margin | 3,584 | (4) | 3,580 |
| Pre-tax earnings | 1,055 | (4) | 1,051 |
| Income tax provision | 406 | (1) | 405 |
| Net earnings | \$ 649 | \$ (3) | \$ 646 |
| Basic earnings per share | \$ 0.42 | \$ (0.01) | \$ 0.41 |
| Diluted earnings per share | \$ 0.41 | \$ (0.01) | \$ 0.40 |

Consolidated Statement of Earnings

| | October 28, 2005 | | October 28, 2005 |
|--------------------------------------|---|------------------|---------------------|
| Nine Months Ended | As Previously Reported ⁽¹⁾ | Adjustments | As Restated |
| (In Millions, Except Per Share Data) | | | |
| Cost of sales | \$ 21,422 | \$ 8 | \$ 21,430 |
| Gross margin | 11,013 | (8) | 11,005 |
| Pre-tax earnings | 3,377 | (8) | 3,369 |
| Income tax provision | 1,300 | (3) | 1,297 |
| Net earnings | \$ 2,077 | \$ (5) | \$ 2,072 |
| Basic earnings per share | \$ 1.34 | \$ - | \$ 1.34 |
| | \$ 1.30 | \$ (0.01) | \$ 1.29 |

**Diluted earnings per
share**

⁽¹⁾ Certain amounts have been reclassified to conform to current classifications. Refer to Note 1 of the notes to consolidated financial statements (unaudited).

7

Note 3: Earnings Per Share - Basic earnings per share (EPS) excludes dilution and is computed by dividing the applicable net earnings by the weighted-average number of common shares outstanding for the period. Diluted earnings per share is calculated based on the weighted-average shares of common stock as adjusted for the potential dilutive effect of share-based awards and convertible notes as of the balance sheet date. The following table reconciles EPS for the three and nine months ended November 3, 2006 and October 28, 2005.

| (In Millions, Except Per Share Data) | Three Months Ended | | Nine Months Ended | |
|--|--------------------|------------------|-------------------|------------------|
| | November 3, 2006 | October 28, 2005 | November 3, 2006 | October 28, 2005 |
| Net earnings | \$ 716 | \$ 646 | \$ 2,492 | \$ 2,072 |
| Weighted average shares outstanding | 1,522 | 1,559 | 1,540 | 1,552 |
| Basic earnings per share | \$ 0.47 | \$ 0.41 | \$ 1.62 | \$ 1.34 |
| Diluted earnings per share: | | | | |
| Net earnings | \$ 716 | \$ 646 | \$ 2,492 | \$ 2,072 |
| Net earnings adjustment for interest on convertible debt, net of tax | 1 | 3 | 3 | 9 |
| Net earnings, as adjusted | \$ 717 | \$ 649 | \$ 2,495 | \$ 2,081 |
| Weighted average shares outstanding | 1,522 | 1,559 | 1,540 | 1,552 |
| Dilutive effect of stock options | 8 | 9 | 8 | 9 |
| Dilutive effect of convertible debt | 21 | 40 | 23 | 47 |
| Weighted average shares, as adjusted | 1,551 | 1,608 | 1,571 | 1,608 |
| Diluted earnings per share | \$ 0.46 | \$ 0.40 | \$ 1.59 | \$ 1.29 |

Stock options to purchase 11.3 million and 5.6 million shares of common stock for the three month periods ended November 3, 2006 and October 28, 2005, respectively, were excluded from the computation of diluted earnings per share because their effect would have been anti-dilutive. Stock options to purchase 10.7 million and 5.2 million shares of common stock for the nine month periods ended November 3, 2006 and October 28, 2005, respectively, were excluded from the computation of diluted earnings per share because their effect would have been anti-dilutive.

Note 4: Restricted Investment Balances - Short-term and long-term investments include restricted balances pledged as collateral for letters of credit for the Company's extended warranty program and for a portion of the Company's casualty insurance and installed sales program liabilities. Restricted balances included in short-term investments were \$220 million at November 3, 2006, \$154 million at October 28, 2005, and \$152 million at February 3, 2006. Restricted balances included in long-term investments were \$42 million at November 3, 2006, \$43 million at October 28, 2005, and \$74 million at February 3, 2006.

Note 5: Property - Property is shown net of accumulated depreciation of \$5.9 billion at November 3, 2006, \$4.8 billion at October 28, 2005, and \$5.1 billion at February 3, 2006.

Note 6: Long-Term Debt - In October 2006, the Company issued \$1 billion of unsecured senior notes, comprised of two tranches: \$550 million of 5.4% Senior Notes maturing in October 2016 and \$450 million of 5.8% Senior Notes maturing in October 2036 (collectively, the "Senior Notes"). The 5.4% Senior Notes and the 5.8% Senior Notes were

each issued at a discount of approximately \$4.4 million. Interest on the Senior Notes is payable semiannually in arrears in April and October of each year until maturity, beginning in April 2007. The discount associated with the issuance is included in long-term debt and is being amortized over the respective terms of the Senior Notes. Issuance costs were approximately \$1.6 million and are being amortized over the respective terms of the Senior Notes. The net proceeds of approximately \$991 million were used for general corporate purposes, including capital expenditures and working capital needs, and to finance repurchases of our common stock.

The Senior Notes may be redeemed by the Company at any time, in whole or in part, at a redemption price plus accrued interest to the date of redemption. The redemption price is equal to the greater of (1) 100% of the principal amount of the Senior Notes to be redeemed, or (2) the sum of the present values of the remaining scheduled payments of principal and interest thereon, discounted to the date of redemption on a semi-annual basis at a specified rate. The indenture governing the Senior Notes does not limit the aggregate principal amount of debt securities that the Company may issue, nor is the Company required to

maintain financial ratios or specified levels of net worth or liquidity. However, the indenture contains various restrictive covenants, none of which is expected to impact the Company's liquidity or capital resources.

Note 7: Supplemental Disclosure

Net interest expense is comprised of the following:

| (In Millions) | Three Months Ended | | Nine Months Ended | |
|-----------------------------|---------------------|------------------------|---------------------|------------------------|
| | November 3, 2006 | October 28, 2005 | November 3, 2006 | October 28, 2005 |
| Long-term debt | \$ 45 | \$ 45 | \$ 129 | \$ 124 |
| Capitalized leases | 9 | 9 | 27 | 29 |
| Interest income | (9) | (13) | (36) | (28) |
| Interest capitalized | (10) | (9) | (23) | (19) |
| Other | 10 | 4 | 13 | 16 |
| Net interest expense | \$ 45 | \$ 36 | \$ 110 | \$ 122 |

Supplemental disclosures of cash flow information:

| (In Millions) | Nine Months Ended | |
|--|------------------------|------------------------|
| | November 3, 2006 | October 28, 2005 |
| Cash paid for interest (net of amount capitalized) | \$ 155 | \$ 128 |
| Cash paid for income taxes | \$ 1,617 | \$ 1,264 |
| Non-cash investing and financing activities: | | |
| Conversions of long-term debt to equity | \$ 75 | \$ 295 |
| Non-cash fixed asset acquisitions, including assets acquired under capital lease | \$ 198 | \$ 26 |

Note 8: Comprehensive Income - Comprehensive income represents changes in shareholders' equity from non-owner sources and is comprised primarily of net earnings plus or minus unrealized gains or losses on available-for-sale equity securities, as well as foreign currency translation adjustments. Comprehensive income totaled \$718 million and \$646 million, compared to net earnings of \$716 million and \$646 million for the three months ended November 3, 2006 and October 28, 2005, respectively. For the nine months ended November 3, 2006 and October 28, 2005, comprehensive income totaled \$2.5 billion and \$2.1 billion, compared to net earnings of \$2.5 billion and \$2.1 billion, respectively.

Note 9: Accounting for Share-Based Payment - Prior to February 1, 2003, the Company accounted for share-based payment plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation." Effective February 1, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123 prospectively for all employee awards granted or modified after January 31, 2003. Therefore, in accordance with the requirements of SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure," costs related to share-based payment plans included in the determination of net earnings were less than that which would have been recognized if the fair-value-based method had been applied to all awards since the original effective date of SFAS No. 123. Effective February 4, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), "Share-Based

Payment,” using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the three and nine month periods ended November 3, 2006 included: (a) the pro rata compensation cost for all share-based payments granted prior to, but not yet vested as of February 4, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) the pro rata compensation cost for all share-based payments granted on or subsequent to February 4, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). In accordance with the modified-prospective-transition method of SFAS No. 123(R), results for prior periods have not been restated. For all grants, the amount of share-based payment expense recognized has been adjusted for estimated forfeitures of awards for which the requisite service is not expected to be provided. Estimated forfeiture rates are developed based on the Company’s analysis of historical forfeiture data for homogeneous employee groups. Prior to the adoption of the fair value recognition provisions of SFAS No. 123(R), share-based payment expense was adjusted for

actual forfeitures as they occurred. This transition resulted in a pre-tax cumulative effect adjustment of \$10 million as of February 4, 2006. The cumulative effect adjustment was presented as a reduction of share-based payment expense in the first quarter of 2006.

For the three month periods ended November 3, 2006 and October 28, 2005, the Company recognized share-based payment expense in selling, general and administrative (SG&A) expenses on the consolidated statements of current and retained earnings (unaudited) totaling \$22 million and \$19 million, respectively. For the nine month periods ended November 3, 2006 and October 28, 2005, share-based payment expense included in SG&A expenses totaled \$56 million and \$57 million, respectively. The total income tax benefit recognized was \$7 million and \$5 million for the three month periods ended November 3, 2006 and October 28, 2005, respectively. For the nine month periods ended November 3, 2006 and October 28, 2005, the total income tax benefit recognized was \$17 million and \$15 million, respectively.

Total unrecognized share-based payment expense for all share-based payment plans was \$136 million at November 3, 2006, of which \$18 million will be recognized during the remainder of 2006, \$58 million in 2007, \$39 million in 2008 and \$21 million thereafter. This results in these amounts being recognized over a weighted-average period of 1.3 years.

Prior to the adoption of SFAS No. 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the consolidated statements of cash flows (unaudited). SFAS No. 123(R) requires the cash flows resulting from the tax benefits of deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. In accordance with the modified-prospective-transition method of SFAS No. 123(R), the prior period consolidated statement of cash flows (unaudited) has not been restated to reflect this change.

As the Company adopted the fair-value recognition provisions of SFAS No. 123 prospectively for all employee awards granted or modified after January 31, 2003, share-based payment expense included in the determination of net earnings for the three and nine month periods ended October 28, 2005 is less than that which would have been recognized if the fair-value-based method had been applied to all awards since the original effective date of SFAS No. 123. The following table illustrates the effect on net earnings and earnings per share in the period if the fair-value-based method had been applied to all outstanding and unvested awards.

| | Three Months Ended October 28, 2005 | Nine Months Ended October 28, 2005 |
|--|--|---|
| (In Millions, Except Per Share Data) | | |
| Net earnings, as reported | \$ 646 | \$ 2,072 |
| Add: Stock-based compensation expense included in net earnings, net of related tax effects | 12 | 34 |
| Deduct: Total stock-based compensation expense determined under the fair-value-based method for all awards, net of related tax effects | (12) | (37) |
| Pro forma net earnings | \$ 646 | \$ 2,069 |
| Earnings per share: | | |
| Basic - as reported | \$ 0.41 | \$ 1.34 |

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| | | | | |
|-----------------------|----|------|----|------|
| Basic - pro forma | \$ | 0.41 | \$ | 1.33 |
| Diluted - as reported | \$ | 0.40 | \$ | 1.29 |
| Diluted - pro forma | \$ | 0.40 | \$ | 1.29 |

Overview of Share-Based Payment Plans

The Company has (a) four equity incentive plans, referred to as the “2006,” “2001,” “1997,” and “1994” Incentive Plans, (b) one share-based plan for awards to non-employee directors and (c) an employee stock purchase plan (ESPP) that allows employees to purchase Company shares through payroll deductions. These plans contain a nondiscretionary antidilution provision that is designed to equalize the value of an award as a result of an equity restructuring. Share-based awards in the form of incentive and non-qualified stock options, performance accelerated restricted stock (PARS), restricted stock and deferred stock units may be granted to key employees from the 2006 plan. No new awards may be granted from the 2001, 1997 and 1994 plans.

The share-based plan for non-employee directors is referred to as the Amended and Restated Directors’ Stock Option and Deferred Stock Unit Plan (Directors’ Plan). Prior to the amendment to the Directors’ Plan in 2005, each non-employee Director was awarded 8,000 options on the date of the first board meeting after each annual meeting of the Company’s shareholders, which occurs in the second quarter of each fiscal year. Since the amendment to the Directors’ Plan in 2005, each non-employee Director is awarded a number of deferred stock units determined by dividing the annual award amount by the fair market value of a share of the Company’s common stock on the award date and rounding up to the next 100 units. The annual award amount used to determine the number of deferred stock units granted to each director was \$115,000 and \$85,000 in 2006 and 2005, respectively.

Share-based awards were authorized for grant to key employees and non-employee directors for up to 169.0 million shares of common stock. Stock options were authorized for up to 129.2 million shares, while PARS, restricted stock and deferred stock units, which represent nonvested stock, were authorized for up to 39.8 million shares of common stock.

At November 3, 2006, there were 49.8 million shares available for grant under the 2006 and Directors’ plans, and 2.8 million shares available under the ESPP.

General terms and methods of valuation for the Company’s share-based awards are as follows:

Stock Options

Stock options generally have terms of seven years, with normally one-third of each grant vesting each year for three years, and are assigned an exercise price of not less than the fair market value of a share of the Company’s common stock on the date of grant.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. When determining expected volatility, the Company considers the historical performance of the Company’s stock as well as implied volatility. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant based on the option’s expected term. The expected term of the options is based on the Company’s evaluation of option holders’ exercise patterns and represents the period of time that options are expected to remain unexercised. The Company uses historical data to estimate the timing and amount of forfeitures. These options are expensed on a straight-line basis over the vesting period, which is considered to be the requisite service period. The assumptions used in the Black-Scholes option-pricing model for options granted in the three and nine month periods ended November 3, 2006 and October 28, 2005 were as follows:

| | | Three Months Ended November 3, 2006 | Nine Months Ended | | | |
|----|------|--|------------------------------|---------|---------|--------|
| \$ | 5.40 | 5,000 | .17 | \$ 5.40 | 5,000 | \$5.40 |
| \$ | 5.16 | 100,000 | 2.52 | \$ 5.16 | 100,000 | \$5.16 |
| | | 105,000 | | | 105,000 | |

Restricted Stock Units – On April 1, 2013, the Company granted 163 Restricted Stock Units or “RSUs” to employees. Based on the exchange ratio of the merger, the RSUs converted into 123,446 RSUs. Each RSU represents a contingent right to receive one share of the Company’s common stock upon vesting. In order to vest, an employee must have continuous service with the Company from time of the grant through April 1, 2016, the vesting date. The RSUs may be settled in cash and do not require the eventual issuance of common stock (although it is an election available to the Company); consequently, the awards are liability-based and the booked valuation will change as the market value for common stock changes. At March 31, 2016, the RSUs were valued at the closing price of the common stock of the Company on that date. Compensation expense was recognized over the three-year vesting period. The RSUs vested on April 1, 2016 and were settled in cash for \$16,858.

A summary of the status of the unvested RSUs and changes during the three months ended March 31, 2016 is presented below.

| | Number of unvested RSUs | Weighted average grant-date fair value |
|---------------------------------------|-------------------------------|---|
| Unvested shares as of January 1, 2016 | 80,278 | \$2.72 per share |
| Granted, forfeited, or other changes | - | |
| Unvested shares as of March 31, 2016 | 80,278 | \$2.72 per share |

NOTE 8 – EARNINGS (LOSS) PER COMMON SHARE

Earnings (loss) per common share is computed by dividing earnings or losses attributable to common stockholders by the weighted average number of shares of common stock outstanding during the period. Potential common stock equivalents are determined using the “if converted” method.

Potentially dilutive securities for the computation of diluted weighted average shares outstanding are as follows:

| | Three Months Ended March 31, | |
|-------------------------|---------------------------------|-----------|
| | 2016 | 2015 |
| Restricted Stock Awards | 2,437,690 | 1,910,349 |
| Restricted Stock Units | - | 95,424 |
| | 2,437,690 | 2,005,773 |

For the three months ended March 31, 2016 and the three months ended March 31, 2015, adjusted earnings were losses, therefore common stock equivalents were excluded from the calculation of diluted net loss per share of common stock, as their effect was anti-dilutive. RSUs were settled in cash during April 2016 and are no longer considered potentially dilutive.

NOTE 9 – DEBT AND INTEREST EXPENSE

| | March 31, 2016 | December 31, 2015 |
|---|-------------------|-------------------------|
| Variable rate revolving credit agreement payable to Société Générale, CIT Bank, NAC, and LegacyTexas Bank, maturing May 20, 2017, secured by the stock of Exploration and its interest in POL, and guaranteed by The Yuma Companies, Inc. | \$29,800,000 | \$29,800,000 |
| Installment loan due February 29, 2016, originating from the financing of insurance premiums at 3.74% interest rate. | - | 108,894 |
| Installment loan due June 11, 2016, originating from the financing of insurance premiums at 3.76% interest rate. | 62,186 | 154,741 |
| | 29,862,186 | 30,063,635 |
| Less: current portion | (29,862,186) | (30,063,635) |
| Total long-term debt | \$- | \$- |

On December 30, 2015, the Company's wholly owned subsidiary, Yuma Exploration and Production Company, Inc. ("Exploration") entered into the Waiver, Borrowing Base Redetermination and Ninth Amendment ("Ninth Amendment") to the credit agreement dated August 10, 2011 with SocGen as Administrative Agent and Issuing Banks, and each of the lenders and guarantors. Pursuant to the Ninth Amendment, the borrowing base was reduced to \$29.8 million and will automatically be reduced to \$20.0 million on May 31, 2016 unless otherwise reduced by or to a different amount by the lenders under the credit agreement. The Ninth Amendment also provided a waiver of the financial covenant related to the maximum permitted ratio of funded debt to EBITDA for the fiscal quarter ended September 30, 2015 and any failure to comply with that financial covenant and certain other financial covenants for the fiscal quarter ended December 31, 2015. Pursuant to the Ninth Amendment, Exploration agreed that on or before February 6, 2016, it would engage an investment bank to explore strategic options for its finances and, on or before March 31, 2016, would either enter into an underwritten commitment for additional capital in an aggregate amount sufficient to pay any borrowing base deficiency then existing or enter into a definitive agreement for the acquisition by a third party of all or substantially all of the assets of Exploration and its subsidiaries by merger, asset purchase, equity purchase or other structure acceptable to the Administrative Agent and the lenders. On February 10, 2016, the Company entered into the merger agreement with Davis (see Note 14 – Agreement and Plan of Merger and Reorganization), and expects to enter into another amendment to the credit agreement to account for the contemplated merger with Davis.

Costs and fees paid to the banks in connection with the revolving credit facility are amortized through May 31, 2016, due to the possible accelerated maturity date pursuant to the Ninth Amendment. SocGen, as Agent Bank, is also paid an annual administrative fee of \$25,000 that is usually amortized over the year, but will also be amortized through May 31, 2016.

The terms of the credit agreement require Exploration to meet a specific current ratio, interest coverage ratio, and a funded debt to EBITDA ratio. The credit agreement also contains a covenant requiring ten percent availability under the current borrowing line in order to pay dividends on the Series A Preferred Stock. In addition, the credit agreement requires the guarantee of the Company. Exploration was not in compliance with all of the loan covenants as of March 31, 2016; however, it is in discussion with the lenders under the credit facility to obtain a waiver of those violations.

The following summarizes interest expense for the three months ended March 31, 2016 and 2015.

| | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2016 | 2015 |
| Credit agreement | \$257,728 | \$241,294 |
| Credit agreement commitment fees | - | 15,828 |
| Amortization of credit agreement loan costs | 262,474 | 65,144 |
| Insurance installment loan | 1,670 | 1,726 |
| Other interest charges | 4,940 | 837 |
| Capitalized interest | (124,164) | (232,822) |
| Total interest expense | \$402,648 | \$92,007 |

NOTE 10 – MERGER WITH PYRAMID OIL COMPANY AND GOODWILL

On September 10, 2014, a wholly owned subsidiary of Pyramid merged with and into Yuma Energy, Inc., a Delaware corporation (“Yuma Co.”), in exchange for 66,336,701 shares of common stock and Pyramid changed its name to “Yuma Energy, Inc.” (the “merger”). As a result of the merger, the former Yuma Co. stockholders received approximately 93% of the then outstanding common stock of the Company and thus acquired voting control. Although the Company was the legal acquirer, for financial reporting purposes the merger was accounted for as a reverse acquisition of Pyramid by Yuma Co. The transaction qualified as a tax-deferred reorganization under Section 368(a) of the Internal Revenue Code of 1986, as amended (the “Code”).

The merger was accounted for as a business combination in accordance with ASC 805 Business Combinations (“ASC 805”). ASC 805, among other things, requires assets acquired and liabilities assumed to be measured at their acquisition date fair values. Goodwill represents the excess of the purchase price over the estimated fair value of the assets acquired net of the fair value of liabilities assumed in an acquisition. Certain assets and liabilities may be adjusted as additional information is obtained; but no later than one year from the acquisition date. The provisions of ASC 350, on Intangibles – Goodwill and Other require that intangible assets with indefinite lives, including goodwill, be evaluated on an annual basis for impairment, or more frequently if events occur or circumstances change that could potentially result in impairment. The goodwill impairment test requires the allocation of goodwill and all other assets and liabilities to reporting units; however, the Company has only one reporting unit. The Company was to perform its goodwill impairment test annually, using a measurement date of July 1.

The drop in crude oil prices and the resulting decline in the Company’s common share price since the merger caused the Company to test goodwill for impairment at June 30, 2015. Goodwill was determined to be fully impaired and as a result, the balance of \$4,927,508 was written off at that time.

NOTE 11 – INCOME TAXES

The following summarizes the income tax expense (benefit) and effective tax rates:

| | Three Months Ended March 31, | |
|--|---------------------------------|---------------|
| | 2016 | 2015 |
| Consolidated net income (loss) before income taxes | \$(4,206,019) | \$(5,977,574) |
| Income tax expense (benefit) | (532,933) | (2,294,582) |

| | | | | |
|--------------------|------|---|------|---|
| Effective tax rate | 12.7 | % | 38.4 | % |
|--------------------|------|---|------|---|

The differences between the U.S. federal statutory rate of 34% and the Company's effective tax rates for the three months ended March 31, 2016 and 2015 are due primarily to state taxes and nondeductible expenses. In addition, March 31, 2016 was impacted by the expected valuation allowance on our deferred tax asset at year-end, which affected our expected annual effective tax rate and the tax effect of nondeductible stock compensation.

The Company knows of no uncertain tax positions and has no unrecognized tax benefits for the three months ended March 31, 2016 or March 31, 2015. When the Company believes that it is more likely than not that a net operating loss or credit may expire unused, it establishes a valuation allowance against that loss or credit. As of March 31, 2016, the Company anticipates that it will have a net deferred tax asset at year-end 2016, for which a valuation allowance will be required. The Company has considered the effect of the valuation allowance in the current period in determining its expected annual effective tax rate to record tax expense for the period ending March 31, 2016. No valuation allowance was established as of March 31, 2016 or March 31, 2015.

NOTE 12 – AT MARKET SECURITY SALES

The Company entered into an At Market Issuance Sales Agreement (“Sales Agreement”) with an investment banking firm (the “Agent”) on December 19, 2014. Under the Sales Agreement, the Company may sell both common stock and Series A Preferred Stock pursuant to the Registration Statement on Form S-3 of the Company filed on November 5, 2013 (Registration No. 333-192094), which became effective under the Securities Act on November 21, 2013. Upon the Company's delivery and the Agent's acceptance of a placement notice, the Agent will use its commercially reasonable efforts, consistent with its sales and trading practices, to sell any shares subject to the placement notice. The Company initiated the sales of securities under the Sales Agreement on February 18, 2015, and as of March 31, 2016, the Company sold the following securities for the net proceeds listed below (the Company made no sales of securities since the second quarter of 2015).

| | Shares | Net Proceeds |
|--------------------------|-----------|-----------------|
| Common Stock | 1,347,458 | \$1,363,160 |
| Series A Preferred Stock | 46,857 | 870,386 |
| Total | | \$2,233,546 |

NOTE 13 – CONTINGENCIES

Certain Legal Proceedings

From time to time, the Company is party to various legal proceedings arising in the ordinary course of business. While the outcome of lawsuits cannot be predicted with certainty, the Company is not currently a party to any proceeding that it believes, if determined in a manner adverse to the Company, could have a potential material adverse effect on its financial condition, results of operations, or cash flows.

On July 9, 2014, Nabors Drilling USA, L.P. and other Nabors entities and Yuma Energy, Inc. and several of its wholly owned subsidiaries were named in a lawsuit filed in the District Court of Harris County, Texas, in the 80th Judicial District, concerning the death of an employee of Timco Services during the drilling of the Crosby 12-1 well. The Company has tendered its defense to its liability insurance carriers who are responding. There has been one unsuccessful mediation session. Depositions are being scheduled. Management believes that the Company has adequate insurance to meet this potential claim.

In September 2015, a suit was filed against the Company and Pyramid Oil LLC styled Mark A. Ontiveros and Louise D. Ontiveros, Trustees of The Ontiveros Family Trust dated March 29, 2007 vs. Pyramid Oil, LLC, et al. In the suit, the plaintiffs allege that the 1950 Community Oil and Gas Lease between them and Pyramid Oil LLC has expired by non-production. The Company claims that the lease is still in effect, as there is no cessation of production time frame set out in the lease; production had temporarily ceased, but was still profitable when measured over an appropriate time period; and the Company was conducting workover operations on a well on the lease in an effort to re-establish production when served with the quit claim deed demand from the plaintiff's attorney. All present owners of the minerals covered by the 1950 Community Oil and Gas Lease, with the exception of the plaintiffs and one other owner, have executed amendments signifying their concurrence that the 1950 Community Oil and Gas Lease is still in force and effect. The parties are presently in the process of document discovery.

Environmental Remediation Contingencies

As of December 31, 2015, there were no known environmental or other regulatory matters related to the Company's operations that were reasonably expected to result in a material liability to the Company. The Company's operations are subject to numerous laws and regulations governing the discharge of materials into the environment or otherwise relating to environmental protection.

Exploration, a subsidiary of the Company, has been named as one of 97 defendants in a matter entitled Board of Commissioners of the Southeast Louisiana Flood Protection Authority – East, Individually and As the Board Governing the Orleans Levee District, the Lake Borgne Basin Levee District, and the East Jefferson Levee District v. Tennessee Gas Pipeline Company, LLC, et al., Civil District Court for the Parish of Orleans, State of Louisiana, No. 13-6911, Division “J” - 5, now removed as Civil Action No. 13-5410, before the United States District Court, Eastern District of Louisiana. Plaintiff filed the suit on July 24, 2013 seeking damages and injunctive relief arising out of defendants' drilling, exploration, and production activities from the early 1900s to the present day in coastal areas east of the Mississippi River in Southeast Louisiana.

The suit alleges that defendants' activities have caused “removal, erosion, and submergence” of coastal lands resulting in significant reduction or loss of the protection such lands afforded against hurricanes and tropical storms. Plaintiff alleges that it now faces increased costs to maintain and operate the man-made hurricane protection system and may reach the point where that system no longer adequately protects populated areas.

Plaintiff lists hundreds of wells, pipelines, and dredging events as possible sources of the alleged land loss. Exploration is named in association with 11 wells, four rights-of-way, and one dredging permit. The suit does not specify any deficiency or harm caused by any individual activity or facility.

Although the suit references various federal statutes as sources of standards of care, plaintiff claims that all causes of action arise under state law: negligence, strict liability, natural servitude of drain, public nuisance, private nuisance, and as third-party beneficiary under breach of contract.

The Company tendered its defense to its liability insurance carriers, who are responding. On February 13, 2015, the federal judge adjudicating the matter granted defendants “Joint Motion to Dismiss for Failure to State a Claim Under Rule 12(b)(6)”, thereby dismissing plaintiff's claims with prejudice in the matter. On February 20, 2015, the Board of Orleans filed a notice of appeal to the U.S. Fifth Circuit. On February 29, 2016, oral arguments were held regarding the appeal, but as of May 23, 2016, no ruling on the appeal has been made. The Company will continue to contest plaintiff's legal arguments and factual assertions. At this point in the legal process, no evaluation of the likelihood of an unfavorable outcome or associated economic loss can be made; therefore no liability has been recorded on the Company's books.

Escheat Audits

The States of Louisiana, Texas, Minnesota, North Dakota and Wyoming have notified the Company that they will examine the Company's books and records to determine compliance with each of the examining state's escheat laws. The review is being conducted by Discovery Audit Services, LLC. The Company has engaged Ryan, LLC to represent it in this matter. The exposure related to the audits is not currently determinable.

NOTE 14 – AGREEMENT AND PLAN OF MERGER AND REORGANIZATION

On February 10, 2016, the Company and privately held Davis Petroleum Acquisition Corp. ("Davis") entered into a definitive merger agreement for an all-stock transaction. Upon completion of the transaction, the Company will reincorporate in Delaware, implement a one for ten reverse split of its common stock, and convert each share of its existing Series A Preferred Stock into 35 shares of common stock prior to giving effect for the reverse split (3.5 shares post reverse split). Following these actions, the Company will issue additional shares of common stock in an amount sufficient to result in approximately 61.1% of the common stock being owned by the current common stockholders of Davis. In addition, the Company will issue approximately 3.3 million shares of a new Series D preferred stock to existing Davis preferred stockholders, which is estimated to have a conversion price of approximately \$5.70 per share, after giving effect for the reverse split. The Series D preferred stock is estimated to have a liquidation preference of approximately \$19.0 million at closing, and will be paid dividends in the form of additional Series D preferred stock at a rate of 7% per annum. Upon closing, there will be an aggregate of approximately 23.7 million shares of common stock outstanding (after giving effect to the reverse stock split and conversion of Series A Preferred Stock to common stock). The transaction is expected to qualify as a tax-deferred reorganization under Section 368(a) of the Code.

The merger agreement is subject to the approval of the shareholders of both companies, as well as other customary conditions and approvals, including authorization to list the newly issued shares on the NYSE MKT. The parties anticipate completing the transaction in the third quarter of 2016.

NOTE 15 – GREATER MASTERS CREEK FIELD AREA

During the first quarter of 2016, the Company shut-in 14 Austin Chalk wells in Beauregard, Rapides and Vernon Parishes, Louisiana due to low oil and natural gas prices. Since production was not restarted from these wells, the associated leases have expired, reducing the Company's proved reserves by approximately 1,629 MBoe, acreage by 22,021 gross (18,140 net) acres, operated proved undeveloped locations by three, and operated non-proved undeveloped locations by seven.

During the first quarter of 2016, the Company received notice from the operator of certain wells in Rapides and Vernon Parishes, Louisiana, that certain wells in which the Company has an interest were shut-in due to current economic conditions. The operator has since sold its interest. Since the operator and the subsequent operator have not restarted production from these wells, the associated leases have expired, reducing the Company's proved reserves by approximately 285 MBoe from year-end 2015, acreage by 18,895 gross (3,737 net) acres, non-operated proved undeveloped locations by three, and non-operated non-proved undeveloped locations by 18.

On April 4, 2016, the Company entered into an amendment effective March 1, 2016 to an oil and gas lease in the Masters Creek Field area with a certain mineral owner for acreage that was not held by production as of March 31, 2016. The total acreage is approximately 25,139 acres and, by virtue of the Company conducting certain location clean-up operations, the lease has now been extended until December 31, 2016. This extension is subject to certain additional performance criteria, including the posting of a bond to cover P&A costs for wells located on this mineral owner's property, and plugging and abandoning six of the mineral owner's wells by December 31, 2016. If the leased

acreage expires, the Company's proved reserves would be reduced by approximately 5,096 MBoe, the number of operated proved undeveloped locations and operated non-proved locations would be reduced by 13 and 16, respectively (See Note 17 – Subsequent Events).

NOTE 16 – TEXAS SOUTHEASTERN GAS MARKETING COMPANY

As of January 1, 2016, the Company decided to discontinue the operations of Texas Southeastern Gas Marketing Company due to the limited volumes of natural gas that it marketed, as well as the costs associated with accounting for the entity. Texas Southeastern Gas Marketing Company is not a significant subsidiary, and this discontinuation of operations does not represent a strategic shift in business for the Company.

NOTE 17 – SUBSEQUENT EVENTS

The Company has evaluated subsequent events through May 23, 2016, the date these financial statements were available to be issued. The Company is not aware of any subsequent events which would require recognition or disclosure in the financial statements, except as noted below or already recognized or disclosed in the Company's filings with the SEC.

Masters Creek Participation

In April 2016, a party to the participation agreement dated July 31, 2013 relating to Yuma's Greater Masters Creek Area exercised its option to participate under the participation agreement for a four percent working interest.

Lease Extension

On April 4, 2016, the Company entered into an amendment effective March 1, 2016 to an oil and gas lease in the Masters Creek Field area with a certain mineral owner for acreage that was not held by production as of March 31, 2016. The total acreage is approximately 25,139 acres and, by virtue of the Company conducting certain location clean-up operations, the lease has now been extended until December 31, 2016. This extension is subject to certain additional performance criteria, including the posting of a bond to cover P&A costs for wells located on this mineral owner's property, and plugging and abandoning six of the mineral owner's wells by December 31, 2016.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the accompanying unaudited consolidated financial statements and