Approach Resources Inc
Form 10-Q
November 06, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended September 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: 001-33801**

**APPROACH RESOURCES INC.**

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **51-0424817** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |
| **One Ridgmar Centre 6500 West Freeway, Suite 800 Fort Worth, Texas** | **76116** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**(817) 989-9000**

**(Registrant s telephone number, including area code)**

**N/A**

**(Former name, former address and former fiscal year, if changed since last report)**

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 ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
x 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

| | |
|---|---|
| Large accelerated filer x | Accelerated filer ¨ |
| Non-accelerated filer ¨ (Do not check if smaller reporting company) | 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 x No

The number of shares of the registrant s common stock, $0.01 par value, outstanding as of October 31, 2014, was 39,555,379.

## PART I FINANCIAL INFORMATION

**Item 1. Financial Statements.**

**Approach Resources Inc. and Subsidiaries**

**Unaudited Consolidated Balance Sheets**

**(In thousands, except shares and per-share amounts)**

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS:** | | |
| Cash and cash equivalents | $ 1,634 | $ 58,761 |
| Restricted cash | | 7,350 |
| Accounts receivable: | | |
| Joint interest owners | 71 | 158 |
| Oil, NGL and gas sales | 20,868 | 22,871 |
| Unrealized gain on commodity derivatives | 2,395 | |
| Prepaid expenses and other current assets | 690 | 592 |
| Deferred income taxes current | | 681 |
| Total current assets | 25,658 | 90,413 |
| **PROPERTIES AND EQUIPMENT:** | | |
| Oil and gas properties, at cost, using the successful efforts method of accounting | 1,614,660 | 1,320,195 |
| Furniture, fixtures and equipment | 5,209 | 2,537 |
| Total oil and gas properties and equipment | 1,619,869 | 1,322,732 |
| Less accumulated depletion, depreciation and amortization | (353,565) | (275,702) |
| Net oil and gas properties and equipment | 1,266,304 | 1,047,030 |
| Unrealized gain on commodity derivatives | 1,018 | |
| Other assets | 9,188 | 8,041 |
| Total assets | $ 1,302,168 | $ 1,145,484 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| **CURRENT LIABILITIES:** | | |
| Accounts payable | $ 33,102 | $ 38,575 |
| Oil, NGL and gas sales payable | 9,708 | 6,101 |
| Accrued liabilities | 57,557 | 37,918 |
| Deferred income taxes current | 1,198 | |
| Unrealized loss on commodity derivatives | 338 | 1,847 |
| Total current liabilities | 101,903 | 84,441 |
| **NON-CURRENT LIABILITIES:** | | |

| | | |
|---|---|---|
| Senior secured credit facility | 89,500 | |
| Senior notes | 250,000 | 250,000 |
| Deferred income taxes | 106,594 | 91,883 |
| Unrealized loss on commodity derivatives | 31 | 315 |
| Asset retirement obligations | 9,054 | 8,350 |
| Total liabilities | 557,082 | 434,989 |
| **COMMITMENTS AND CONTINGENCIES** | | |
| **STOCKHOLDERS EQUITY:** | | |
| Preferred stock, $0.01 par value, 10,000,000 shares authorized none outstanding | | |
| Common stock, $0.01 par value, 90,000,000 shares authorized, 39,337,147 and 39,047,699 issued and outstanding, respectively | 391 | 390 |
| Additional paid-in capital | 570,642 | 565,237 |
| Retained earnings | 174,053 | 144,868 |
| Total stockholders equity | 745,086 | 710,495 |
| Total liabilities and stockholders equity | $ 1,302,168 | $ 1,145,484 |

*See accompanying notes to these unaudited consolidated financial statements*

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**Approach Resources Inc. and Subsidiaries**

**Unaudited Consolidated Statements of Operations**

**(In thousands, except shares and per-share amounts)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| **REVENUES:** | | | | |
| Oil, NGL and gas sales | $ 68,124 | $ 44,196 | $ 203,459 | $ 122,737 |
| **EXPENSES:** | | | | |
| Lease operating | 7,665 | 4,370 | 23,462 | 13,746 |
| Production and ad valorem taxes | 3,335 | 3,167 | 12,429 | 8,791 |
| Exploration | 891 | 1,193 | 3,595 | 2,010 |
| General and administrative | 7,675 | 6,171 | 23,612 | 17,810 |
| Depletion, depreciation and amortization | 25,959 | 19,413 | 78,138 | 54,951 |
| Total expenses | 45,525 | 34,314 | 141,236 | 97,308 |
| **OPERATING INCOME** | 22,599 | 9,882 | 62,223 | 25,429 |
| **OTHER:** | | | | |
| Interest expense, net | (5,442) | (5,179) | (15,936) | (8,859) |
| Equity in income (losses) of investee | | 340 | (186) | 160 |
| Realized loss on commodity derivatives | (764) | (840) | (5,423) | (1,247) |
| Unrealized gain (loss) on commodity derivatives | 18,810 | (3,438) | 5,206 | (3,248) |
| Other expense | | | (109) | |
| **INCOME BEFORE INCOME TAX PROVISION** | 35,203 | 765 | 45,775 | 12,235 |
| **INCOME TAX PROVISION** | 12,756 | 270 | 16,590 | 4,300 |
| **NET INCOME** | $ 22,447 | $ 495 | $ 29,185 | $ 7,935 |
| **EARNINGS PER SHARE:** | | | | |
| Basic | $ 0.57 | $ 0.01 | $ 0.74 | $ 0.20 |
| Diluted | $ 0.57 | $ 0.01 | $ 0.74 | $ 0.20 |
| **WEIGHTED AVERAGE SHARES OUTSTANDING:** | | | | |
| Basic | 39,363,441 | 39,011,555 | 39,325,552 | 38,980,971 |
| Diluted | 39,379,779 | 39,032,813 | 39,340,961 | 39,002,731 |

*See accompanying notes to these unaudited consolidated financial statements*

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**Approach Resources Inc. and Subsidiaries**

**Unaudited Consolidated Statements of Cash Flows**

**(In thousands)**

| | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 |
|---|---|---|
| **OPERATING ACTIVITIES:** | | |
| Net income | $ 29,185 | $ 7,935 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depletion, depreciation and amortization | 78,138 | 54,951 |
| Amortization of loan origination fees | 1,151 | 617 |
| Unrealized (gain) loss on commodity derivatives | (5,206) | 3,248 |
| Exploration expense | 3,595 | 2,010 |
| Share-based compensation expense | 5,726 | 5,389 |
| Deferred income taxes | 16,590 | 4,300 |
| Equity in losses (income) of investee | 186 | (160) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 2,090 | (2,630) |
| Prepaid expenses and other current assets | (169) | 342 |
| Accounts payable | (5,793) | 15,300 |
| Oil, NGL and gas sales payable | 3,607 | 491 |
| Accrued liabilities | 19,130 | 27,203 |
| Cash provided by operating activities | 148,230 | 118,996 |
| **INVESTING ACTIVITIES:** | | |
| Additions to oil and gas properties | (297,122) | (221,514) |
| Contribution to equity method investment | (186) | (8,279) |
| Change in restricted cash | 7,350 | |
| Additions to furniture, fixtures and equipment, net | (2,672) | (394) |
| Cash used in investing activities | (292,630) | (230,187) |
| **FINANCING ACTIVITIES:** | | |
| Borrowings under credit facility | 231,421 | 129,059 |
| Repayment of amounts outstanding under credit facility | (141,921) | (235,950) |
| Proceeds from issuance of senior notes | | 242,746 |
| Loan origination fees | (2,227) | 58 |
| Cash provided by financing activities | 87,273 | 135,913 |
| **CHANGE IN CASH AND CASH EQUIVALENTS** | (57,127) | 24,722 |
| **CASH AND CASH EQUIVALENTS**, beginning of period | $ 58,761 | $ 767 |
| **CASH AND CASH EQUIVALENTS**, end of period | $ 1,634 | $ 25,489 |

| | | |
|---|---|---|
| **SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:** | | |
| Cash paid for interest | $ 10,529 | $ 3,045 |
| | | |
| **SUPPLEMENTAL DISCLOSURE OF NON-CASH TRANSACTION:** | | |
| Asset retirement obligations capitalized | $ 428 | $ 416 |

*See accompanying notes to these unaudited consolidated financial statements*

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

**1. Summary of Significant Accounting Policies**

**Organization and Nature of Operations**

Approach Resources Inc. ( Approach, the Company, we, us or our ) is an independent energy company engaged i exploration, development, production and acquisition of oil and gas properties. We focus on finding and developing oil and natural gas reserves in oil shale and tight gas sands. Our properties are primarily located in the Permian Basin in West Texas. We also own interests in the East Texas Basin.

**Consolidation, Basis of Presentation and Significant Estimates**

The interim consolidated financial statements of the Company are unaudited and contain all adjustments (consisting primarily of normal recurring accruals) necessary for a fair statement of the results for the interim periods presented. Results for interim periods are not necessarily indicative of results to be expected for a full year due in part to the volatility in prices for oil, NGLs and gas, future commodity prices for commodity derivative contracts, global economic and financial market conditions, interest rates, access to sources of liquidity, estimates of reserves, drilling risks, geological risks, transportation restrictions, the timing of acquisitions, product supply and demand, market competition and interruptions of production. You should read these consolidated interim financial statements in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission on February 25, 2014.

The accompanying interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of the Company and its wholly owned subsidiaries. Intercompany accounts and transactions are eliminated. In preparing the accompanying financial statements, management has made certain estimates and assumptions that affect reported amounts in the financial statements and disclosures of contingencies. Actual results may differ from those estimates. Significant assumptions are required in the valuation of proved oil and gas reserves, which affect our estimate of depletion expense as well as our impairment analyses. Significant assumptions also are required in our estimation of accrued liabilities, commodity derivatives, income tax provision, share-based compensation and asset retirement obligations. It is at least reasonably possible these estimates could be revised in the near term, and these revisions could be material. Certain prior-year amounts have been reclassified to conform to current-year presentation. These classifications have no impact on the net income reported.

**Recent Accounting Pronouncements**

In April 2014, the Financial Accounting Standards Board ( FASB ) issued guidance that raised the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. Under the updated standard, a discontinued operation is (i) a component of an entity or group of components that has been disposed of by sale, disposed of other than by sale or is classified as held for sale that represents a strategic shift that has or will have a major effect on an entity s operations and financial results, or (ii) an acquired business or nonprofit activity that is classified as held for sale on the date of the acquisition. This update is aimed at reducing the frequency of disposals reported as discontinued operations by focusing on strategic shifts that have or will have a major effect on an entity s operations and financial results. This accounting standards update is effective for annual reporting periods beginning on or after December 15, 2014, and will be applied prospectively. The Company is evaluating the impact of this new guidance and does not expect it to have a significant impact on the consolidated financial statements.

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

In May 2014, the FASB issued an accounting standards update for Revenue from Contracts with Customers, which supersedes the revenue recognition requirements in Topic 605, Revenue Recognition. This accounting standard update provides new guidance concerning recognition and measurement of revenue and requires additional disclosures about the nature, timing and uncertainty of revenue and cash flows arising from contracts with customers. This new guidance is effective retrospectively for annual reporting periods beginning on or after December 15, 2016, with early application not permitted. The Company is evaluating our existing revenue recognition policies to determine whether any contracts will be affected by the new requirements.

## 2. Equity Method Investment

In September 2012, we entered into a joint venture to build an oil pipeline in Crockett and Reagan Counties, Texas, which is used to transport our oil to market. In October 2012, we made an initial contribution of $10 million to the joint venture for pipeline and facilities construction, and in 2013, we contributed $8.3 million to the joint venture for pipeline and facilities construction. Our contributions are recorded at cost and are included in investing activities under Contribution to equity method investment on our consolidated statements of cash flows. Our share of the investee s earnings was recorded on our consolidated statement of operations for the three and nine month periods ended September 30, 2013. In October 2013, we completed the sale of the joint venture, and net proceeds to Approach at closing totaled approximately $109.1 million, after deducting our share of transactional costs paid at closing. Of the $109.1 million in proceeds, $7.4 million was restricted pursuant to an escrow agreement. The escrow agreement terminated on June 1, 2014, and the cash held in escrow was subsequently released. We incurred $0.2 million in post-closing working capital adjustments during the nine months ended September 30, 2014.

## 3. Earnings Per Common Share

We report basic earnings per common share, which excludes the effect of potentially dilutive securities, and diluted earnings per common share, which includes the effect of all potentially dilutive securities unless their impact is antidilutive. The following table provides a reconciliation of the numerators and denominators of our basic and diluted earnings per share (dollars in thousands, except per-share amounts).

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Income (numerator): | | | | |
| Net income basic | $ 22,447 | $ 495 | $ 29,185 | $ 7,935 |
| Weighted average shares (denominator): | | | | |
| Weighted average shares basic | 39,363,441 | 39,011,555 | 39,325,552 | 38,980,971 |
| Dilution effect of share-based compensation, treasury method | 16,338 | 21,258 | 15,409 | 21,760 |

| | | | | |
|---|---|---|---|---|
| Weighted average shares diluted | 39,379,779 | 39,032,813 | 39,340,961 | 39,002,731 |
| Net income per share: | | | | |
| Basic | $ 0.57 | $ 0.01 | $ 0.74 | $ 0.20 |
| Diluted | $ 0.57 | $ 0.01 | $ 0.74 | $ 0.20 |

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

## 4. Long-Term Debt

The following table provides a summary of our long-term debt at September 30, 2014, and December 31, 2013 (in thousands).

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Senior secured credit facility | $ 89,500 | $ |
| Senior notes | 250,000 | 250,000 |
| Total long-term debt | $ 339,500 | $ 250,000 |

***Revolving Credit Facility***

At September 30, 2014, the borrowing base and aggregate lender commitments under our amended and restated senior secured revolving credit facility (the Credit Facility ) was $450 million, with maximum commitments from the lenders of $1 billion and a maturity date of May 7, 2019. The borrowing base is redetermined semi-annually in April and October based on our oil, NGL and gas reserves. We, or the lenders, can each request one additional borrowing base redetermination each calendar year.

Borrowings under the Credit Facility bear interest based on the agent bank s prime rate plus an applicable margin ranging from 0.50% to 1.50%, or the sum of the LIBOR rate plus an applicable margin ranging from 1.50% to 2.50%. In addition, we pay an annual commitment fee ranging from 0.375% to 0.50% of unused borrowings available under the Credit Facility. Margins vary based on the borrowings outstanding compared to the aggregate commitments of the lenders.

We had outstanding borrowings of $89.5 million under our Credit Facility at September 30, 2014, compared to no outstanding borrowings at December 31, 2013. The weighted average interest rate applicable to borrowings under our Credit Facility for the nine months ended September 30, 2014, was 1.4%. We had outstanding unused letters of credit under our Credit Facility totaling $0.3 million at September 30, 2014, and December 31, 2013, which reduce amounts available for borrowing under our Credit Facility.

Obligations under the Credit Facility are secured by mortgages on substantially all of the oil and gas properties of the Company and its subsidiaries. The Company is required to maintain liens covering the oil and gas properties of the Company and its subsidiaries representing at least 80% of the total value of all oil and gas properties of the Company and its subsidiaries.

On November 4, 2014, we entered into a first amendment to the Credit Facility, which, among other things, (a) increases the borrowing base to $600 million from $450 million, (b) maintains the aggregate commitments of the lenders at $450 million and (c) provides for the applicable margin or interest rate to be paid based on utilization of borrowing base, rather than utilization of aggregate commitments of the lenders.

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

***Covenants***

Our Credit Facility contains two principal financial covenants:

- a consolidated modified current ratio covenant (as defined in the Credit Facility) that requires us to maintain a ratio of not less than 1.0 to 1.0 as of the last day of any fiscal quarter, and

- a consolidated interest coverage ratio covenant (as defined in the Credit Facility) that requires us to maintain a ratio of consolidated EBITDAX to interest of not less than 2.5 to 1.0 as of the last day of any fiscal quarter.

Our Credit Facility also contains covenants restricting cash distributions and other restricted payments, transactions with affiliates, incurrence of other debt, consolidations and mergers, the level of operating leases, asset sales, investment in other entities and liens on properties.

In addition, the obligations of the Company may be accelerated upon the occurrence of an Event of Default (as defined in the Credit Facility). Events of Default include customary events for a financing agreement of this type, including, without limitation, payment defaults, the inaccuracy of representations and warranties, defaults in the performance of affirmative or negative covenants, defaults on other indebtedness of the Company or its subsidiaries, bankruptcy or related defaults, defaults related to judgments and the occurrence of a Change of Control (as defined in the Credit Facility), which includes instances where a third party becomes the beneficial owner of more than 50% of the Company s outstanding equity interests entitled to vote.

***Senior Notes***

In June 2013, we completed our public offering of $250 million principal amount of 7% Senior Notes due 2021 (the Senior Notes ). Annual interest on the Senior Notes is $17.5 million, payable semi-annually on June 15 and December 15.

We issued the Senior Notes under a senior indenture dated June 11, 2013, as supplemented by a supplemental indenture of even date, among the Company, our subsidiary guarantors and Wells Fargo Bank, National Association, as trustee.

On and after June 15, 2016, we may redeem some or all of the Senior Notes at specified redemption prices, plus accrued and unpaid interest to the redemption date. Before June 15, 2016, we may redeem up to 35% of the Senior Notes at a redemption price of 107% of the principal amount, plus accrued and unpaid interest to the redemption date, with the proceeds of certain equity offerings. In addition, before June 15, 2016, we may redeem some or all of the Notes for cash at a redemption price equal to 100% of their principal amount plus an applicable make-whole premium and accrued and unpaid interest to the redemption date. If we sell certain of our assets or experience specific kinds of changes of control, we may be required to offer to purchase the Senior Notes from holders. The Senior Notes are fully and unconditionally guaranteed on a senior unsecured basis by each of our subsidiaries, subject to certain customary release provisions. A subsidiary guarantor may be released from its obligations under the guarantee:

in connection with any sale or other disposition of all or substantially all of the assets of that guarantor (including by way of merger or consolidation) to a person that is not (either before or after giving effect to such transaction) the Company or a subsidiary guarantor, if the sale or other disposition otherwise complies with the indenture;

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

in connection with any sale or other disposition of the capital stock of that guarantor to a person that is not (either before or after giving effect to such transaction) the Company or a subsidiary guarantor, if that guarantor no longer qualifies as a subsidiary of the Company as a result of such disposition and the sale or other disposition otherwise complies with the indenture;

if the Company designates any restricted subsidiary that is a guarantor to be an unrestricted subsidiary in accordance with the indenture;

upon defeasance or covenant defeasance of the notes or satisfaction and discharge of the indenture, in each case, in accordance with the indenture;

upon the liquidation or dissolution of that guarantor, provided that no default or event of default occurs under the indenture as a result thereof or shall have occurred and is continuing; or

in the case of any restricted subsidiary that, after the issue date of the notes, is required under the indenture to guarantee the notes because it becomes a guarantor of indebtedness issued or an obligor under a credit facility with respect to the Company and/or its subsidiaries, upon the release or discharge in full from its (i) guarantee of such indebtedness or (ii) obligation under such credit facility, in each case, which resulted in such restricted subsidiary s obligation to guarantee the notes.

The Indenture restricts our ability, among other things, to (i) sell certain assets, (ii) pay distributions on, redeem or repurchase, equity interests, (iii) incur additional debt, (iv) make certain investments, (v) enter into transactions with affiliates, (vi) incur liens and (vii) merge or consolidate with another company. These restrictions are subject to a number of important exceptions and qualifications. If at any time the Senior Notes are rated investment grade by both Moody s Investors Service and Standard & Poor s Ratings Services and no default (as defined in the Indenture) has occurred and is continuing, many of these restrictions will terminate. The Indenture contains customary events of default.

***Subsidiary Guarantors***

The Senior Notes are guaranteed on a senior unsecured basis by each of our consolidated subsidiaries. Approach Resources Inc. is a holding company with no independent assets or operations. The subsidiary guarantees are full and unconditional and joint and several, and any subsidiaries of the Company other than the subsidiary guarantors are minor. There are no significant restrictions on the Company s ability, or the ability of any subsidiary guarantor, to obtain funds from its subsidiaries through dividends, loans, advances or otherwise.

At September 30, 2014, we were in compliance with all of our covenants, and there were no existing defaults or events of default, under our debt instruments.

**5. Commitments and Contingencies**

Our contractual obligations include long-term debt, daywork drilling contracts, operating lease obligations, asset retirement obligations and employment agreements with our executive officers. On January 3, 2014, we entered into an employment agreement with Sergei Krylov as the Company s Executive Vice President and Chief Financial Officer. Our maximum commitment under this employment agreement, which would apply if Mr. Krylov were terminated without cause, is $1.3 million. In August 2014, we extended our existing gas purchase and processing agreement with DCP Midstream, LP through August 2023. In October 2014, we extended two daywork drilling contracts through March 2015 and September 2015, respectively, with aggregate contractual

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

obligations of approximately $12 million. We have retained a third drilling rig contracted on a well-to-well basis. Since December 31, 2013, there have been no other material changes to our contractual obligations.

We are involved in various legal and regulatory proceedings arising in the normal course of business. While we cannot predict the outcome of these proceedings with certainty, we do not believe that an adverse result in any pending legal or regulatory proceeding, individually or in the aggregate, would be material to our consolidated financial condition or cash flows.

## 6. Income Taxes

The effective income tax rate for the three and nine months ended September 30, 2014, was 36.2%. Total income tax expense for the three and nine months ended September 30, 2014, differed from amounts computed by applying the U.S. federal statutory tax rates to pre-tax income due primarily to state taxes.

The effective income tax rates for the three and nine months ended September 30, 2013, were 35.3% and 35.1%, respectively. Total income tax expense for the three and nine months ended September 30, 2013, differed from amounts computed by applying the U.S. federal statutory tax rates to pre-tax income due primarily to state taxes and the impact of permanent differences between book and taxable income.

## 7. Fair Value of Financial and Derivative Instruments

During the three months ended September 30, 2014, we converted a two-way crude oil collar covering 500 Bbls per day for 2015 with a long put of $84.00/bbl and a short call of $91.00/bbl to a three-way crude oil collar with a short put at $75.00/bbl, a long put at $84.00/bbl and a short call at $94.00/bbl. A three-way collar consists of a short put option contract (the lower price), a long put option contract (the middle price) and a short call option contract (the higher price). This type of instrument provides a higher ceiling price as compared to a two-way collar and limits downside risk to the market price plus the difference between the middle price and the lower price if the market price drops below the lower price. The following table provides our outstanding commodity derivative positions at September 30, 2014.

| Commodity and Period | | Contract Type | Volume Transacted | Contract Price |
|---|---|---|---|---|
| **Crude Oil** | | | | |
| October 2014 | December 2014 | Collar | 550 Bbls/d | $90.00/Bbl - $105.50/Bbl |
| October 2014 | December 2014 | Collar | 950 Bbls/d | $85.05/Bbl - $95.05/Bbl |
| October 2014 | December 2014 | Collar | 2,000 Bbls/d | $89.00/Bbl - $98.85/Bbl |
| October 2014 | March 2015 | Collar | 1,500 Bbls/d | $85.00/Bbl - $95.30/Bbl |
| January 2015 | December 2015 | Collar | 2,100 Bbls/d | $84.00/Bbl - $91.00/Bbl |
| January 2015 | December 2015 | Collar | 1,000 Bbls/d | $90.00/Bbl - $102.50 Bbl |
| January 2015 | December 2015 | | 500 Bbls/d | $75.00/Bbl - $84.00/Bbl |

| | | | | |
|---|---|---|---|---|
| | | Three-Way Collar | | - $94.00/Bbl |
| **Natural Gas Liquids** | | | | |
| *Propane* | | | | |
| October 2014 | December 2014 | Swap | 500 Bbls/d | $41.16/Bbl |
| *Natural Gasoline* | | | | |
| October 2014 | December 2014 | Swap | 175 Bbls/d | $83.37/Bbl |
| **Natural Gas** | | | | |
| October 2014 | December 2014 | Swap | 360,000 MMBtu/month | $4.18/MMBtu |
| October 2014 | December 2014 | Swap | 35,000 MMBtu/month | $4.29/MMBtu |

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

| Commodity and Period | Contract Type | Volume Transacted | Contract Price |
|---|---|---|---|
| October 2014 December 2014 | Swap | 160,000 MMBtu/month | $4.40/MMBtu |
| October 2014 June 2015 | Collar | 80,000 MMBtu/month | $4.00/MMBtu - $4.74/MMBtu |
| January 2015 December 2015 | Swap | 200,000 MMBtu/month | $4.10/MMBtu |
| January 2015 December 2015 | Collar | 130,000 MMBtu/month | $4.00/MMBtu - $4.25/MMBtu |

Subsequent to September 30, 2014, we converted a two-way crude oil collar covering 500 Bbls per day for 2015 with a long put of $84.00/bbl and a short call of $91.00/bbl to a three-way crude oil collar with a short put at $75.00/bbl, a long put at $84.00/bbl and a short call at $95.00/bbl.

The following table summarizes the fair value of our open commodity derivatives as of September 30, 2014, and December 31, 2013 (in thousands).

| | Asset Derivatives | | | Liability Derivatives | | |
|---|---|---|---|---|---|---|
| | Balance Sheet Location | Fair Value | | Balance Sheet Location | Fair Value | |
| | | September 30, 2014 | December 31, 2013 | | September 30, 2014 | December 31, 2013 |
| **Derivatives not designated as hedging instruments** | | | | | | |
| Commodity derivatives | Unrealized gain on commodity derivatives | $ 3,413 | $ 9,108 | Unrealized loss on commodity derivatives | $ 369 | $ 11,270 |

The following table summarizes the change in the fair value of our commodity derivatives (in thousands).

| | Income Statement Location | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|---|
| | | 2014 | 2013 | 2014 | 2013 |
| **Derivatives not designated as hedging instruments** | | | | | |
| Commodity derivatives | Realized loss on commodity derivatives | $ (764) | $ (840) | $ (5,423) | $ (1,247) |
| | Unrealized gain(loss) on commodity derivatives | 18,810 | (3,438) | 5,206 | (3,248) |

| | | | |
|---|---|---|---|
| $ 18,046 | $ (4,278) | $ (217) | $ (4,495) |

Unrealized gains and losses, at fair value, are included on our consolidated balance sheets as current or non-current assets or liabilities based on the anticipated timing of cash settlements under the related contracts. Changes in the fair value of our commodity derivative contracts are recorded in earnings as they occur and included in other income (expense) on our consolidated statements of operations. We estimate the fair values of swap contracts based on the present value of the difference in exchange-quoted forward price curves and contractual settlement prices multiplied by notional quantities. We internally valued the option contracts using industry-standard option pricing models and observable market inputs. We use our internal valuations to determine the fair values of the contracts that are reflected on our consolidated balance sheets. Realized gains and losses are also included in other income (expense) on our consolidated statements of operations.

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

We are exposed to credit losses in the event of nonperformance by the counterparties on our commodity derivatives positions and have considered the exposure in our internal valuations. However, we do not anticipate nonperformance by the counterparties over the term of the commodity derivatives positions.

To estimate the fair value of our commodity derivatives positions, we use market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated or generally unobservable. We primarily apply the market approach for recurring fair value measurements and attempt to use the best available information. We determine the fair value based upon the hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and lowest priority to unobservable inputs (Level 3 measurement). The three levels of fair value hierarchy are as follows:

Level 1 Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. At September 30, 2014, we had no Level 1 measurements.

Level 2 Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors and current market and contractual prices for the underlying instruments, as well as other relevant economic measures. Our derivatives, which consist primarily of commodity swaps and collars, are valued using commodity market data which is derived by combining raw inputs and quantitative models and processes to generate forward curves. Where observable inputs are available, directly or indirectly, for substantially the full term of the asset or liability, the instrument is categorized in Level 2. At September 30, 2014, all of our commodity derivatives were valued using Level 2 measurements.

Level 3 Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management s best estimate of fair value. At September 30, 2014, we had no Level 3 measurements.

***Financial Instruments Not Recorded at Fair Value***

The following table sets forth the fair values of financial instruments that are not recorded at fair value on our financial statements (in thousands).

**September 30, 2014**

| | Carrying Amount | Fair Value |
|---|---|---|
| Senior Notes | $ 250,000 | $ 251,500 |

The fair value of the Senior Notes uses pricing that is readily available in the public market. Accordingly, the fair value of the Senior Notes would be classified as Level 2 in the fair value hierarchy.

**Approach Resources Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**September 30, 2014**

**8. Share-Based Compensation**

In February 2014, we awarded an aggregate of 245,157 restricted shares to our executive officers, of which 163,438 shares are subject to certain performance conditions and 81,719 shares are subject to three-year total shareholder return ( TSR ) conditions, assuming maximum TSR is achieved. Assuming target TSR is achieved, then 54,479 shares are subject to three-year TSR conditions. The aggregate fair market value of the award, assuming target TSR is achieved is $4.5 million, which will be expensed over a service period of approximately three years, subject to performance and three-year TSR conditions.

Effective May 16, 2014, we entered into an executive grant and separation agreement (the Separation Agreement ) with Ralph P. Manoushagian, former Executive Vice President Land, upon his retirement. As set forth in the Separation Agreement, we granted Mr. Manoushagian 41,281 restricted stock units with an aggregate fair market value of $0.8 million that will be settled on December 31, 2014. We also recorded a benefit of $1.1 million in share-based compensation expense related to the forfeiture of 66,684 outstanding unvested shares of restricted stock previously awarded to Mr. Manoushagian.

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

The following discussion is intended to assist in understanding our results of operations and our financial condition. This section should be read in conjunction with management s discussion and analysis contained in our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission ( SEC ) on February 25, 2014. Our consolidated financial statements and the accompanying notes included elsewhere in this Quarterly Report on Form 10-Q contain additional information that should be referred to when reviewing this material. Certain statements in this discussion may be forward-looking. These forward-looking statements involve risks and uncertainties, which could cause actual results to differ from those expressed in this report. A glossary containing the meaning of the oil and gas industry terms used in this management s discussion and analysis follows the Results of Operations table in this Item 2.

**Cautionary Statement Regarding Forward-Looking Statements**

Various statements in this report, including those that express a belief, expectation or intention, as well as those that are not statements of historical fact, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act ). The forward-looking statements may include projections and estimates concerning the timing and success of specific projects, typical well economics and our future reserves, production, revenues, costs, income, capital spending, 3-D seismic operations, interpretation and results and obtaining permits and regulatory approvals. When used in this report, the words will, believe, intend, expect, may, should, anticipate, could, estim predict, project, potential or their negatives, other similar expressions or the statements that include those words, are intended to identify forward-looking statements, although not all forward-looking statements contain such identifying words.

These forward-looking statements are largely based on our expectations, which reflect estimates and assumptions made by our management. These estimates and assumptions reflect our best judgment based on currently known market conditions and other factors. Although we believe such estimates and assumptions to be reasonable, they are inherently uncertain and involve a number of risks and uncertainties that are beyond our control. In addition, management s assumptions about future events may prove to be inaccurate. We caution all readers that the forward-looking statements contained in this report are not guarantees of future performance, and we cannot assure any reader that such statements will be realized or the forward-looking events and circumstances will occur. Actual results may differ materially from those anticipated or implied in the forward-looking statements due to the factors listed or referred to in the Risk Factors section and elsewhere in this report. All forward-looking statements speak only as of the date of this report. We disclaim any obligation to publicly update or revise any forward-looking statements as a result of new information, future events or otherwise, unless required by law. These cautionary statements qualify all forward-looking statements attributable to us, or persons acting on our behalf. The risks, contingencies and uncertainties relate to, among other matters, the following:

- uncertainties in drilling, exploring for and producing oil and gas;
- oil, NGL and gas prices;
- overall United States and global economic and financial market conditions;

domestic and foreign demand and supply for oil, NGLs, gas and the products derived from such hydrocarbons;

our inability to obtain additional financing necessary to fund our operations and capital expenditures and to meet our other obligations;

the effect of government regulation and permitting and other legal requirements, including laws or regulations that could restrict or prohibit hydraulic fracturing;

disruption of credit and capital markets;

our financial position;

our cash flows and liquidity;

disruptions to, capacity constraints in or other limitations on the pipeline systems that deliver our oil, NGLs and gas and other processing and transportation considerations;

marketing of oil, NGLs and gas;

high costs, shortages, delivery delays or unavailability of drilling and completion equipment, materials, labor or other services;

competition in the oil and gas industry;

uncertainty regarding our future operating results;

interpretation of 3-D seismic data;

replacing our oil, NGL and gas reserves;

our ability to retain and attract key personnel;

our business strategy, including our ability to recover oil, NGLs and gas in place associated with our Wolfcamp shale oil resource play in the Permian Basin;

development of our current asset base or property acquisitions;

estimated quantities of oil, NGL and gas reserves and present value thereof;

plans, objectives, expectations and intentions contained in this report that are not historical; and

other factors discussed in our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC on February 25, 2014.

**Overview**

Approach Resources Inc. is an independent energy company focused on the exploration, development, production and acquisition of unconventional oil and gas reserves in the Midland Basin of the greater Permian Basin in West Texas, where we lease approximately 136,500 net acres. We believe our concentrated acreage position provides us an opportunity to achieve cost, operating and recovery efficiencies in the development of our drilling inventory. We are currently developing significant resource potential from the Wolfcamp shale oil formation. Additional drilling targets could include the Clearfork, Canyon Sands, Strawn and Ellenburger zones. We sometimes refer to our development project in the Permian Basin as Project Pangea, which includes Pangea West. Our management and technical team have a proven track record of finding and developing reserves through advanced drilling and completion techniques. As the operator of all of our estimated proved reserves and production, we have a high degree of control over capital expenditures and other operating matters.

At December 31, 2013, our estimated proved reserves were 114.7 million barrels of oil equivalent ( MMBoe ), made up of 40% oil, 29% NGLs, 31% gas and 39% proved developed. Substantially all of our proved reserves are located in the Permian Basin in Crockett and Schleicher Counties, Texas. At September 30, 2014, we owned working interests in 752 producing oil and gas wells.

**Third Quarter 2014 Activity**

During the three months ended September 30, 2014, we produced 1,306 MBoe, or 14.2 MBoe/d. We drilled 18 horizontal wells and completed 16 horizontal wells. We currently have three horizontal rigs running in Project Pangea.

**Capital Expenditures**

For the three months ended September 30, 2014, our capital expenditures totaled $104.9 million, consisting of $94 million for drilling and completion activities, $8.5 million for infrastructure projects, $1.5 million for acreage acquisitions and extensions and $0.9 million for buildings and other equipment.

**Results of Operations**

The following table sets forth summary information regarding oil, NGL and gas revenues, production, average product prices and average production costs and expenses for the three and nine months ended September 30, 2014 and 2013. We determine a barrel of oil equivalent using the ratio of six Mcf of natural gas to one Boe, and one barrel of NGLs to one Boe. The ratios of six Mcf of natural gas to one Boe and one barrel of NGLs to one Boe do not assume price equivalency and, given price differentials, the price for a Boe for natural gas or NGLs may differ significantly from the price for a barrel of oil.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| **Revenues (in thousands):** | | | | |
| Oil | $ 47,194 | $ 31,708 | $ 140,509 | $ 87,551 |
| NGLs | 11,628 | 7,231 | 33,486 | 19,682 |
| Gas | 9,302 | 5,257 | 29,464 | 15,504 |
| Total oil, NGL and gas sales | 68,124 | 44,196 | 203,459 | 122,737 |
| Realized loss on commodity derivatives | (764) | (840) | (5,423) | (1,247) |
| Total oil, NGL and gas sales including derivative impact | $ 67,360 | $ 43,356 | $ 198,036 | $ 121,490 |
| **Production:** | | | | |
| Oil (MBbls) | 507 | 314 | 1,482 | 969 |
| NGLs (MBbls) | 392 | 242 | 1,057 | 682 |
| Gas (MMcf) | 2,445 | 1,538 | 6,727 | 4,393 |
| Total (MBoe) | 1,306 | 812 | 3,659 | 2,383 |
| Total (MBoe/d) | 14.2 | 8.8 | 13.4 | 8.7 |
| **Average prices:** | | | | |
| Oil (per Bbl) | $ 93.14 | $ 101.02 | $ 94.84 | $ 90.39 |
| NGLs (per Bbl) | 29.70 | 29.87 | 31.69 | 28.84 |
| Gas (per Mcf) | 3.80 | 3.42 | 4.38 | 3.53 |
| Total (per Boe) | $ 52.17 | $ 54.41 | $ 55.60 | $ 51.50 |
| Realized loss on commodity derivatives (per Boe) | (0.58) | (1.03) | (1.49) | (0.52) |
| Total including derivative impact (per Boe) | $ 51.59 | $ 53.38 | $ 54.11 | $ 50.98 |
| **Costs and expenses (per Boe):** | | | | |
| Lease operating | $ 5.87 | $ 5.38 | $ 6.41 | $ 5.77 |
| Production and ad valorem taxes | 2.55 | 3.90 | 3.40 | 3.69 |
| Exploration | 0.68 | 1.47 | 0.98 | 0.84 |
| General and administrative | 5.88 | 7.60 | 6.45 | 7.47 |
| Depletion, depreciation and amortization | 19.88 | 23.91 | 21.35 | 23.06 |

*Bbl.* One stock tank barrel, of 42 U.S. gallons liquid volume, used herein to reference oil, condensate or NGLs.

*Boe.* Barrel of oil equivalent, determined using the ratio of six Mcf of gas to one Bbl of oil equivalent, and one Bbl of NGLs to one Bbl of oil equivalent.

*MBbl.* Thousand barrels of oil, condensate or NGLs.

*MBoe.* Thousand barrels of oil equivalent.

*Mcf.* Thousand cubic feet of natural gas.

*MMBoe.* Million barrels of oil equivalent.

*MMcf.* Million cubic feet of natural gas.

*NGLs.* Natural gas liquids.

*/d.* Per day when used with volumetric units or dollars.

***Three Months Ended September 30, 2014, Compared to Three Months Ended September 30, 2013***

*Oil, NGL and gas sales.* Oil, NGL and gas sales increased $23.9 million, or 54%, for the three months ended September 30, 2014, to $68.1 million, from $44.2 million for the three months ended September 30, 2013. The increase in oil, NGL and gas sales was due to an increase in production volumes ($27 million), partially offset by a decrease in average realized commodity prices ($3.1 million). Production volumes increased as a result of our continued development in Project Pangea.

*Net income*. Net income for the three months ended September 30, 2014, was $22.4 million, or $0.57 per diluted share, compared to net income of $0.5 million, or $0.01 per diluted share, for the three months ended September 30, 2013. Net income for the three months ended September 30, 2014, included an unrealized gain on commodity derivatives of $18.8 million and a realized loss on commodity derivatives of $0.8 million. Net income for the three months ended September 30, 2014, increased primarily due to higher revenues ($23.9 million), and an increase in gains from our unrealized commodity derivatives ($22.2 million), partially offset by higher operating expenses as a result of increased production ($11.2 million).

*Oil, NGL and gas production.* Production for the three months ended September 30, 2014, totaled 1,306 MBoe (14.2 MBoe/d), compared to production of 812 MBoe (8.8 MBoe/d) in the prior-year period, a 61% increase. Production for the three months ended September 30, 2014 and 2013 was 39% oil, 30% NGLs and 31% gas. Production volumes increased during the three months ended September 30, 2014, as a result of our continued development in Project Pangea. We expect production to continue to increase for the remainder of 2014 due to our development project in the Permian Basin.

*Commodity derivatives activities*. Our commodity derivatives activity resulted in a realized loss of $0.8 million for the three months ended September 30, 2014 and 2013. Our average realized price, including the effect of commodity derivatives, was $51.59 per Boe for the three months ended September 30, 2014, compared to $53.38 per Boe for the three months ended September 30, 2013. Realized gains and losses on commodity derivatives are derived from the relative movement of commodity prices in relation to the fixed pricing in our derivatives contracts for the respective periods. The unrealized gain on commodity derivatives was $18.8 million for the three months ended September 30, 2014 compared to an unrealized loss of $3.4 million for the three months ended September 30, 2013. As commodity prices increase or decrease, the fair value of the open portion of those positions decreases or increases, respectively.

Historically, we have not designated our derivative instruments as cash-flow hedges. We record our open derivative instruments at fair value on our consolidated balance sheets as either unrealized gains or losses on commodity derivatives. We record changes in such fair value in net income on our consolidated statements of operations under the caption entitled unrealized gain (loss) on commodity derivatives.

*Lease operating*. Our lease operating expenses ( LOE ) increased $3.3 million, or 75.4%, for the three months ended September 31, 2014, to $7.7 million, or $5.87 per Boe, from $4.4 million, or $5.38 per Boe, for the three months ended September 30, 2013. The increase in LOE per Boe for the three months ended September 30, 2014, was primarily due to increases in water hauling and compressor rental and repair, partially offset by decreases in well repairs, workovers and maintenance and pumpers and supervision. The following table summarizes LOE per Boe.

| | Three Months Ended September 30, 2014 | 2013 | Change | % Change |
|---|---|---|---|---|
| Water hauling and other | $ 2.20 | $ 1.72 | $ 0.48 | 27.9% |
| Compressor rental and repair | 1.83 | 1.54 | 0.29 | 18.8 |
| Well repairs, workovers and maintenance | 0.96 | 1.17 | (0.21) | (17.9) |
| Pumpers and supervision | 0.88 | 0.95 | (0.07) | (7.4) |
| Total | $ 5.87 | $ 5.38 | $ 0.49 | 9.1% |

*Production and ad valorem taxes*. Our production and ad valorem taxes increased $0.1 million, or 5.3%, for the three months ended September 30, 2014, to $3.3 million from $3.2 million for the three months ended September 30, 2013. The increase in production and ad valorem taxes was primarily due to an increase in oil, NGL and gas sales between the two periods. Production and ad valorem taxes were $2.55 per Boe and $3.90 per Boe and approximately 4.9% and 7.2% of oil, NGL and gas sales for the three months ended September 30, 2014 and 2013, respectively. Production and ad valorem taxes per Boe for the three months ended September 30, 2014 decreased due to a refund from the state of Texas for production taxes on natural gas properties of $1 million relating to tax reimbursements.

*Exploration*. We recorded $0.9 million, or $0.68 per Boe, and $1.2 million, or $1.47 per Boe, of exploration expense for the three months ended September 30, 2014 and 2013, respectively. Exploration expense for the respective periods resulted primarily from lease expirations.

*General and administrative*. Our general and administrative expenses ( G&A ) increased $1.5 million, or 24.4%, to $7.7 million, or $5.88 per Boe, for the three months ended September 30, 2014, from $6.2 million, or $7.60 per Boe, for the three months ended September 30, 2013. The increase in G&A was primarily due to higher salaries and benefits resulting from increased staffing. G&A per Boe for the three months ended September 30, 2014, decreased due to higher production as a result of our continued development in Project Pangea. The following table summarizes G&A in millions and G&A per Boe.

| | Three Months Ended September 30, 2014 | | 2013 | | Change | | |
|---|---|---|---|---|---|---|---|
| | $MM | Boe | $MM | Boe | $MM | Boe | % Change |
| Salaries and benefits | $ 3.5 | $ 2.65 | $ 2.5 | $ 3.09 | $ 1.0 | $ (0.44) | (14.2)% |
| Share-based compensation | 2.0 | 1.50 | 1.6 | 1.97 | 0.4 | (0.47) | (23.9) |
| Professional fees | 0.2 | 0.16 | 0.6 | 0.70 | (0.4) | (0.54) | (77.1) |
| Other | 2.0 | 1.57 | 1.5 | 1.84 | 0.5 | (0.27) | (14.7) |
| Total | $ 7.7 | $ 5.88 | $ 6.2 | $ 7.60 | $ 1.5 | $ (1.72) | (22.6)% |

*Depletion, depreciation and amortization.* Our depletion, depreciation and amortization expense ( DD&A ) increased $6.5 million, or 33.7%, to $26 million for the three months ended September 30, 2014, from $19.4 million for the three months ended September 30, 2013. Our DD&A per Boe decreased by $4.03 per Boe, or 16.9%, to $19.88 per Boe for the three months ended September 30, 2014, compared to $23.91 per Boe for the three months ended September 30, 2013. The increase in DD&A expense over the prior-year period was primarily due to higher production. The decrease in DD&A per Boe over the prior-year period was primarily due to lower oil and gas property carrying costs relative to estimated proved developed reserves.

*Interest expense, net.* Our interest expense, net, increased $0.2 million, or 5.1%, to $5.4 million for the three months ended September 30, 2014, from $5.2 million for the three months ended September 30, 2013. We expect our interest expense to remain higher than the prior-year period as a result of increased borrowings for the remainder of 2014 as we continue to develop Project Pangea.

*Income taxes.* Our income taxes were $12.8 million and $0.3 million for the three months ended September 30, 2014 and 2013, respectively. The increase in income taxes was primarily due to an increase in income before income taxes in the 2014 period. Our effective income tax rate for the three months ended September 30, 2014, was 36.2%, compared to 35.3% for the three months ended September 30, 2013.

***Nine Months Ended September 30, 2014, Compared to Nine Months Ended September 30, 2013***

*Oil, NGL and gas sales.* Oil, NGL and gas sales increased $80.7 million, or 65.8%, for the nine months ended September 30, 2014, to $203.4 million, from $122.7 million for the nine months ended September 30, 2013. The increase in oil, NGL and gas sales was due to an increase in production volumes ($65.4 million) and an increase in average realized commodity prices ($15.3 million). Production volumes increased as a result of our continued development in Project Pangea.

*Net income*. Net income for the nine months ended September 30, 2014, was $29.2 million, or $0.74 per diluted share, compared to net income of $7.9 million, or $0.20 per diluted share, for the nine months ended September 30, 2013. Net income for the nine months ended September 30, 2014, included an unrealized gain on commodity derivatives of $5.2 million and a realized loss on commodity derivatives of $5.4 million. Net income for the nine months ended September 30, 2014, increased due to higher revenues ($80.7 million), and an increase in gain from our unrealized commodity derivatives ($8.5 million), partially offset by higher operating expenses as a result of increased production ($43.9 million), an increase in interest expense ($7.1 million), and losses on our realized commodity derivatives ($4.2 million).

*Oil, NGL and gas production.* Production for the nine months ended September 30, 2014, totaled 3,659 MBoe (13.4 MBoe/d), compared to production of 2,383 MBoe (8.7 MBoe/d) in the prior-year period, a 53.5% increase. Production for the nine months ended September 30, 2014 and 2013, was 41% oil, 29% NGLs and 31% gas. Production volumes increased during the nine months ended September 30, 2014, as a result of our continued development in Project Pangea. We expect production to continue to increase for the remainder of 2014 due to our development project in the Permian Basin.

*Commodity derivatives activities*. Our commodity derivatives activity resulted in a realized loss of $5.4 million and $1.2 million for the nine months ended September 30, 2014 and 2013, respectively. Our average realized price, including the effect of commodity derivatives, was $54.11 per Boe for the nine months ended September 30, 2014, compared to $50.98 per Boe for the nine months ended September 30, 2013. Realized gains and losses on commodity derivatives are derived from the relative movement of commodity prices in relation to the fixed pricing in our derivatives contracts for the respective periods. The unrealized gain on commodity derivatives was $5.2 million for the nine months ended September 30, 2014, compared to an unrealized loss of $3.2 million for the nine months ended September 30, 2013. As commodity prices increase or decrease, the fair value of the open portion of those positions decreases or increases, respectively.

*Lease operating*. Our LOE increased $9.7 million, or 70.7%, for the nine months ended September 30, 2014, to $23.5 million, or $6.41 per Boe, from $13.7 million, or $5.77 per Boe, for the nine months ended September 30, 2013. The increase in LOE per Boe for the nine months ended September 30, 2014, was primarily due to increases in compressor rental and repair, well repairs, workovers and maintenance and water hauling, partially offset by a decrease in pumpers and supervision. The following table summarizes LOE per Boe.

| | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 | Change | % Change |
|---|---|---|---|---|
| Compressor rental and repair | $ 1.86 | $ 1.57 | $ 0.29 | 18.5% |
| Well repairs, workovers and maintenance | 1.84 | 1.66 | 0.18 | 10.8 |
| Water hauling and other | 1.81 | 1.54 | 0.27 | 17.5 |
| Pumpers and supervision | 0.90 | 1.00 | (0.10) | (10.0) |
| Total | $ 6.41 | $ 5.77 | $ 0.64 | 11.1% |

*Production and ad valorem taxes*. Our production and ad valorem taxes increased $3.6 million, or 41.4%, for the nine months ended September 30, 2014, to $12.4 million, from $8.8 million for the nine months ended September 30, 2013. The increase in production and ad valorem taxes was primarily due to an increase in oil, NGL and gas sales between the two periods. Production and ad valorem taxes were $3.40 per Boe and $3.69 per Boe and approximately 6.1% and 7.2% of oil, NGL and gas sales for the nine months ended September 30, 2014 and 2013, respectively. Production and ad valorem taxes per Boe for the nine months ended September 30, 2014 decreased due to a refund from the state of Texas for production taxes on natural gas properties of $1 million relating to tax reimbursements.

*Exploration*. We recorded $3.6 million, or $0.98 per Boe, and $2.0 million, or $0.84 per Boe, of exploration expense for the nine months ended September 30, 2014 and 2013, respectively. Exploration expense for the respective periods resulted primarily from lease expirations.

*General and administrative*. Our G&A increased $5.8 million, or 32.6%, to $23.6 million, or $6.45 per Boe, for the nine months ended September 30, 2014, from $17.8 million, or $7.47 per Boe, for the nine months ended September 30, 2013. The increase in G&A was primarily due to higher salaries resulting from increased staffing. G&A per Boe for the nine months ended September 30, 2014, decreased due to higher production as a result of our continued development in Project Pangea. Share-based compensation for the nine months ended September 30, 2014 includes a benefit of forfeited stock awards of $1.1 million related to the retirement of one of our executive officers. The following table summarizes G&A in millions and G&A per Boe.

| | Nine Months Ended September 30, 2014 | | Nine Months Ended September 30, 2013 | | Change | | |
|---|---|---|---|---|---|---|---|
| | $MM | Boe | $MM | Boe | $MM | Boe | % Change |
| Salaries and benefits | $ 10.4 | $ 2.84 | $ 7.1 | $ 2.98 | $ 3.3 | $ (0.14) | (4.7)% |
| Share-based compensation | 5.7 | 1.56 | 5.4 | 2.26 | 0.3 | (0.70) | (31.0) |
| Professional fees | 1.4 | 0.39 | 1.1 | 0.44 | 0.3 | (0.05) | (11.4) |
| Other | 6.1 | 1.66 | 4.2 | 1.79 | 1.9 | (0.13) | (7.3) |
| Total | $ 23.6 | $ 6.45 | $ 17.8 | $ 7.47 | $ 5.8 | $ (1.02) | (13.7)% |

*Depletion, depreciation and amortization*. Our DD&A increased $23.2 million, or 42.2%, to $78.1 million for the nine months ended September 30, 2014, from $55 million for the nine months ended September 30, 2013. Our DD&A per Boe decreased by $1.71 per Boe, or 7.4%, to $21.35 per Boe for the nine months ended September 30, 2014, compared to $23.06 per Boe for the nine months ended September 30, 2013. The increase in DD&A expense over the prior-year period was primarily due to higher production. The decrease in DD&A per Boe over the prior-year period was primarily due to lower oil and gas property carrying costs relative to estimated proved developed reserves.

*Interest expense, net.* Our interest expense, net, increased $7.1 million, or 79.9%, to $15.9 million for the nine months ended September 30, 2014, from $8.9 million for the nine months ended September 30, 2013. This increase was primarily due to interest payable on the Senior Notes that were issued in June 2013. We expect our interest expense to remain higher than the prior-year period as a result of increased borrowings for the remainder of 2014 as we continue to develop Project Pangea.

*Income taxes.* Our income taxes were $16.6 million and $4.3 million for the nine months ended September 30, 2014 and 2013, respectively. The increase in income taxes was primarily due to an increase in income before income taxes in the 2014 period. Our effective income tax rate for the nine months ended September 30, 2014, was 36.2%, compared to 35.1% for the nine months ended September 30, 2013.

**Liquidity and Capital Resources**

We generally will rely on cash generated from operations, available cash, borrowings under our Credit Facility and, to the extent that credit and capital market conditions will allow, future public equity and debt offerings to satisfy our liquidity needs. Our ability to fund planned capital expenditures and to make acquisitions depends upon our future operating performance, availability of borrowings under our Credit Facility, and more broadly, on the availability of equity and debt financing, which is affected by prevailing economic conditions in our industry and financial, business and other factors, some of which are beyond our control. We cannot predict whether additional liquidity from equity or debt financings beyond our Credit Facility will be available on acceptable terms, or at all, in the foreseeable future.

Our cash flows from operations are driven by commodity prices, production volumes, relative expense levels and the effect of commodity derivatives. Prices for oil and gas are affected by national and international economic and political environments, national and global supply and demand for hydrocarbons, seasonal influences of weather and other factors beyond our control. Cash flows from operations are primarily used to fund exploration and development of our oil and gas properties.

We believe we have adequate liquidity from cash generated from operations and unused borrowing capacity under our Credit Facility for current working capital needs and maintenance of our current development project. However, we may determine to use various financing sources, including the issuance of common stock, preferred stock, debt, convertible securities and other securities for future development of reserves, acquisitions, additional working capital or other liquidity needs, if such financing is available on acceptable terms. We cannot guarantee that such financing will be available on acceptable terms or at all. Using some of these financing sources may require approval from the lenders under our Credit Facility.

***Liquidity***

We define liquidity as funds available under our Credit Facility, cash and cash equivalents. At September 30, 2014, and December 31, 2013, we had $89.5 million and no outstanding borrowings under our Credit Facility and liquidity of $361.8 million and $408.4 million, respectively. The table below summarizes our liquidity position at September 30, 2014, and December 31, 2013 (dollars in thousands).

| | Liquidity at September 30, 2014 | Liquidity at December 31, 2013 |
|---|---|---|
| Borrowing base | $ 450,000 | $ 350,000 |
| Cash and cash equivalents | 1,634 | 58,761 |
| Long-term debt Credit Facility | (89,500) | |

| | | |
|---|---|---|
| Undrawn letters of credit | (325) | (325) |
| Liquidity | $ 361,809 | $ 408,436 |

The lenders under our Credit Facility completed their semi-annual borrowing base redetermination, resulting in an increase in the borrowing base to $600 million from $450 million, effective November 4, 2014. We have elected to leave the aggregate lender commitments unchanged at $450 million. Additional information regarding the Credit Facility is included in Note 4. Long-Term Debt.

***Working Capital***

Our working capital is affected primarily by our cash and cash equivalents balance and our capital spending program. We had a working capital deficit of $76.2 million at September 30, 2014, compared to a working capital surplus of $6 million at December 31, 2013. The primary reason for the change in working capital was an increase in accrued liabilities, and a decrease in our cash balance due to an increase in our capital expenditures. To the extent we operate, or end fiscal year 2014, with a working capital deficit, we expect such deficit to be more than offset by liquidity available under our Credit Facility.

***Cash Flows***

The following table summarizes our sources and uses of funds for the periods noted (in thousands).

| | **Nine Months Ended September 30,** | |
|---|---|---|
| | **2014** | **2013** |
| Cash flows provided by operating activities | $ 148,230 | $ 118,996 |
| Cash flows used in investing activities | (292,630) | (230,187) |
| Cash flows provided by financing activities | 87,273 | 135,913 |
| Net (decrease) increase in cash and cash equivalents | $ (57,127) | $ 24,722 |

***Operating Activities***

Cash flows provided by operating activities increased by 24.6%, or $29.2 million, to $148.2 million during the nine months ended September 30, 2014, compared to the prior-year period. The increase in our cash flows provided by operating activities was primarily due to an increase in oil, NGL and gas sales from higher production, partially offset by an increase in total expenses and the timing of payments and receipts of working capital components.

***Investing Activities***

Cash flows used in investing activities increased by $62.4 million for the nine months ended September 30, 2014, to $292.6 million, compared to the prior-year period. Our capital expenditures for the nine months ended September 30, 2014, were primarily attributable to drilling and development ($276.9 million), infrastructure projects ($14.8 million), acreage acquisitions and extensions ($4.4 million) and buildings and other equipment ($3.7 million). Additionally, $7.4 million in restricted cash was released from escrow related to the sale of our interest in the Wildcat pipeline, offset by $0.2 million in post-closing working capital adjustments related to the sale. During the nine months ended September 30, 2014, we drilled a total of 50 horizontal wells and completed 51 horizontal wells in Project Pangea.

***Financing Activities***

During the nine months ended September 30, 2014, cash flows provided by financing activities decreased by $48.6 million, compared to the prior-year period. We had $89.5 million of outstanding borrowings under our Credit Facility at September 30, 2014. During the nine months ended September 30, 2014, net cash flows provided by financing activities included borrowings under our Credit Facility of $231.4 million that were partially offset by repayments of outstanding borrowings under our Credit Facility

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of $141.9 million. This compares to the nine months ended September 30, 2013, when we had net cash flows provided by financing activities that primarily included borrowings under our Credit Facility of $129.1 million and net proceeds from our offering of the Senior Notes of $242.7 million that were partially offset by repayments of outstanding borrowings under our Credit Facility of $235.9 million.

**Credit Facility**

At September 30, 2014, the borrowing base and aggregate lender commitments under our Credit Facility was $450 million, with maximum commitments from the lenders of $1 billion and a maturity date of May 7, 2019. We had outstanding borrowings of $89.5 million under our Credit Facility at September 30, 2014, compared to no outstanding borrowings at December 31, 2013. The weighted average interest rate applicable to borrowings under our credit facility for the nine months ended September 30, 2014, was 1.4%. Additional information regarding our credit arrangements is included in Note 4. Long-Term Debt.

On November 4, 2014, we entered into a first amendment to the Credit Facility, which, among other things, (a) increases the borrowing base to $600 million from $450 million, (b) maintains the aggregate commitments of the lenders at $450 million and (c) provides for the applicable margin or interest rate to be paid based on utilization of borrowing base, rather than utilization of aggregate commitments of the lenders.

To date, we have experienced no disruptions in our ability to access our Credit Facility. However, our lenders have substantial ability to reduce our borrowing base on the basis of subjective factors, including the loan collateral value that each lender, in its discretion and using the methodology, assumptions and discount rates as such lender customarily uses in evaluating oil and gas properties, assigns to our properties.

**Contractual Obligations**

Our contractual obligations include long-term debt, daywork drilling contracts, operating lease obligations, asset retirement obligations and employment agreements with our executive officers. On January 3, 2014, we entered into an employment agreement with Sergei Krylov as the Company s Executive Vice President and Chief Financial Officer. Our maximum commitment under Mr. Krylov s employment agreement, which would apply if Mr. Krylov were terminated without cause, is $1.3 million. In August 2014, we amended our existing gas purchase and processing agreement with DCP Midstream, LP to extend the term through August 2023. In October 2014, we extended two daywork drilling contracts through March 2015 and September 2015, respectively, with aggregate contractual obligations of approximately $12 million. We have retained a third drilling rig contracted on a well-to-well basis. Since December 31, 2013, there have been no other material changes to our contractual obligations.

**Off-Balance Sheet Arrangements**

From time to time, we enter into off-balance sheet arrangements and transactions that can give rise to off-balance sheet obligations. As of September 30, 2014, the off-balance sheet arrangements and transactions that we have entered into include undrawn letters of credit and operating lease agreements. We do not believe that these arrangements have or are reasonably likely to have a current or future material effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**General Trends and Outlook**

Our financial results depend upon many factors, particularly the price of oil and gas. Commodity prices are affected by changes in market demand, which is impacted by domestic and foreign supply of oil and gas, overall domestic and global economic conditions, commodity processing, gathering and transportation availability and the availability of refining capacity, price and availability of alternative fuels, price and quantity of foreign imports, domestic and foreign governmental regulations, political conditions in or affecting other gas producing and oil producing countries, weather and technological advances affecting oil and gas consumption. As a result, we cannot accurately predict future oil and gas prices, and therefore, we cannot determine what effect increases or decreases will have on our capital program, production volumes and future revenues. A substantial or extended decline in oil and gas prices could have a material adverse effect on our business, financial condition, results of operations, quantities of oil and gas reserves that may be economically produced and liquidity that may be accessed through our borrowing base under our Credit Facility and through capital markets.

In addition to production volumes and commodity prices, finding and developing sufficient amounts of oil and gas reserves at economical costs are critical to our long-term success. Future finding and development costs are subject to changes in the industry, including the costs of acquiring, drilling and completing our projects. We focus our efforts on increasing oil and gas reserves and production while controlling costs at a level that is appropriate for long-term operations. Our future cash flow from operations will depend on our ability to manage our overall cost structure.

Like all oil and gas production companies, we face the challenge of natural production declines. Oil and gas production from a given well naturally decreases over time. Additionally, our reserves have a rapid initial decline. We attempt to overcome this natural decline by drilling to develop and identify additional reserves, farm-ins or other joint drilling ventures, and by acquisitions. However, during times of severe price declines, we may from time to time reduce current capital expenditures and curtail drilling operations in order to preserve liquidity. A material reduction in capital expenditures and drilling activities could materially reduce our production volumes and revenues and increase future expected costs necessary to develop existing reserves.

We also face the challenge of financing exploration, development and future acquisitions. We believe we have adequate liquidity from cash generated from operations and unused borrowing capacity under our Credit Facility for current working capital needs and maintenance of our current development project. However, we may determine to use various financing sources, including the issuance of common stock, preferred stock, debt, convertible securities and other securities for future development of reserves, acquisitions, additional working capital or other liquidity needs, if such financing is available on acceptable terms. We cannot guarantee that such financing will be available on acceptable terms or at all. Using some of these financing sources may require approval from the lenders under our Credit Facility.

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

Some of the information below contains forward-looking statements. The primary objective of the following information is to provide forward-looking quantitative and qualitative information about our potential exposure to market risks. The term market risk refers to the risk of loss arising from adverse changes in oil and gas prices, and other related factors. The disclosure is not meant to be a precise indicator of expected future losses, but rather an indicator of reasonably possible losses. This forward-looking information provides an indicator of how we view and manage our ongoing market risk exposures. Our market risk sensitive instruments were entered into for commodity derivatives and investment purposes, not for trading purposes.

**Commodity Price Risk**

Given the current economic outlook, we expect commodity prices to remain volatile. Even modest decreases in commodity prices can materially affect our revenues and cash flow. In addition, if commodity prices remain suppressed for a significant amount of time, we could be required under successful efforts accounting rules to write down some of our oil and gas properties.

We enter into financial swaps, options and collars to reduce the risk of commodity price fluctuations. We do not designate such instruments as cash flow hedges. Accordingly, we record open commodity derivatives positions on our consolidated balance sheets at fair value and recognize changes in such fair values as other income (expense) on our consolidated statements of operations as they occur.

The table below summarizes our commodity derivatives positions outstanding at September 30, 2014.

| **Commodity and Period** | **Contract Type** | **Volume Transacted** | **Contract Price** |
|---|---|---|---|
| **Crude Oil** | | | |
| October 2014 December 2014 | Collar | 550 Bbls/d | \$90.00/Bbl - \$105.50/Bbl |
| October 2014 December 2014 | Collar | 950 Bbls/d | \$85.05/Bbl - \$95.05/Bbl |
| October 2014 December 2014 | Collar | 2,000 Bbls/d | \$89.00/Bbl - \$98.85/Bbl |
| October 2014 March 2015 | Collar | 1,500 Bbls/d | \$85.00/Bbl - \$95.30/Bbl |
| January 2015 December 2015 | Collar | 2,100 Bbls/d | \$84.00/Bbl - \$91.00/Bbl |
| January 2015 December 2015 | Collar | 1,000 Bbls/d | \$90.00/Bbl - \$102.50 Bbl |
| January 2015 December 2015 | Three-Way Collar | 500 Bbls/d | \$75.00/Bbl - \$84.00/Bbl - \$94.00/Bbl |
| **Natural Gas Liquids** | | | |
| *Propane* | | | |
| October 2014 December 2014 | Swap | 500 Bbls/d | \$41.16/Bbl |
| *Natural Gasoline* | | | |
| October 2014 December 2014 | Swap | 175 Bbls/d | \$83.37/Bbl |
| Natural Gas | | | |
| October 2014 December 2014 | Swap | 360,000 MMBtu/month | \$4.18/MMBtu |
| October 2014 December 2014 | Swap | 35,000 MMBtu/month | \$4.29/MMBtu |
| October 2014 December 2014 | Swap | 160,000 MMBtu/month | \$4.40/MMBtu |
| October 2014 June 2015 | Collar | 80,000 MMBtu/month | \$4.00/MMBtu - \$4.74/MMBtu |
| January 2015 December 2015 | Swap | 200,000 MMBtu/month | \$4.10/MMBtu |
| | Collar | 130,000 MMBtu/month | \$4.00/MMBtu - \$4.25/MMBtu |

January 2015 December 2015

At September 30, 2014, the fair value of our open derivative contracts was a net asset of $3 million, compared to a net liability of $2.2 million at December 31, 2013. Subsequent to September 30, 2014, we converted a two-way crude oil collar covering 500 Bbls per day for 2015 with a long put of $84.00/bbl and a short call of $91.00/bbl to a three-way crude oil collar with a short put at $75.00/bbl, a long put at $84.00/bbl and a short call at $95.00/bbl.

JPMorgan Chase Bank, N.A. and KeyBank National Association are currently the only counterparties to our commodity derivatives positions. We are exposed to credit losses in the event of nonperformance by counterparties on our commodity derivatives positions. However, we do not anticipate nonperformance by the counterparties over the term of the commodity derivatives positions. JPMorgan is the administrative agent and a participant, and KeyBank is the documentation agent and a participant, in our Credit Facility and the collateral for the outstanding borrowings under our Credit Facility is used as collateral for our commodity derivatives.

Unrealized gains and losses, at fair value, are included on our consolidated balance sheets as current or non-current assets or liabilities based on the anticipated timing of cash settlements under the related contracts. Changes in the fair value of our commodity derivatives contracts are recorded in earnings as they occur and included in other income (expense) on our consolidated statements of operations. We estimate the fair values of swap contracts based on the present value of the difference in exchange-quoted forward price curves and contractual settlement prices multiplied by notional quantities. We internally valued the option contracts using industry-standard option pricing models and observable market inputs. We use our internal valuations to determine the fair values of the contracts that are reflected on our consolidated balance sheets. Realized gains and losses are also included in other income (expense) on our consolidated statements of operations.

For the nine months ended September 30, 2014, we recorded an unrealized gain on commodity derivatives of $5.2 million from the change in fair value of our commodity derivative positions, compared to an unrealized loss of $3.2 million for the nine months ended September 30, 2013. A hypothetical 10% increase in commodity prices would have resulted in a $11.2 million decrease in the fair value of our commodity derivatives positions recorded on our balance sheet at September 30, 2014, and a corresponding increase in the unrealized loss on commodity derivatives recorded on our consolidated statement of operations for the nine months ended September 30, 2014.

**Item 4. Controls and Procedures.**

**Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Such controls include those designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to management, including the President and Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), as appropriate, to allow timely decisions regarding required disclosure.

Our management, with the participation of our CEO and CFO, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Exchange Act) as of September 30, 2014. Based on this evaluation, the CEO and CFO have concluded that, as of September 30, 2014 our disclosure controls and procedures were effective, in that they ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

**Internal Control over Financial Reporting**

There were no changes made in our internal control over financial reporting (as defined in Rule 13a-15(f) promulgated under the Exchange Act) during the three months ended September 30, 2014, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Limitations Inherent in All Controls**

Our management, including the CEO and CFO, recognizes that the disclosure controls and procedures and internal controls (discussed above) cannot prevent all errors or all attempts at fraud. Any controls system, no matter how well-crafted and operated, can only provide reasonable, and not absolute, assurance of achieving the desired control objectives. Because of the inherent limitations in any control system, no evaluation or implementation of a control system can provide complete assurance that all control issues and all possible instances of fraud have been or will be detected.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings.

There have been no material developments in the legal proceedings described in Part I, Item 3. Legal Proceedings of our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC on February 25, 2014.

### Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the risks discussed in the following report that we have filed with the SEC, which risks could materially affect our business, financial condition and results of operations: Annual Report on Form 10-K for the year ended December 31, 2013, under the headings Item 1. Business Markets and Customers; Competition; and Regulation, Item 1A. Risk Factors, Item 7. Management Discussion and Analysis of Financial Condition and Results of Operations General Trends and Outlook and Item 7A. Quantitative and Qualitative Disclosures about Market Risk filed with the SEC on February 25, 2014.

There have been no material changes to the risk factors discussed in our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC on February 25, 2014, which is accessible on the SEC s website at *www.sec.gov* and our website at *www.approachresources.com*.

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

The following table provides information relating to our purchase of shares of our common stock during the three months ended September 30, 2014. The repurchases reflect shares withheld upon vesting of restricted stock under our 2007 Stock Incentive Plan to satisfy statutory minimum tax withholding obligations.

**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid Per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| Month #1 July 1, 2014 July 31, 2014 | 1,282 | $ 21.04 | | |
| Month #2 August 1, 2014 August 31, 2014 | 502 | 18.92 | | |
| Month #3 September 1, 2014 September 30, 2014 | 227 | 17.17 | | |
| Total | 2,011 | $ 20.07 | | |

### Item 6. Exhibits.

See Index to Exhibits following the signature page of this report for a description of the exhibits furnished as part of this report.

**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.

| | |
|---|---|
| | APPROACH RESOURCES INC. |
| Date: November 6, 2014 | By: /s/ J. Ross Craft<br>J. Ross Craft<br>Chairman of the Board,<br><br>Chief Executive Officer and President<br><br>(Principal Executive Officer) |
| Date: November 6, 2014 | By: /s/ Sergei Krylov<br>Sergei Krylov<br>Executive Vice President and Chief Financial Officer<br><br>(Principal Financial Officer) |

## Index to Exhibits

| *Exhibit Number* | *Description of Exhibit* |
|---|---|
| 3.1 | Restated Certificate of Incorporation of Approach Resources Inc. (filed as Exhibit 3.1 to the Company s Quarterly Report on Form 10-Q filed December 13, 2007, and incorporated herein by reference). |
| 3.2 | Second Amended and Restated Bylaws of Approach Resources Inc., effective November 6, 2013 (filed as Exhibit 3.2 to the Company s Current Report on Form 8-K filed November 8, 2013, and incorporated herein by reference). |
| 4.1 | Specimen Common Stock Certificate (filed as Exhibit 4.1 to the Company s Registration Statement on Form S-1/A filed October 18, 2007 (File No. 333-144512), and incorporated herein by reference). |
| 4.2 | Senior Indenture, dated as of June 11, 2013, among Approach Resources Inc., as issuer, the subsidiary guarantors named therein, as guarantors, and Wells Fargo Bank, National Association, as trustee (filed as Exhibit 4.1 to the Company s Current Report on Form 8-K filed June 11, 2013, and incorporated herein by reference). |
| 4.3 | First Supplemental Indenture, dated as of June 11, 2013, among Approach Resources Inc., as issuer, the subsidiary guarantors named therein, as guarantors, and Wells Fargo Bank, National Association, as trustee (filed as Exhibit 4.2 to the Company s Current Report on Form 8-K filed June 11, 2013, and incorporated herein by reference). |
| 10.1 | First Amendment dated as of November 4, 2014, to Amended and Restated Credit Agreement dated as of May 7, 2014, by and among the Company, JPMorgan Chase Bank, N.A., as Administrative Agent, and each of the Lenders party thereto (filed as Exhibit 10.1 to the Company s Current Report on Form 8-K filed November 5, 2014, and incorporated herein by reference). |
| *10.2 | Amendment dated August 4, 2014, to Gas Purchase Contract dated as of January 1, 2011, between Approach Resources I, LP and Approach Oil & Gas Inc., as Seller, and DCP Midstream, LP, as Buyer. |
| *31.1 | Certification by the President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| *31.2 | Certification by the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| *32.1 | Certification by the President and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| *32.2 | Certification by the Chief Financial Officer Pursuant to U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| *101.INS | XBRL Instance Document. |
| *101.SCH | XBRL Taxonomy Extension Schema Document. |

| ***Exhibit Number*** | ***Description of Exhibit*** |
|---|---|
| *101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document. |
| *101.LAB | XBRL Taxonomy Extension Label Linkbase Document. |
| *101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document. |
| *101.DEF | XBRL Taxonomy Extension Definition Linkbase Document. |

* Filed herewith.