

VICTORY ENERGY CORP  
Form 10-Q  
November 14, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the quarterly period ended September 30, 2012**

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

**Commission file number 002-76219NY**

**VICTORY ENERGY CORPORATION**

(Exact Name of Company as Specified in its Charter)

**Nevada**

(State or other jurisdiction of  
incorporation or organization)

**87-0564472**

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

**3355 Bee Caves Road Ste 608, Austin, Texas 78746**

(Address of principal executive offices) (Zip Code)

**(512)-347-7300**

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(Registrant's telephone number, including area code)

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(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 Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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). Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

**Applicable only to issuers involved in bankruptcy proceedings during the preceding five years**

Check whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court.

Yes  No

**Applicable only to corporate issuers:**

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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. As of November 1, 2012, there were 27,512,919 shares of common stock, par value \$0.001, issued and outstanding and held by 1,434 stockholders of record. This reflects the 1:50 reverse stock split that became effective on January 12, 2012.

**VICTORY ENERGY CORPORATION**

**QUARTERLY REPORT ON**

**FORM 10-Q**

**FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2012**

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### Cautionary Notice Regarding Forward Looking Statements

Victory Energy Corporation desires to take advantage of the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. This report contains a number of forward-looking statements that reflect management's current views and expectations with respect to business, strategies, future results and events and financial performance. All statements made in this report other than statements of historical fact, including statements that address operating performance, events or developments that management expects or anticipates will or may occur in the future, including statements related to revenues, cash flow, profitability, adequacy of funds from operations, statements expressing general optimism about future operating results and non-historical information, are forward looking statements. In particular, the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “may,” “will,” variations of such words and similar expressions identify forward-looking statements, but are not the exclusive means of identifying such statements and their absence does not mean that the statement is not forward-looking.

Readers should not place undue reliance on these forward-looking statements, which are based on management's current expectations and projections about future events, are not guarantees of future performance, are subject to risks, uncertainties and assumptions and apply only as of the date of this report. Victory Energy Corporation's actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. It is not possible to identify all of these risks, uncertainties or assumptions. Among the important factors that could cause actual results to differ materially from those in the forward-looking statements are:

- continued operating losses;
- our auditors questioning of our ability to continue as a going concern;
- difficulties in raising additional capital;
- our inability to pay a preferred return to The Navitus Energy Group for new capital contributions to Aurora Energy Partners
- challenges in growing our business;
- designation of our common stock as a “penny stock” under SEC regulations;
- FINRA requirements that may limit the ability to buy and sell our common stock;
- volatility in the price of our common stock;
- the highly speculative nature of an investment in our common stock;
- climate change and greenhouse gas regulations;
- global economic conditions;
- the substantial amount of capital required by our operations;
- the volatility of oil and natural gas prices;
- the high level of risk associated with drilling for and producing oil and natural gas;
- assumptions associated with reserve estimates;
- the potential that drilling activities will not yield oil or natural gas in commercial quantities;
- seismic studies may not guarantee the presence of oil or natural gas in commercial quantities;
- potential exploration, production and acquisitions may not maintain revenue levels in the future;
- future acquisitions may yield revenues or production that differ significantly from our projections;
- difficulties associated with managing a growing enterprise;
- strong competition from other oil and natural gas companies;

- the unavailability or high cost of drilling rigs and related equipment;
- our inability to control properties that we do not operate;
- our dependence on key management personnel and technical experts;
- our dependence on third parties for the marketing of our natural gas production;
- our inability to keep pace with technological advancements in our industry;
- the potential for write-downs in the carrying values of our oil and natural gas properties;
- our compliance with complex laws governing our business;
- our failure to comply with environmental laws and regulations;
- the demand for oil and natural gas and our ability to transport our production;
- the financial condition of the operators of the properties in which we own an interest;
- our levels of insurance or those of our operators may be insufficient;
- terrorist attacks on our operations;
- the dilutive effect of additional issuances of our common stock, options or warrants;
- any impairments of our oil and gas properties; and
- the results of pending litigation.
- the dissolution of the Aurora Energy Partners agreement

Additionally, the information set forth under the heading “Risk Factors” in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011, as well as disclosures made under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 2 of this report could cause actual results to differ materially from those in the forward-looking statements. Other unpredictable or unknown factors not discussed in this report could also cause actual results to differ materially from those in the forward-looking statements. The reader should not place undue reliance on these forward-looking statements, which speak only as of the date of this report. Unless legally required, we undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

## Part I – Financial Information

## Item 1. Financial Statements

## VICTORY ENERGY CORPORATION AND SUBSIDIARY

## COMBINED BALANCE SHEETS

	September 30, 2012 (Unaudited)	December 31, 2011
<b>CURRENT ASSETS</b>		
Cash	\$ 99,363	\$ 475,623
Accounts receivable - net	60,674	79,185
Other receivable - net	-	-
Prepaid expenses	4,209	29,555
Total current assets	164,246	584,363
<b>FIXED ASSETS</b>		
Furniture and equipment	20,982	10,623
Accumulated depreciation	(4,771)	(3,550)
Total furniture and fixtures, net	16,211	7,073
Producing oil and natural gas properties, net of impairment	1,841,973	1,585,745
Accumulated depletion	(1,210,165)	(1,026,900)
Drilling costs in process	221,126	266,625
Undeveloped land	661,983	101,259
Total oil and gas properties, net	1,514,917	926,729
<b>TOTAL ASSETS</b>	<b>\$ 1,695,374</b>	<b>\$ 1,518,165</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 1,269	\$ 170,317
Accrued interest	-	150,267
Accrued liabilities	191,290	179,979
Accrued liabilities - related parties	28,040	156,656
Liability for unauthorized preferred stock issued	9,283	32,164
Total current liabilities	229,882	689,383
<b>OTHER LIABILITIES</b>		
Senior secured convertible debenture, net of debt discount	-	632,534
Deferred tax liability	-	748,763



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Asset retirement obligation	30,004	30,004
<b>TOTAL LIABILITIES</b>	<b>259,886</b>	<b>2,100,684</b>
<b>STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Common Stock, \$0.001 par value, 47,500,000 shares authorized, 27,511,819 and 7,647,494 issued and outstanding, respectively	402,172	382,308
Additional paid in capital	43,399,217	35,126,462
Accumulated deficit	(42,365,901 )	(36,091,289 )
<b>TOTAL STOCKHOLDERS' EQUITY (DEFICIT)</b>	<b>1,435,488</b>	<b>(582,519 )</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>	<b>\$ 1,695,374</b>	<b>\$ 1,518,165</b>

See the accompanying notes to the combined financial statements.

## VICTORY ENERGY CORPORATION AND SUBSIDIARY

## COMBINED STATEMENTS OF OPERATIONS

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
REVENUE	\$ 77,035	\$ 90,570	\$ 209,151	\$ 253,794
<b>COSTS AND EXPENSES</b>				
Lease operating expenses	21,285	18,384	64,695	90,385
Production taxes	3,630	12,829	15,780	22,093
Exploration	52,290	69,426	199,236	131,699
Exploration - non cash	10,125	43,875	30,375	43,875
General and administrative expense	454,545	306,216	1,459,710	1,370,822
General and administrative expense - non cash	221,831	138,875	784,291	174,075
Depletion, depreciation, and accretion	15,679	10,166	47,760	40,770
Total expenses	779,385	599,771	2,601,847	1,873,719
<b>LOSS FROM OPERATIONS</b>	<b>(702,350 )</b>	<b>(509,201 )</b>	<b>(2,392,696 )</b>	<b>(1,619,925 )</b>
<b>OTHER INCOME AND EXPENSE</b>				
Gain on sale of oil and gas assets	-	-	(268,169 )	-
Impairment of assets	162,703	-	162,703	-
Interest expense	3,040	332,604	3,987,381	1,511,019
Total other income and expense	165,743	332,604	3,881,915	1,511,019
<b>NET LOSS BEFORE TAX BENEFIT</b>	<b>(868,093 )</b>	<b>(841,805 )</b>	<b>(6,274,611 )</b>	<b>(3,130,944 )</b>
<b>TAX BENEFIT</b>	<b>-</b>	<b>76,671</b>	<b>-</b>	<b>466,703</b>
<b>NET LOSS</b>	<b>\$ (868,093 )</b>	<b>\$ (765,134 )</b>	<b>\$ (6,274,611 )</b>	<b>\$ (2,664,241 )</b>
Weighted average shares, basic and diluted	27,511,583	7,647,494	21,866,363	4,483,911
Net loss per share, basic and diluted	\$ (0.03 )	\$ (0.10 )	\$ (0.29 )	\$ (0.59 )

*See the accompanying notes to the combined financial statements.*



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Net change in cash and cash equivalents	(376,260	)	111,659
Beginning cash and cash equivalents	475,623		111,572
Ending cash and cash equivalents	\$ 99,363		\$ 223,231

*See the accompanying notes to the combined financial statements.*

## VICTORY ENERGY CORPORATION AND SUBSIDIARY

## COMBINED STATEMENTS OF CASH FLOW

(Unaudited)

	For the Nine Months Ended September 30,	
	2012	2011
Supplemental schedule of non-cash investing and financing activities:		
Preferred stock converted to common stock	\$ 22,881	\$ 53,490
Debentures exchanged for common stock	\$ 4,559,775	\$ 1,112,500
Accrued interest exchanged for common stock	\$ 206,731	\$ 37,940
Warrant incentives for fund raising	\$ 432,684	\$ -
Deferred tax liability	\$ -	\$ 360,327
Supplemental disclosures of cash flow information:		
Cash paid during the period for		
Interest	\$ 318	\$ 19,872
Income taxes	\$ -	\$ -

*See the accompanying notes to the combined financial statements.*

**Victory Energy Corporation and Subsidiary**

**Notes to the Combined Financial Statements**

**(Unaudited)**

**Note 1 – Financial Statement Presentation**

Basis of Presentation

The accompanying combined balance sheet as of December 31, 2011, which has been derived from audited financial statements, and the accompanying interim combined financial statements as of September 30, 2012, for the three months and nine months ended September 30, 2012 and 2011, have been prepared by management pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial reporting. These interim combined financial statements are unaudited and, in the opinion of management, include all adjustments (consisting only of normal recurring adjustments and accruals) necessary to present fairly the combined financial condition, results of operations and cash flows of Victory Energy Corporation and Aurora Energy Partners (hereinafter collectively referred to as the "Company," or "we") as of and for the periods presented in accordance with accounting principles generally accepted in the United States of America ("GAAP").

Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012 or for any other interim period during such year. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted in accordance with the rules and regulations of the SEC. The accompanying combined financial statements should be read in conjunction with the audited combined financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011 filed with the SEC on March 30, 2012.

Organization and nature of operations

**Victory Energy Corporation** (OTCQB symbol "VYFY") was organized under the laws of the State of Nevada on January 7, 1982. Prior to May 3, 2006, the Company operated as Victory Capital Holdings Corporation among other corporate names. The Company is authorized to issue 47,500,000 shares of \$0.001 par value common stock.

On January 12, 2012 the Company implemented a 1:50 reverse stock split. All information in this Form 10-Q reflects this reverse stock split.

The Company is engaged in the exploration, acquisition, development and production of domestic oil and gas properties. Current operations are primarily located onshore in Texas and New Mexico. We are headquartered in Austin, Texas.

The Company may invest in oil and gas projects directly, or through its 50% partnership in Aurora Energy Partners, a Texas general partnership ("Aurora", or "AEP"). Currently all of the Company's oil and gas assets are held through Aurora. The Company is the managing partner of AEP. Our future capital and exploration expenditures will focus primarily on oil or liquid-rich gas projects. The Company will develop its investment opportunities through both internal capabilities and strategic industry relationships.

#### Going Concern

As reported in the combined financial statements, we had a net loss of \$6,274,611 for the nine months ended September 30, 2012. Of this amount, \$4,704,828 was for non-cash expenses including the amortization of the debt discount and warrants associated with the Company's 10% Senior Secured Convertible Debentures, the unamortized portion of the debt discount recognized on the conversion of the debentures to common stock on February 29, 2012, depletion, depreciation, impairment, warrants given for services, and stock based compensation.

The cash proceeds from the sale of the Company's debentures and new contributions to the Aurora partnership by The Navitus Energy Group ("Navitus") have allowed the Company to continue operations and invest in new oil and gas properties. Management anticipates that operating losses will continue in the near term until new wells are drilled, successfully completed and incremental production increases revenue. As of September 30, 2012 on a year-to-date basis the Company has invested \$925,933 in the acquisition of land or the drilling of wells.

At September 30, 2012, the Company had a working capital deficit of \$65,636 and was in active discussions with Navitus and others related to longer term financing required for our capital expenditures planned for the remaining part of 2012 and 2013. Without additional outside investment from the sale of equity securities and/or debt financing, our capital expenditures and overhead expenses must be reduced to a level commensurate with available cash flows.

The accompanying combined financial statements are prepared as if the Company will continue as a going concern. The combined financial statements do not contain adjustments, including adjustments to assets and liabilities, which might be necessary if the Company were unable to continue as a going concern.

## **Note 2 – Summary of Significant Accounting Policies**

### Principles of combination

The accompanying combined financial statements are presented in accordance with GAAP. The combined financial statements include the accounts of Victory Energy Corporation and Aurora. The Company holds a 50% equity interest in Aurora. Since the Company serves as managing partner and is responsible for managing all business operations of Aurora, the financial statements of Aurora have been combined with the financial statements of the Company. All significant intercompany transactions have been eliminated. The remaining 50% of Aurora is owned by Navitus which, in turn, is effectively controlled by investors who have a significant stake in the Company's common shares and serve as directors on the Company's Board of Directors. For this reason, the Company has chosen to eliminate all references to presumably unaffiliated non-controlling entities and interests in the combination process. The combined financial statements reflect necessary adjustments, all of which were of a recurring nature and are in the opinion of management necessary for a fair presentation.

### Reclassification

Some balances on the prior's year's combined financial statements have been reclassified to conform to the current year presentation. Such reclassifications had no effect on net income or earnings per share.

### Accounting estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods reported. Actual results could differ from these estimates.



Significant estimates include volumes of oil and natural gas reserves used in calculating depletion of proved oil and natural gas properties, future net revenues and abandonment obligations, impairment of proved and unproved properties, future income taxes and related assets and liabilities, the fair value of various common stock, warrants and option transactions, and contingencies. Oil and natural gas reserve estimates, which are the basis for unit-of-production depletion and the calculation of impairment, have numerous inherent uncertainties. The accuracy of any reserve estimate is a function of the quality of available data, the engineering and geological interpretation and judgment. Results of drilling, testing and production subsequent to the date of the estimate may justify revision of such estimate. Accordingly, reserve estimates are often different from the quantities of oil and natural gas that are ultimately recovered. In addition, reserve estimates are vulnerable to changes in wellhead prices of crude oil and natural gas. Such prices have been volatile in the past and can be expected to be volatile in the future.

These significant estimates are based on current assumptions that may be materially affected by changes to future economic conditions such as the market prices received for sales of volumes of oil and natural gas, interest rates, the fair value of the Company's common stock and corresponding volatility, and the Company's ability to generate future taxable income. Future changes to these assumptions may affect these significant estimates materially in the near term.

#### Revenue Recognition

The Company uses the sales method of accounting for oil and natural gas revenues. Under this method, revenues are recognized based on actual volumes of gas and oil sold to purchasers. The volumes sold may differ from the volumes to which the company is entitled based on our interests in the properties. Differences between volumes sold and entitled volumes create oil and gas imbalances which are generally reflected as adjustments to reported proved oil and gas reserves and future cash flows in their supplemental oil and gas disclosures. If their excess takes of natural gas or oil exceed their estimated remaining proved reserves for a property, a natural gas or oil imbalance liability is recorded in the consolidated balance sheet.

#### Allowance for Doubtful Accounts

The Company recognizes an allowance for doubtful accounts to ensure trade receivables are not overstated due to uncollectability. Bad debt reserves are maintained for all customers based on a variety of factors, including the length of time receivables are past due, macroeconomic conditions, significant one-time events and historical experience. An additional reserve for individual accounts is recorded when they become aware of a customer's inability to meet its financial obligations, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. If circumstances related to customers change, estimates of the recoverability of receivables would be further adjusted.

### Earnings per share

Basic earnings per share are computed using the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilutive effects of common stock equivalents such as options, warrants and convertible securities. Given the historical and projected future losses of the Company, all potentially dilutive common stock equivalents are considered anti-dilutive.

### Fair Value of Financial Instruments

The Company's financial instruments consist of cash, accounts receivable, other assets, fixed assets, derivative liability, deferred revenue, accounts payable, accrued liabilities and short-term debt. The estimated fair value of cash, accounts receivable, other assets, accounts payable, deferred revenue and accrued liabilities approximated their carrying amounts due to the short-term nature of these instruments. The carrying value of short-term debt also approximates fair value since their terms are similar to those in the lending market for comparable loans with comparable risks. None of these instruments are held for trading purposes.

The Company utilizes various types of financing to fund its business needs, including debt with warrants attached and other instruments indexed to its stock. The Company reviews its warrants and conversion features of securities issued as to whether they are freestanding or contain an embedded derivative and if so, whether they are classified as a liability at each reporting period until the amount is settled and reclassified into equity with changes in fair value recognized in current earnings.

Inputs used in the valuation to derive fair value are classified based on a fair value hierarchy which distinguishes between assumptions based on market data (observable inputs) and an entity's own assumptions (unobservable inputs). The hierarchy consists of three levels:

- Level one – Quoted market prices in active markets for identical assets or liabilities;
- Level two – Inputs other than level one inputs that are either directly or indirectly observable; and
- Level three – Unobservable inputs developed using estimates and assumptions, which are developed by the reporting entity and reflect those assumptions that a market participant would use.

Determining which category an asset or liability falls within the hierarchy requires significant judgment. The Company evaluates its hierarchy disclosures each quarter. The following table presents all assets that were measured and recognized at fair value as of September 30, 2012 and for the three months then ended on a non-recurring basis. The assets shown below were presented at fair value due to the impairment analysis indicating an estimated fair value

below the carrying value for the proved oil and gas properties.

Fair value of assets measured and recognized at fair value on a non-recurring basis as of September 30, 2012 were as follows:

Description	Level 1	Level 2	Level 3	Total (Loss) Recognized for Valuation	Total Unrealized (Loss)
Proved Properties (net)	\$ —	\$ —	\$631,808	\$ (162,703)	) \$ --
Totals	\$ —	\$ —	\$631,808	\$ (162,703)	) \$ --

The Company valued the producing properties at their fair value in accordance with the applicable Accounting Standards Codification (“ASC”) standard due to the impairment indicators prevalent as of September 30, 2012. The inputs that were used in determining the fair value of these assets were Level 3 inputs. These inputs consist of but are not limited to the following: estimates of reserve quantities, estimates of future production costs and taxes, estimates of consistent pricing of commodities, 10% discount rate, etc. During the three months ended September 30, 2012, the Company recorded \$162,703 in asset impairment charges for the non-commercial Uno Mas well and an undeveloped land prospect in New Mexico.

### Note 3 - Other Receivables

On May 10, 2012, the Company sold its interests in the Jones County Oil Play and the Atwood Secondary Oil Recovery project for \$400,000 in cash payable in two even installments in May and July, 2012 to CO Energy. The sale resulted in a one-time pre-tax gain of \$268,169. As the Company has yet to receive the second installment on the note and now believes that CO Energy may be in financial difficulty, the Company has recognized a bad debt reserve equal to the balance due on the note of \$200,000.

#### **Note 4 – Oil and natural gas properties**

##### Oil and natural gas properties

The Company accounts for its oil and natural gas properties using the successful efforts method of accounting. Under this method, all costs associated with property acquisitions, successful exploratory wells, all development wells, including dry hole development wells, and asset retirement obligation assets are capitalized. Additionally, interest is capitalized while wells are being drilled and the underlying property is in development. Costs of exploratory wells are capitalized pending determination of whether each well has resulted in the discovery of proved reserves. Oil and natural gas mineral leasehold costs are capitalized as incurred. Items charged to expense generally include geological and geophysical costs, costs of unsuccessful exploratory wells, and oil and natural gas production costs. Capitalized costs of proved properties including associated salvage are depleted on a well-by-well or field-by-field (common reservoir) basis using the units-of-production method based upon proved producing oil and natural gas reserves. The depletion rate is the current period production as a percentage of the total proved producing reserves. The depletion rate is applied to the net book value of property costs to calculate the depletion expense. Proved reserves materially impact depletion expense. If the proved reserves decline, then the depletion rate (the rate at which we record depletion expense) increases, reducing net income. Dispositions of oil and natural gas properties are accounted for as adjustments to capitalized costs with gain or loss recognized upon sale. A gain (loss) is recognized to the extent the sales price exceeds or is less than original cost or the carrying value, net of impairment. Oil and natural gas properties are also subject to impairment at the end of each reporting period. Unproved property costs are excluded from depletable costs until the related properties are developed. See impairment discussed in “Long-lived assets and intangible assets” below.

We depreciate other property and equipment using the straight-line method based on estimated useful lives ranging from five to 10 years.

For unproved property costs, management reviews these investments for impairment on a property-by-property basis if a triggering event should occur that may suggest that impairment may be required.

On April 3, 2012, the Company, through its partnership with Aurora, acquired a 5% working interest stake in the Chapman Ranch prospect area located in Nueces County, Texas. Two wells may be drilled on this acreage. The first well was spud on September 11, 2012 and was recently completed. Production is still being evaluated. The commerciality of this first well will be determined in November 2012 and then a decision made on whether to pursue the other potential drilling location.

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On May 10, 2012, the Company, through its partnership with Aurora, sold its interests in the Jones County Oil Play and the Atwood Secondary Oil Recovery project for \$400,000 in cash and recognized a pre-tax gain of \$268,169. The Company no longer has producing properties in Oklahoma. The Company was to receive proceeds on an installment basis but has taken a reserve for bad debts against the second payment of \$200,000 otherwise due in July.

On April 18, 2012, the Company spud a development well in our Bootleg Canyon prospect (5% working interest) in Pecos County, Texas. The well was successfully completed and is currently producing. Another development well is planned for late 2012. This acreage has the opportunity for additional development drilling in 2013.

On June 5, 2012, the Company, through its partnership with Aurora, acquired 335 gross acres of land just east of Eagle Lake, Texas in Colorado County. The Company holds a 50% working interest in the SRV prospect. Land acquisition costs of \$32,011 were incurred to-date for SRV. A well is planned for the fourth quarter of 2012.

On June 13, 2012, the Company, through its partnership with Aurora, acquired a 4% working interest before payout, and a 3% (after pay-out) working interest in the Pinetop oil and gas prospect located in Lea County, New Mexico. The first well was spud in late June. That initial well has now been drilled, completed and is successfully producing oil and gas. The Company recorded its first sales in October 2012. The Company believes that this prospect will provide a multi-well development opportunity during 2013 and 2014.

Other capital expenditures were incurred in the first quarter of 2012, as reported previously, including a position in undeveloped land in Glasscock County, Texas. The land acquisition there cost \$480,000. We refer to this area as the Lightnin' prospect. The Company plans to farm-out a portion of its working interest prior to drilling the first well on this acreage, leaving us with about a 25% working interest position. Farm-out discussions continue and we anticipate that the first Lightnin' well will spud in December 2012. If successful, this prospect will provide a multi-well development opportunity to the Company on acreage where we hold a significant working interest position.

The year-to-date capital expenditures total about \$925,933 which excludes exploration expense.

The Company formally updates its oil and gas reserves on an annual basis. We expect that our 2012 drilling program will result in additions to our proved developed and proved undeveloped reserves position.

At September 30, 2012, oil and natural gas properties, net of property sales in May 2012, are comprised of the following as of:

	September 30, 2012	December 31, 2011
Land	\$ 661,983	\$ 101,259
Drilling and work in process	221,126	268,436
Proved property – purchased gas wells	3,013,170	3,015,322
Proved property – drilled gas wells	1,748,742	1,753,026
Producing oil wells	439,479	219,700
Total oil and natural gas properties, cost	6,084,500	5,357,743
Less: accumulated depletion and impairment	(4,569,583 )	(4,431,014 )
Oil and natural gas properties, net	\$ 1,514,917	\$ 926,729

Depletion expense for the three months ended September 30, 2012 and 2011 was \$14,929 and \$9,772, respectively. Depletion expense for the nine months ended September 30, 2012 and 2011 was \$36,887 and \$40,770, respectively.

#### Long-lived assets and intangible assets

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the carrying amount of the asset, including any intangible assets associated with that asset, exceeds its estimated future undiscounted net cash flows, the Company will recognize an impairment loss equal to the difference between its carrying amount and its estimated fair value. The fair value used to calculate the impairment for producing oil and natural gas field that produces from a common reservoir is first determined by comparing the undiscounted future net cash flows associated with total proved properties to the carrying value of the underlying evaluated property. If the cost of the underlying evaluated property is in excess of the undiscounted future net cash flows, the future net cash flows are discounted at 10%, which the Company believes approximates fair value, to determine the amount of impairment.

For unproved property costs, management reviews these investments for impairment on a property-by-property basis if a triggering event should occur that may suggest that impairment may be required.

During the nine months ended September 30, 2012 and 2011, respectively, the Company recorded \$162,703 and zero in impairment losses on its oil and gas properties.

**Note 5 – Liabilities to Related Parties**

The Company uses the legal and accounting services of two of its members of its Board of Directors in the ordinary course of the Company’s business. In addition, under the Second Amended Partnership Agreement, the Company pays a preferred return to Navitus on funds raised by Navitus and contributed to Aurora.

	September 30, 2012	December 31, 2011
Liabilities to related parties	\$ 28,040	\$ 156,656

**Note 6 – Liability for Unauthorized Preferred Stock Issued**

During the year ended December 31, 2006, the Company authorized 10,000,000 shares of Preferred Stock, convertible to common stock at the rate of 100 shares of common for every share of preferred. During 2006, the Company issued 715,517 shares of this preferred stock for cash of \$246,950. The Company subsequently issued additional preferred stock and had several preferred shareholders converted their shares into common stock during the years ended December 31, 2010, 2009, 2008, and 2007.

During the course of the Company’s internal investigation, it was determined by the Company’s legal counsel that the preferred shares had not been duly authorized by the State of Nevada. Since the Company had issued and received consideration for the preferred stock, notwithstanding that the stock was not legally authorized, the Company reclassified the preferred stock into a liability and does not present preferred stock in the equity section of the balance sheet. The Company has offered to settle the debt with the remaining holders of the unauthorized preferred stock by honoring the terms of conversion of one share of preferred into 100 shares of common stock on a pre-split basis. The Company intends to cancel the preferred stock once all remaining preferred stockholders have converted.

There were 68,966 and 238,966 shares of unconverted preferred stock liability outstanding at September 30, 2012 and December 31, 2011, respectively.

The remaining liability for the unconverted preferred stock is based on the original cash tendered and consisted of the following as of:

	September 30, 2012	December 31, 2011
Liability for unauthorized preferred stock	\$ 9,283	\$ 32,164

### **Note 7 – Senior Secured Convertible Debentures**

Between October 15, 2010, and February 29, 2012, the Company entered into agreements with accredited investors for the cash sale by the Company of an aggregate of \$5,120,000 of 10% Senior Secured Convertible Debentures (the “Debentures”) which were convertible into an aggregate of 20,480,000 shares of the Company’s common stock at a conversion price of \$0.25 per share of common stock, subject to the customary adjustments for stock splits, stock dividends, recapitalizations and the like. There are no registration rights for the converted shares. All share references have been adjusted to reflect a 1:50 reverse stock split by the Company on January 12, 2012.

On February 29, 2012, all of the \$4,559,775 then outstanding Debentures were converted into 18,239,101 shares of the Company’s common stock at a conversion price of \$.25 per share in accordance with their terms. Accrued interest in the amount of \$206,731 on the outstanding Debentures at the time of conversion was converted into 903,464 shares of the Company’s common stock, at a conversion price of \$0.2288 per share.

During the two months ended February 29, 2012, the Company issued \$1,725,000 of the senior convertible Debentures for cash. The Company determined the initial fair value of the beneficial conversion feature was approximately \$1,663,351. The Company also determined that the relative fair value of the warrants issued with the debentures was \$61,649 which was calculated using a Black-Scholes option pricing model using assumptions of an expected life of 5 years, a stock volatility ranging from 673.2% to 674.8%, a risk free interest rate ranging from .71% to .87%, and no expected dividend yield. The initial fair value of the warrants of \$61,649 and the beneficial conversion feature of \$1,663,351 were recorded by the Company as a total financing discount of \$1,725,000 which the Company was amortizing to interest expense over the life of the Debentures.

### **Note 8 – Shareholders Equity**



The Company estimates the fair value of employee stock options and warrants granted using the Black-Scholes Option Pricing Model. Key assumptions used to estimate the fair value of warrants and stock options include the exercise price of the award, the fair value of the Company's common stock on the date of grant, the expected warrant or option term, the risk free interest rate at the date of grant, the expected volatility and the expected annual dividend yield on the Company's common stock.

The Company recognized non-cash compensation expense of \$63,456 and \$677,666 from warrants granted to consultants and directors for their services and from stock options issued to officers and employees for the three and nine months ended September 30, 2012, respectively. For the three and nine months ended September 30, 2011, the Company recognized \$182,750 and \$217,950 in non-cash expense for warrants and options granted to consultants, officers, and directors.

The following weighted average assumptions were used in estimating the fair value of share-based payment arrangements during the three months ended September 30, 2012:

Annual dividends	0
Expected volatility	561.5 – 568.8%
Risk-free interest rate	0.62% - .72%
Expected life	5 years

During the three months ended September 30, 2012, the following unregistered securities were issued for the purposes noted (all shares and prices have been adjusted for the 1:50 reverse stock split effective for the Company on January 12, 2012):

On August 23, 2012, we issued warrants to purchase 249,900 shares of common stock at an exercise price of \$.65 to Navitus in consideration of a new capital contribution to Aurora of \$249,900 pursuant to the terms and conditions of the amended Aurora partnership agreement. The Board valued the warrants at \$152,439 under the Black Scholes parameters above and recorded the amount as a cost against the funds raised in the equity accounts of the Company.

On September 14, 2012, we issued warrants to purchase 100,000 shares of common stock at an exercise price of \$.51 to Navitus in consideration of a new capital contribution to Aurora of \$100,000 pursuant to the terms and conditions of the amended Aurora partnership agreement. The Board valued the warrants at \$48,000 under the Black Scholes parameters above and recorded the amount as a cost against the funds raised in the equity accounts of the Company.

On September 28, 2012 we authorized warrants to be issued to purchase a total of 60,000 shares of common stock at an exercise price of \$.46 to members of the board in return for their board service during the months of April through September, 2012. Each of the five board members earns warrants to purchase 2,000 shares for each monthly meeting attended. These warrants will be physically issued by us to the individuals on December 31, 2012. The Board valued the warrants at \$28,800 under the Black Scholes parameters above and recognized a non-cash charge of that amount for services during the three months ended September 30, 2012.

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

The following discussion is intended to assist you in understanding our business and results of operations together with our present financial condition. This section should be read in conjunction with our combined financial statements and the accompanying notes included elsewhere in this report. Statements in this section of our quarterly report may be forward-looking statements. These forward-looking statements involve risks and uncertainties. We caution that a number of factors could cause future production, revenues and expenses to differ materially from our expectations.

The following is management's discussion and analysis of significant factors that have affected certain aspects of our financial position and results of operations during the periods included in the accompanying unaudited combined financial statements. You should read this in conjunction with the discussion under "Financial Information" and the audited combined financial statements included in our Annual Report on Form 10-K for the years ended December 31, 2011 and 2010.

### **General Overview**

We are an independent oil and natural gas company engaged in the acquisition, exploration and production of oil and natural gas properties, through our partnership in Aurora. We are geographically focused onshore in the United States in Texas and New Mexico. The Company attempts to increase long-term shareholder value by implementing a strategy to increase oil reserves, improve financial returns (higher production, lower costs per barrel of energy produced) and effectively managing the capital on our balance sheet. Profitability and cash flow should improve as a result of our capital budget expenditures and the drilling of commercially successful wells. Year-to-date 2012 capital expenditures as of September 30, 2012 total \$925,933, with over half of that being for land assets. During the remainder of 2012 most of the planned capital investment will be on wells.

Our revenue, profitability, cash flow, oil and natural gas reserves value, future growth, and ability to borrow funds or obtain additional capital, as well as the carrying value of our properties, are substantially dependent on prevailing prices of natural gas and oil. Historically, the markets for natural gas and oil have been volatile, and those markets are

likely to continue to be volatile in the future. It is impossible to predict future natural gas and oil price movements with certainty. Prices for natural gas and oil are subject to wide fluctuations in response to relatively minor changes in the supply of and demand for natural gas and oil, market uncertainty, and a variety of additional factors beyond our control.

### **Going Concern**

As reported in the combined financial statements, we had a net loss of \$6,274,611 for the nine months ended September 30, 2012. Of this amount, \$4,704,828 was for non-cash expenses including the amortization of the debt discount and warrants associated with the Company's 10% Senior Secured Convertible Debentures, the unamortized portion of the debt discount recognized on the conversion of the debentures to common stock on February 29, 2012, warrants given for services, depletion, impairment and stock based compensation.

The cash proceeds from the sale of debentures by the Company, and new capital contributions into Aurora made by Navitus, have allowed the Company to continue operations and invest in new oil and gas properties. Management anticipates that operating losses will continue in the near term until new wells are drilled, successfully completed and incremental production increases revenue. As of September 30, 2012 on a year-to-date basis the Company has invested approximately \$925,333 in the acquisition of land or the drilling of wells this year.

At September 30, 2012, the Company had a working capital deficit of \$65,636 and was in active discussions with Navitus and others related to longer term financing required for our capital expenditures planned for the remaining part of 2012 and 2013. Without additional outside investment from the sale of equity securities and/or debt financing our capital expenditures and overhead expenses must be reduced to a level commensurate with available cash flows.

The accompanying combined financial statements are prepared as if the Company will continue as a going concern. The combined financial statements do not contain adjustments, including adjustments to assets and liabilities, which might be necessary if the Company were unable to continue as a going concern.

**Three Months Ended September 30, 2012 compared to the Three Months Ended September 30, 2011**

Our revenue, operating expenses, and net income for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 were as follows:

	Three Months Ended September 30,		Change	Percentage Change Inc (Dec)	
	2012	2011			
REVENUE	\$77,035	\$90,570	\$(13,535 )	(14.9	%)
COSTS AND EXPENSES					
Lease operating expense	21,285	18,384	2,901	15.8	%
Production Taxes	3,630	12,829	(9,199 )	(71.7	%)
Exploration	52,290	69,426	(17,136 )	(24.7	%)
Exploration - non cash	10,125	43,875	(33,750 )	(76.9	%)
General and administrative expense	454,545	306,216	148,329	48.4	%
General and administrative expense - non cash	221,831	138,875	82,956	59.7	%
Depletion and accretion	15,679	10,166	5,513	54.2	%
Total expenses	779,385	599,771	179,614		
LOSS FROM OPERATIONS	(702,350)	(509,201)	(193,149)	(37.9	%)
OTHER INCOME AND EXPENSE					
Impairment of assets	162,703	-	162,703	n/m	
Interest expense	3,040	332,604	(329,564)	n/m	
Total other income and expense	165,743	332,604	(166,861)		
NET LOSS BEFORE TAX BENEFIT	(868,093)	(841,805)			
TAX BENEFIT	-	76,671			
NET LOSS	\$(868,093)	\$(765,134)			

*Revenues:* All of our revenue was derived from the sale of oil and natural gas. Our revenues decreased \$13,535 or 14.9% to \$77,035 for the three months ended September 30, 2012 from \$90,570 for the three months ended September 30, 2011. The decrease reflects a decline in both the price and volume of natural gas sold to a weighted average of \$4.03 per Mcf (thousand cubic feet) for the 14,349 Mcf of gas sold during the three months ending September 30, 2012 from a weighted average of \$7.10 per Mcf for the 16,688 Mcf of gas sold during the three months ended September 30, 2011. The decline in physical gas production is attributable to the normal productivity decline that occurs with these types of wells over time. During the three months ended September 30, 2012, we also sold 406 barrels of oil at a weighted average of \$81.39 per barrel compared to 111 barrels of oil at a weighted average price of \$87.75 per barrel in the three month period ended September 30, 2011.

*Lease Operating Expenses:* Our cost of production increased \$2,901 or 15.8% to \$21,285 for the three months ended September 30, 2012 from \$18,384 for the three months ended September 30, 2011. The increase in lease operating expenses reflects an increase in the number of operating properties in the three months ended September 30, 2012 compared to the three months ended September 30, 2011.

*Production Taxes:* Production taxes decreased \$9,199 or 71.7% to \$3,630 for the three months ended September 30, 2012 from \$12,829 for the three months ended September 30, 2011. This results primarily from the decline in revenue for the three months ended September 30, 2012 compared to the same period in 2011.

*Exploration Expense:* Exploration expense decreased \$17,136 or 24.7% to \$52,290 for the three months ended September 30, 2012 from \$69,426 for the three months ended September 30, 2011. The change is not considered meaningful and simply reflects the timing of expenses for exploration activities.

*Exploration Expense – non cash:* Exploration non-cash expense decreased \$33,750 to \$10,125 for the three months ended September 30, 2012 from \$43,875 for the three months ended September 30, 2011. This decrease reflects the vesting of exploration-dedicated employee stock options during the three months ended September 30, 2012. The Company first awarded stock options (some of which vested immediately) to employees during the three months ended September 30, 2011.

*General and Administrative Expense:* General and administrative expenses increased \$148,329 or 48.4% to \$454,545 for the three months ended September 30, 2012 from \$306,216 for the three months ended September 30, 2011. The cash G&A burn rate was higher for this this period in 2012 primarily due to additional headcount in Austin (CFO and Accounting Manager) and non-recurring costs associated with the transfer of accounting services from California to Texas.

*General and Administrative Expense – non cash:* General and administrative non-cash expenses increased \$82,956 to \$221,831 for the three months ended September 30, 2012 from \$138,875 for the three months ended September 30, 2011. This increase reflects the bad debt expense of \$200,000 recorded in the third quarter of 2012 associated with the sale of oil and gas assets to CO Energy in May 2012, warrants issued for Board service, all net of a negative adjustment for warrants authorized in a prior period of this year.

*Depletion and Accretion:* Depletion, accretion, and depreciation increased \$5,513 or 54.2% to \$15,679 for the three months ended September 30, 2012 from \$10,166 for the three months ended September 30, 2011. The increase reflects the increase in the amount of producing wells in the during the respective time periods.

*Impairment of Assets:* During the three months ended September 30, 2012, the Company recorded \$162,703 in asset impairment charges for our Uno Mas well which was deemed not commercial and a charge associated with the write-off of other undeveloped land costs in New Mexico. There were no impairment charges for the three months ending September 30, 2011.

*Interest Expense:* Interest expense was \$3,040 for the three months ending September 30, 2012. This represents the 10% preferred return which Navitus receives under the Second Amended Partnership Agreement for capital contributions to Aurora arranged by Navitus. During the three months ended September 30, 2011, the Company incurred \$332,604 in interest expense virtually all of which was associated with the Company's 10% Senior Secured Convertible Debentures which were converted to common stock on February 29, 2012.

*Income Taxes:* There is no provision for income tax recorded for either the three months ended September 30, 2012 or for the three months ended September 30, 2011 due to the expected operating losses of both years. We had available Federal income tax net operating loss ("NOL") carry forwards of approximately \$13,130,000 at December 31, 2011. Our NOL generally begins to expire in 2025.

The realization of future tax benefits is dependent on our ability to generate taxable income within the carry forward period. Given the Company's history of net operating losses, management has determined that it is more-likely-than-not the Company will not be able to realize the tax benefit of the carry forwards. Current standards require that a valuation allowance thus be established when it is more likely than not that all or a portion of deferred tax assets will not be realized.

All tax benefits recognized in 2011 and 2012 due to the timing difference in tax effect between the accounting and tax basis of the Debentures were eliminated when the Debentures were converted to common stock on February 29, 2012.

*Net Loss:* We had a net loss of \$863,093 for the three months ended September 30, 2012 compared to a net loss of \$765,134 for the three months ended September 30, 2011. The net loss for the three months ended September 30, 2012 included \$200,000 in bad debt allowance recognized for the final payment due in July, 2012, on the sale of the Jones County Oil Play and the Atwood Secondary Oil Recovery recorded May 10, 2012. The net loss for the three months ended September 30, 2012 should be viewed in light of the cash flow from operations discussed below.

**Nine Months Ended September 30, 2012 Compared to the Nine Months Ended September 30, 2011**

Our revenue, operating expenses, and net income for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 were as follows:

	Nine Months Ended September 30,		Change	Percentage Change Inc (Dec)	
	2012	2011			
REVENUE	\$209,151	\$253,794	\$(44,643 )	(17.6	%)
COSTS AND EXPENSES					
Lease operating expense	64,695	90,385	(25,690 )	(28.4	%)
Production Taxes	15,780	22,093	(6,313 )	(28.6	%)
Exploration	199,236	131,699	67,537	51.3	%
Exploration - non cash	30,375	43,875	(13,500 )	(30.8	%)
General and administrative expense	1,459,710	1,370,822	88,888	6.5	%
General and administrative expense - non cash	784,291	174,075	610,216	350.5	%
Depletion and accretion	47,760	40,770	6,990	17.1	%
Total expenses	2,601,847	1,873,719	728,128		
LOSS FROM OPERATIONS	(2,392,696)	(1,619,925)	(772,771 )	(47.7	%)
OTHER INCOME AND EXPENSE					
Gain on sale of assets	(268,169 )	-	(268,169 )	n/m	
Impairment of assets	162,703	-	162,703	n/m	
Interest expense	3,987,381	1,511,019	2,476,362	n/m	
Total other expense	3,881,915	1,511,019	2,370,896		
NET LOSS BEFORE TAX BENEFIT	(6,274,611)	(3,130,944)			
TAX BENEFIT	-	466,703			
NET LOSS	\$(6,274,611)	\$(2,664,241)			

*Revenues:* All of our revenue was derived from the sale of oil and natural gas. Our revenues decreased \$44,643 or 17.6% to \$209,151 for the nine months ended September 30, 2012 from \$253,794 for the nine months ended September 30, 2011. The decrease reflects a decline in both the price and volume of natural gas sold to a weighted average of \$4.19 per Mcf (thousand cubic feet) for the 43,789 Mcf of gas sold for the nine months ending September 30, 2012 from a weighted average of \$6.74 per Mcf for the 50,762 Mcf of gas sold in the nine months ended September 30, 2011. The decline in physical gas production is attributable to the normal productivity decline that occurs with these types of wells over time. During the nine months ended September 30, 2012, we also sold 898 barrels of oil at weighted average price of \$87.69 per barrel compared to 168 barrels of oil sold in the three month



period ended September 30, 2011 at weighted average price of \$90.31 per barrel.

*Lease Operating Expenses:* Our cost of production decreased \$25,690 or 28.4% to \$64,695 for the nine months ended September 30, 2012 from \$90,385 for the nine months ended September 30, 2011. The decrease is primarily due to a credit received from a drilling services company in early 2012 for an over-charge paid in 2011.

*Production Taxes:* Production taxes decreased \$6,313 to \$15,780 for the nine months ended September 30, 2012 from \$22,093 for the nine months ended September 30, 2011. The decrease is primarily due to the effect of lower gas volumes and sales prices in 2012 compared to 2011.

*Exploration Expense:* Exploration expense increased \$67,537 or 51.3% to \$199,236 for the nine months ended September 30, 2012 from \$131,699 for the nine months ended September 30, 2011. The increase reflects the higher overall level of exploration activities for the nine months ended September 30, 2012 compared to the nine month period ended September 30, 2011.

*Exploration Expense – non cash:* Exploration non-cash expense decreased \$13,500 to \$30,375 for the nine months ended September 30, 2012 from \$43,875 for the nine months ended September 30, 2011. The decrease reflects the amortization of the non-cash charges in the current year related to the initial grants of stock options (some of which vested immediately) to employees in the nine month period ended September 30, 2011.

*General and Administrative Expense- cash:* General and administrative expenses increased \$88,888 or 6.5% to \$1,459,710 for the nine months ended September 30, 2012 from \$1,370,822 for the nine months ended September 30, 2011. For the most part, the increase reflects the increase in non-recurring accounting service expenses associated with the transfer of the accounting function from Irvine, CA, to Austin, TX during the three month period ending September 30, 2012 and the compensation expense associated with the addition of one officer and one employee compared to no such costs for the same three months ending September 30, 2011.

*General and Administrative Expense – non cash:* General and administrative non-cash expenses increased \$610,216 or 350.5% to \$784,291 for the nine months ended September 30, 2012 from \$174,075 for the nine months ended September 30, 2011. The increase reflects charges in 2012 related to a bad debt expense associated with the sale of oil and gas assets in May 2012, grants related to non-qualified stock options to employees and officers of the Company, the amortization of previous of stock option as they vest over time, the cost of warrants granted to affiliates and non-affiliates is of the Company for special consulting assistance in certain undertakings of the Company, and warrants granted to a related party to serve as general counsel of the Company all net of a negative adjustment for warrants authorized in a prior period of this year.

*Depletion and Accretion:* Depletion, accretion, and depreciation increased \$6,990 or 17.1% to \$47,760 for the nine months ended September 30, 2012 from \$40,770 for the nine months ended September 30, 2011. The increase is due to the additional depletion of the operating oil wells in early 2012 which the Company did not have in the nine months ending September 30, 2011 notwithstanding the reduction in amount of assets subject to depletion as a result of the sale of the Jones County/Atwood properties in May, 2012.

*Gain on Sale of Assets:* On May 10, 2012, the Company sold its interests in the Jones County Oil Play and the Atwood Secondary Oil Recovery project for \$400,000 in cash payable in two even installments in May and July, 2012. The sale resulted in a one-time gain of \$268,169. The Company has recognized a bad debt allowance of \$200,000 against the second installment which was due in July, 2012.

*Impairment of Assets:* During the nine months ended September 30, 2012, the Company recorded \$162,703 in asset impairment charges for our Uno Mas well which was deemed not commercial and a charge associated with the write-off of other undeveloped land costs in New Mexico. There were no impairment charges for the nine months ending September 30, 2011.

*Interest Expense:* Interest expense increased \$2,476,362 to \$3,987,381 for the nine months ended September 30, 2012 from \$1,511,019 for the nine months ended September 30, 2011. For the nine months ended September 30, 2012, \$265,460 represents the amortization of the non-cash debt discount associated with the sale of the Debentures from January 1, 2012 up to the point where the Debentures were converted to common stock on February 29, 2012, \$3,661,781 represents the recognition of the remaining non-cash debt discount associated with the conversion of all the outstanding Debentures to common stock on February 29, 2012, and \$57,100, for the most part, represents the actual interest expense accrued on the Debentures outstanding until the conversion of the Debentures on February 29, 2012, and \$3,040 represents the 10% return paid to Navitus for arranging for additional contributions to AEP.

*Income Taxes:* There is no provision for income tax recorded for either the nine months ended September 30, 2012 or for the nine months ended September 30, 2011 due to the expected operating losses of both years. We had available NOL carry forwards of approximately \$13,130,000 at December 31, 2011. Our NOL generally begins to expire in 2025.

The realization of future tax benefits is dependent on our ability to generate taxable income within the carry forward period. Given the Company's history of net operating losses, management has determined that it is more-likely-than-not the Company will not be able to realize the tax benefit of the carry forwards. Current standards require that a valuation allowance thus be established when it is more likely than not that all or a portion of deferred tax assets will not be realized.

All tax benefits recognized in 2011 and 2012 due to the timing difference in tax effect between the accounting and tax basis of the Company's Debentures were eliminated when the Debentures were converted to common stock during the three month period ended September 30, 2012.

*Net Loss:* We had a net loss of \$6,274,611 for the nine months ended September 30, 2012 compared to a net loss of \$2,664,241 for the nine months ended September 30, 2011. This net loss should be viewed in light of the cash flow from operations discussed below.

## Liquidity and Capital Resources

Our cash, total current assets, total assets, total current liabilities, and total liabilities as of September 30, 2012 as compared to September 30, 2011, are as follows:

	September 30,	
	2012	2011
Cash	\$99,363	\$223,231
Total current assets	164,246	345,455
Total assets	1,695,374	1,282,316
Total current liabilities	229,882	330,192
Total liabilities	259,886	1,287,508

At September 30, 2012, we had a working capital deficit of \$65,636 compared to a working capital surplus of \$15,263 at September 30, 2011. Current liabilities decreased to \$229,882 at September 30, 2012 from \$330,192 at September 30, 2011 primarily due to the pay down of accounts payable offset somewhat by an increase in accrued royalties and the conversion of accrued interest to common stock.

Net cash used in operating activities for the nine months ended September 30, 2012 was \$1,748,270 after the net loss of \$6,274,611 was decreased by \$4,704,828 in non-cash charges and offset by \$178,487 in changes to the working capital accounts. This compares to cash used in operating activities for the nine months ended September 30, 2011 of \$1,613,778 after the net loss for that period of \$2,664,241 was decreased by \$1,163,861 in non-cash charges offset by \$113,398 in changes to the working capital accounts.

Net cash used in investing activities for the nine months ended September 30, 2012 was \$936,292 of which \$263,650 was for drilling and related costs for exploration efforts, \$661,983 was used to acquire land and rights to land for drilling, and \$10,359 was used to purchase furniture and fixtures for the Austin, Texas office. This compares to \$417,567 in drilling costs and \$8,329 in purchases of furniture and fixtures for the then new Austin, Texas office during the nine months ended September 30, 2011.

Net cash provided by financing activities for the nine months ended September 30, 2012 was \$2,308,302 of which \$1,815,000 came from the sale of the Company's 10% Senior Secured Convertible Debentures, \$200,000 came from the sale of the Company's investment in the Jones County/Atwood properties, \$349,900 came from contributions from Navitus, and \$4,874 came from the exercise of warrants. In the meantime, \$61,472 in distributions was made to Navitus in accordance with the Second Amended Aurora Partnership Agreement. This compares to \$2,151,333 provided by financing activities during the nine months ended September 30, 2011 of which \$2,270,000 came from the sale of the Company's 10% Senior Secured Convertible Debentures while \$68,667 was used to pay down a bank

line of credit and \$50,000 was used to pay off a note due a related party.

### Item 3. Qualitative and Quantitative Discussions About Market Risk

As a smaller reporting company we are not required to provide the information required by this Item. However, we did include market risk factors in our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the SEC on March 30, 2012.

### 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 our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Pursuant to Rule 13a-15(e) under the Exchange Act, the Company carried out an evaluation, with the participation of the Company's management, including the Company's Chief Executive Officer ("CEO") (the Company's principal executive officer) and Chief Financial Officer ("CFO") (the Company's principal financial and accounting officer), of the effectiveness of the Company's disclosure controls and procedures (as defined under Rule 13a-15(e) under the Exchange Act) as of September 30, 2012. Based upon that evaluation, our management concluded that our control over financial reporting and related disclosure controls and procedures are effective.

## Changes in Internal Controls

There have been no changes in the Company's internal control over financial reporting during the period covered by this report that have materially affected, or that are reasonably likely to materially affect, the Company's internal control over financial reporting.

## Part II – Other Information

### Item 1. Legal Proceedings

There have been no material developments in the status of the litigation as reported in Item 3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2011 filed with the SEC on March 30, 2012.

### Item 1A. Risk Factors

As a smaller reporting company we are not required to provide the information required by this Item. However, we did include risk factors in our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the SEC on March 30, 2012.

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

During the three months ended September 30, 2012, the following unregistered securities were issued for the purposes noted. All shares and prices have been adjusted for the 1:50 reverse stock split effective for the Company on January 12, 2012.

On August 23, 2012, we issued warrants to purchase 249,900 shares of common stock at an exercise price of \$.65 to Navitus in consideration of a capital contribution by Aurora of \$249,900 pursuant to the Company's capital contribution agreement with Aurora. The Board valued the warrants at \$152,439 under the Black Scholes parameters in Part I Note 6 above and recorded the amount as a cost against the funds raised in the equity accounts of the Company.

On September 14, 2012, we issued warrants to purchase 100,000 shares of common stock at an exercise price of \$.51 to Navitus in consideration of a capital contribution by Aurora of \$100,000 pursuant to the Company's capital contribution agreement with Aurora. The Board valued the warrants at \$48,000 under the Black Scholes parameters in Part I Note 6 above and recorded the amount as a cost against the funds raised in the equity accounts of the Company.

On September 28, 2012 we authorized warrants to be issued to purchase a total of 60,000 shares of common stock at an exercise price of \$.46 to members of the board in return for their board service during the months of April through September, 2012. Each of the five board member earns warrants to purchase 2,000 shares for each monthly meeting attended. These warrants will be physically issued by us to the individuals on December 31, 2012. The Board valued the warrants at \$28,800 under the Black Scholes parameters Part I Note 6 above and recognized a non-cash charge of that amount for services during the three months ended September 30, 2012.

Unless otherwise indicated, we relied on the exemption from registration relating to offerings that do not involve any public offering pursuant to Section 4(2) under the Securities Act of 1933 (the "Act") and/or Rule 506 of Regulation D of the Act. We believe that each investor had adequate access to information about us through the investor's relationship with us.

### Item 3. Default Upon Senior Securities

There is no information required to be reported under this Item.

### Item 4. Removed and Reserved

There is no information required to be reported under this Item.

### Item 5. Other Information

There is no information required to be reported under this Item.

Item 6. Exhibits

(a) Exhibits

- 5.02 Employment Agreement with Mark Biggers as Chief Financial Officer originally noticed in Form 8K on December 28, 2011
- 10.1 Second Amended Partnership Agreement for Aurora Energy Partners
- 31.1 Rule 13a-14(a)/15d-14(a) Certification by Kenneth Hill
- 31.2 Rule 13a-14(a)/15d-14(a) Certification by Mark Biggers
- 101.SCH\* XBRL Taxonomy Extension Schema Document
- 101.CAL\* XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF\* XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB\* XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE\* XBRL Taxonomy Extension Presentation Linkbase Document

XBRL (Extensible Business Reporting Language) information is furnished and not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

Signature

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.

VICTORY ENERGY  
CORPORATION

Date: November 14, 2012

By: /s/ KENNETH HILL  
Kenneth Hill  
Chief Executive Officer  
and Director