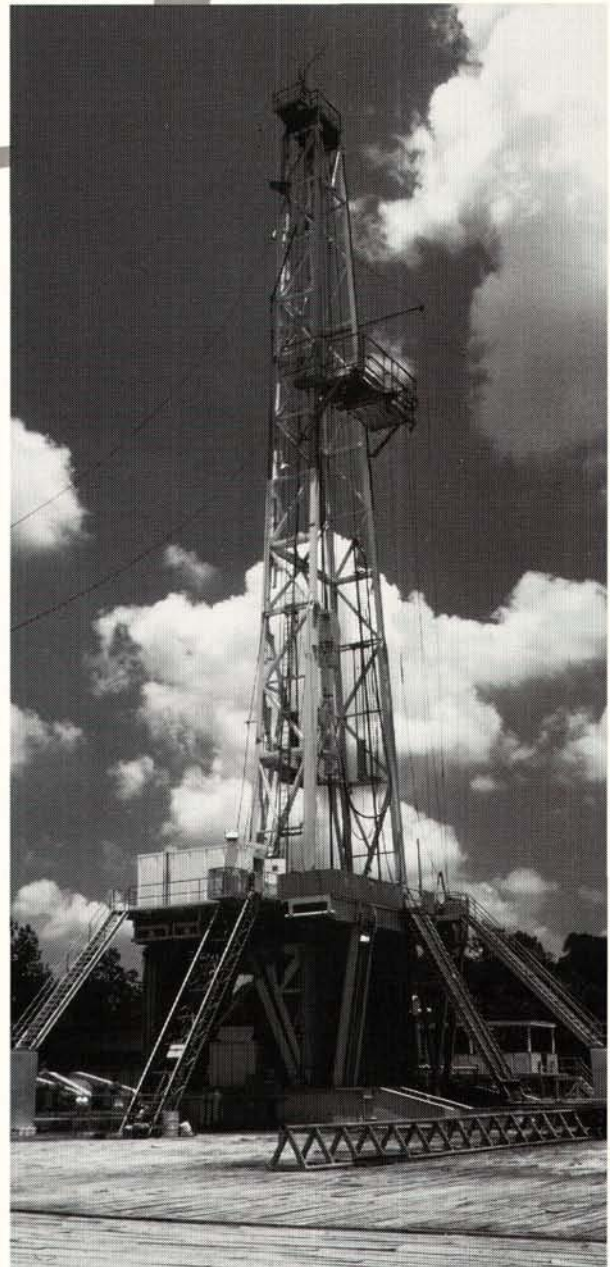


Chesapeake  
Energy  
Corporation

Annual  
Report

93



## Selected Financial Data

<i>Twelve months ended June 30</i>	1993	1992	1991
<b>INCOME DATA</b> (in thousands, except per share data)			
Oil and gas sales .....	\$ 11,602	\$ 10,520	\$ 4,334
Service operations and other .....	6,406	8,198	2,109
Total revenues .....	18,008	18,718	6,443
Production expenses .....	2,590	2,003	760
Oil and gas property DD&A .....	4,184	2,910	1,585
Service operations .....	3,653	4,113	606
Other DD&A .....	557	974	351
General and administrative, net .....	3,920	3,414	2,119
Interest and other .....	2,282	2,577	317
Provision for legal and other settlements .....	1,286	-	-
Total costs .....	18,472	15,991	5,738
Income (loss) before income tax .....	(464)	2,727	705
Income tax expense (benefit) .....	(99)	1,337	243
Net income (loss) .....	(365)	1,390	462
Weighted average shares outstanding .....	3,728	3,101	3,101
<b>PROPERTY DATA</b> (\$ in thousands)			
Oil reserves (MBbls) .....	9,622	11,147	3,212
Gas reserves (MMcf) .....	79,763	68,618	17,334
Equivalent thousand barrels .....	22,915	22,583	6,101
Equivalent million cubic feet .....	137,495	135,500	36,606
Discounted future net revenues—standardized measure (after tax) .....	\$ 119,744	\$ 125,752	\$ 22,054
Oil production (MBbls) .....	276	374	163
Gas production (MMcf) .....	2,677	1,252	646
Production in equivalent million cubic feet .....	4,333	3,496	1,624
Average oil price (\$/Bbl) .....	\$ 20.20	\$ 21.85	\$ 20.15
Average gas price (\$/Mcf) .....	\$ 2.25	\$ 1.88	\$ 1.59
Reserve life index .....	31.7	38.8	22.5

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# Chesapeake Energy Corporation

## WHO WE ARE

Chesapeake Energy Corporation, headquartered in Oklahoma City, Oklahoma, is an independent oil and natural gas exploration and production company which became a publicly owned company in February 1993. It is traded on the NASDAQ National Market System under the symbol CSPK.

## WHAT WE DO

Chesapeake utilizes its advanced technological expertise in the drilling of vertical and horizontal wells to exploit areas of proven hydrocarbon production. It teams with major oil companies and well-capitalized independents to develop its existing inventory of more than 150 proved and probable drilling locations. The company has a domestic geographic focus with activities concentrated in southern Texas and southern Oklahoma.

## WHAT WE'VE ACCOMPLISHED

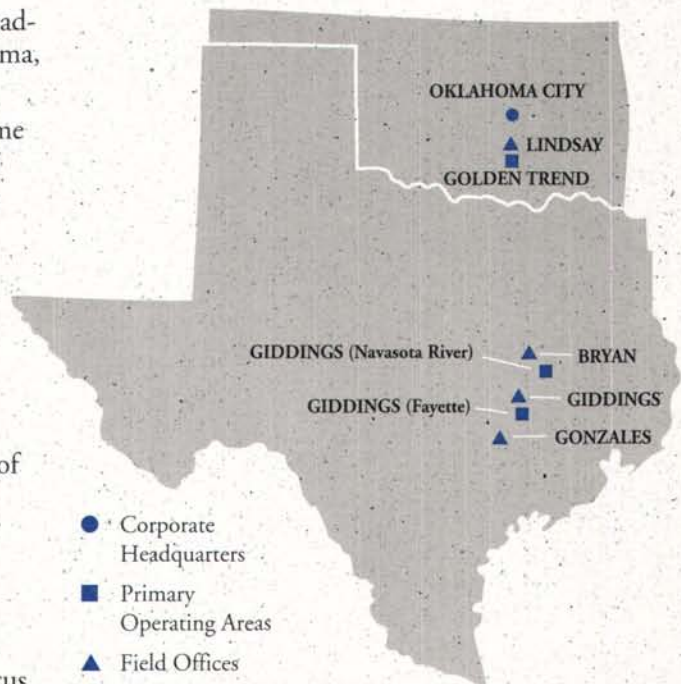
During the past four years, Chesapeake has:

- Increased annual production over 2600%;
- Increased total assets over 900%;
- Increased total revenue over 2700%;
- Increased total reserves over 1100%.

## WHAT'S AHEAD

Chesapeake's shareholders should benefit from:

- A reserve and production mix of approximately 60% natural gas and expected to increase to 70-75% over the next several years;
- A projected drilling schedule which should significantly increase company production and revenues;
- Advanced technical expertise, particularly in the application of horizontal drilling technology;
- Management and directors own 55% of common shares outstanding, thereby aligning the interests of management and shareholders.





# Letter to Shareholders

**F**iscal 1993 was a year of major change for Chesapeake Energy Corporation as we made the transition from private to public ownership. This transition has set the stage for future earnings and asset growth.

The success of Chesapeake's initial public offering (IPO) in February 1993 was an important step in implementing our plan for increased profitability and growth for the company. Chesapeake received net proceeds of approximately \$25.2 million from the public offering of 2.3 million shares of the company's common stock. This offering allowed the company to significantly reduce long-term debt and improve working capital.

## CORPORATE STRATEGY

Chesapeake's business strategy is based on our view that the ownership and development of domestic energy reserves, particularly natural gas, will create substantial benefits to our shareholders. To maximize those benefits, we have concentrated our efforts in three areas.

First, we have acquired more than 100,000 gross acres of prospective undeveloped leasehold in our primary operating areas. With our projected drilling schedule of 40-50 wells per year, this undeveloped leasehold should provide the company with three to five years of low-risk drilling opportunities.

Second, Chesapeake continues to be one of the leaders in the application of advanced horizontal drilling techniques. We are now drilling opposing and stacked laterals from a single vertical wellbore. Technical advances such as these have helped lower horizontal drilling costs by approximately 25% during the past year. This trend should continue as we incorporate more innovations in this rapidly expanding area of high technology.

Third, the alliances we have created with larger energy companies, such as Amerada Hess, Mobil, Texaco and Union Pacific Resources Company, demonstrate the quality of Chesapeake's asset base and the innovative spirit of management. For example, Chesapeake recently announced joint development and financing agreements with Union Pacific in the Giddings Field which could lead to the risk-free development of as much as 18 to 30 billion cubic feet of gas equivalent (BCFE), net to the company's interest.

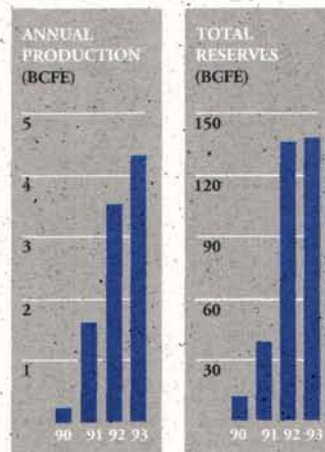
Additionally, in early 1994 Chesapeake plans to begin operations on a horizontal drilling project in southern Oklahoma with Texaco and Mobil as our partners. If successful, the venture could significantly increase the company's inventory of low-risk developmental opportunities.

## CHESAPEAKE'S STRENGTH

Since inception, Chesapeake's strength has been the acquisition and development of high quality undeveloped properties. In this regard, we have concentrated our efforts in two primary operating areas: the Giddings Field in southern Texas and the Golden Trend Field in southern Oklahoma.

Our use of advanced seismic, drilling, and completion technologies in these fields has enabled Chesapeake to increase its annual production by more than 2600% during the past four years. We believe our technical capabilities and leasehold inventory will continue to provide substantial growth opportunities in the next several years.

## OPERATIONAL RESULTS



Although constrained by limited capital, we nevertheless enjoyed operational success in fiscal 1993. During the year, we drilled 37 wells, 34 of which were commercially productive. The company's production for the year increased by 24% to 4.3 BCFE and total company

reserves also grew to an all-time high of 137.5 BCFE. Additionally, revenues from oil and gas sales increased 10% despite an 11% decrease in average oil and gas prices.

Chesapeake's finding costs for fiscal 1993 were approximately \$0.85 per thousand cubic feet of gas equivalent (MCFE) in our primary operating areas and \$1.07 per MCFE overall. These attractive finding costs and attractive development opportunities enabled the company to reinvest its cash flow in finding additional reserves. With a



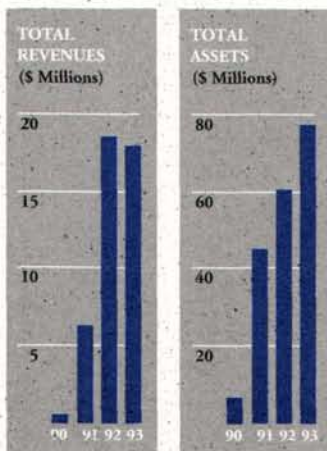
capital budget for new wells of only \$7.4 million, we were still able to replace 176% of our production in 1993.

This was achieved even though the increased drilling activity that resulted from our IPO did not materially affect our operating results in fiscal 1993. However, we are now seeing the benefits of increased drilling activity. In the first quarter of fiscal 1994, net production was up 56% compared to the first fiscal quarter of 1993. For all of fiscal 1994, we anticipate increasing production volumes by more than 50% over the previous year. This trend should provide excellent earnings and cash flow increases, creating strong momentum for per share value growth.

### FINANCIAL RESULTS

Despite reporting a loss of \$365,000 in fiscal 1993, we believe the strength of our management team and our strategy of growth through drilling will translate into improved financial results in fiscal 1994.

To a large degree, the company's earnings decline in 1993 was the result of a special charge of \$1.3 million as a provision for litigation expense and legal settlements. Although distasteful, the settlements have now allowed management to focus its efforts on enhancing shareholder value through the development of the company's large reserve base.



During the past four fiscal years, we have increased our revenues from \$0.6 million to \$18.0 million, increased our annual production from 0.2 BCFE to 4.3 BCFE, increased total assets from \$7.5 million to \$77.8 million, and enlarged our proved reserve

base from 10.9 BCFE to 137.5 BCFE. These four-year growth rates are among the highest in the independent energy sector. As our capital requirements are met, we expect impressive rates of growth to continue.

### OUTLOOK FOR OUR FUTURE

Some of our peers are spreading their drilling budgets across both domestic and international drilling projects. We believe this is an inappropriate strategy for a medium-sized independent producer. Therefore, Chesapeake has focused virtually all of its fiscal 1994 capital budget on developmental drilling in the Giddings and Golden Trend Fields, two of the most active fields in the nation and areas where we have historically performed well.

Our goals for 1994 and beyond remain ambitious. We believe the rest of the decade will be rewarding for well-managed, gas-leveraged companies that have demonstrated the capability to grow through drilling. We will continue to concentrate on areas where we have competitive advantages such as the Giddings and Golden Trend Fields. We intend to increase our asset base and financial strength through continued acquisition and development of strategic leasehold blocks where we can utilize our geological and engineering strengths to deliver attractive financial results.

We emphasize to all of our current and prospective shareholders that we are dedicated to creating consistent and sustained growth in shareholder value. With management owning more than 50% of the outstanding common shares, the financial interests of management and shareholders are truly aligned.

We are grateful to our dedicated employees for their hard work and strong performance during a challenging year. We also wish to thank our directors for their leadership and counsel and our shareholders for their continued confidence. We encourage you to share our enthusiasm for Chesapeake's future.

Aubrey K. McClendon  
*Chairman and Chief Executive Officer*

Tom L. Ward  
*President and Chief Operating Officer*



# Primary Operating Areas

**D**uring the past two years, Chesapeake has focused its capital expenditures in the Giddings Field of southern Texas and the Golden Trend Field of southern Oklahoma. These areas continue to be the emphasis of Chesapeake's development strategy. In these fields, the company has developed a proprietary land and geological base and can add value by utilizing its expertise in horizontal drilling and seismic interpretation. Additionally, by attracting major companies to participate in Chesapeake's projects, the company can reduce its financial risk and build important long-term relationships with larger companies that have greater land and financial resources.

## GIDDINGS FIELD

Chesapeake's most important assets are located in the Giddings Field of southern Texas, one of the most active oil and gas fields in the nation. Since 1991, Chesapeake, Union Pacific and others have drilled more than 600 horizontal wells in Giddings with a total capital investment of approximately \$800 million.

The primary producing zone in this field is the Austin Chalk - a formation that has been maligned during the last few years as a result of drilling disappointments 200 miles away in the Pearsall Field. In Giddings, however, the Austin Chalk has proven to be a prolific producer. The results speak for themselves. During the fourth fiscal quarter of 1993 and the first fiscal quarter of 1994, the

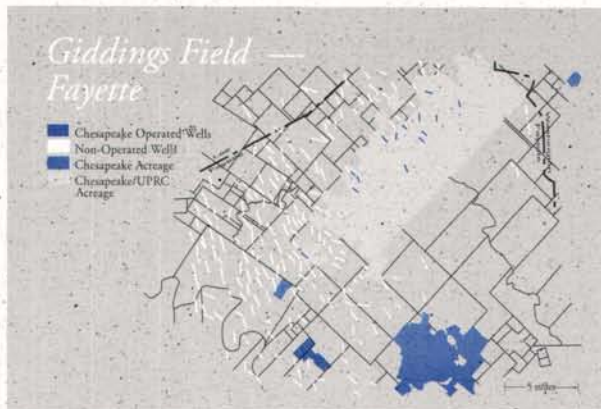
company operated or participated in 12 horizontal Austin Chalk wells in Giddings. Ten of these wells registered sustained flow rates for the first thirty days of production in excess of five million cubic feet of gas equivalent per day. All of these wells are expected to pay out within three years and seven of them should pay out within 180 days from first production. Chesapeake knows of no other onshore field in the nation where economic returns from drilling are better than in Giddings.

There are three major reasons for the success of the Austin Chalk play in Giddings. First, the geological setting of the field has created more intense fracturing than in other areas of Chalk production. Second, continued technical advancements in horizontal drilling have significantly lowered finding costs. Third, operators are cooperating on wellbore spacing patterns to minimize competitive drainage problems.

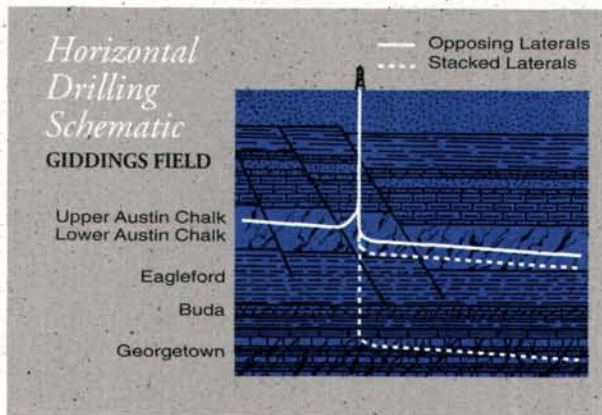
## UNION PACIFIC AGREEMENT

In October 1993, Chesapeake and Union Pacific reached an agreement to jointly develop a 20,000 acre block in the Giddings Field. This agreement provides Chesapeake with the option of limited recourse financing for Chesapeake's anticipated \$15-20 million share of development costs. If Chesapeake elects the financing option, Union Pacific will earn an 8% interest rate on the amounts financed and 15% of Chesapeake's production after project payout.

Chesapeake believes a financing arrangement of this type is unprecedented in the industry. Additionally, Union Pacific's confidence in project payout is an important validation of Chesapeake's commitment to the Giddings Field.







### HORIZONTAL TECHNOLOGY DEVELOPMENTS

In the last two years, the technology enabling Chesapeake and others to drill profitable horizontal wells in the Giddings Field has advanced rapidly in three major areas. First, Chesapeake's geologists now are using enhanced seismic technology to more accurately predict the existence and location of hydrocarbon-bearing fractures, or "sweet spots", within the Austin Chalk. This ability significantly decreases the risk of drilling uneconomic wells.

Second, advancements in drilling technology such as MWD ("measurement-while-drilling") tools, which provide a continuous analysis of the drillbit's location when drilling horizontally, assist engineers in guiding the drillbit into the anticipated sweet spots. Improvements in downhole motor and drillbit technology have enabled the rate of penetration to double during the past two years. These advances have resulted in lower finding costs.

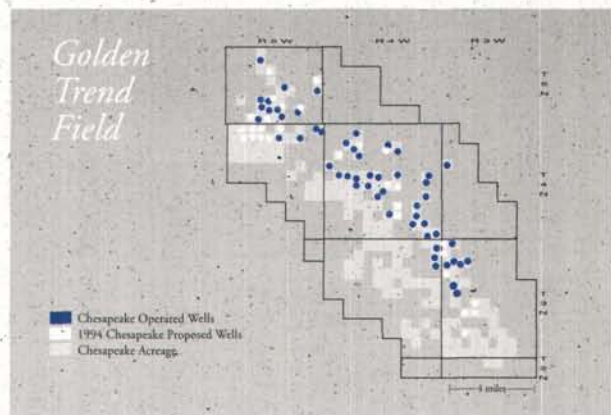
Third, Chesapeake has recently developed the expertise to drill opposing laterals (horizontal wellbores drilled in opposite directions) and stacked laterals (one horizontal wellbore in one interval with a second lateral drilled in the same direction in a lower interval). The opposing lateral and stacked lateral wells can double the amount of reserves recovered with only a 25 to 50 percent increase in total well costs. Chesapeake believes continued advancements in drilling technology could enable the company to lower its finding costs by another 10-20% during the next few years.

### GOLDEN TREND

Chesapeake's second primary operating area is the Golden Trend Field of southern Oklahoma. It is one of the most active fields in the Mid-Continent region of the nation. During the last ten years, Chesapeake, Amerada Hess, Anadarko, Mobil, Phillips, OXY and others have drilled more than 400 wells in the Golden Trend with a total capital investment of approximately \$350 million.

Wells in the Golden Trend Field have many attractive characteristics, including reserves that are long-lived, reserves weighted 85% towards liquids-rich natural gas, predictable and controllable drilling costs, and the probability of multiple zone completions. Chesapeake has developed a significant geological and engineering niche in the Golden Trend that has enabled it to have three-year finding costs of \$0.85 per-MCFE, and production costs, including severance taxes, of \$0.39 per MCFE.

Moreover, the company's land position in the Golden Trend is strong. With approximately 150 drilling locations in inventory, Chesapeake anticipates drilling 20-25 wells per year in the Golden Trend.





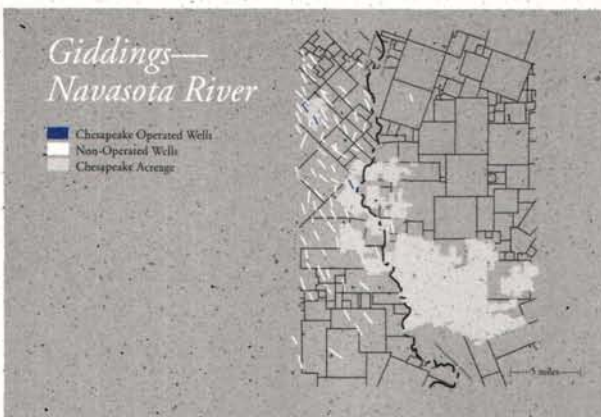
## NEW AREAS

### NAVASOTA RIVER

In early 1993, Chesapeake acquired approximately 30,000 gross acres of leasehold in the Navasota River area of the Giddings Field. The company believes the results from its drilling activities on this block will be as attractive as those from its other wells in Giddings.

As a result of the Union Pacific financing discussed above, Chesapeake intends to accelerate its drilling in the Navasota River area during fiscal 1994.

Ultimately, the company believes as many as 60 horizontal wells can be drilled in the Navasota River area. Success with this project would significantly enhance the company's reserves, earnings, and cash flow.



### SHOLEM ALECHEM

In September 1993, Chesapeake reached agreements with Texaco and Mobil to initiate a horizontal drilling project in the Sholem Alechem portion of southern Oklahoma's giant Sho-Vel-Tum Field. This field has produced more than one billion barrels of oil and one trillion cubic feet of natural gas since its discovery more than 80 years ago. Chesapeake believes the application of horizontal drilling technology in this field could result in a significant increase in the recovery of remaining reserves from the field.

The initial phase of this project involves drilling two horizontal wells in the Sycamore formation in early 1994. If the initial two wells are successful, the parties can elect to expand the initial agreements to a secondary phase in which as many as 100 horizontal wells could be drilled.

The Sholem Alechem agreements are an important example of Chesapeake's ability to identify new areas where the application of its technical capabilities can result in added value. The agreements also reflect continuing recognition among major companies of Chesapeake's operating expertise and efficiency. As the company further develops its relationships with these and other land-rich major companies, additional opportunities for creating future growth are anticipated.



# *Directors and Officers*

## **DIRECTORS**

Aubrey K. McClendon

*Chairman of the Board and Chief Executive Officer*

Tom L. Ward

*President and Chief Operating Officer*

Edgar F. Heizer, Jr.

*Private Venture Capitalist*

Breene M. Kerr

*Chairman and President*

*Kerr Consolidated*

Shannon T. Self

*Partner*

*Self, Giddens & Lees, Inc.*

Frederick B. Whittemore

*Advisory Director*

*Morgan Stanley & Co.*

Walter C. Wilson

*General Agent*

*Massachusetts Mutual Life Insurance Company*

## **PRINCIPAL OFFICERS**

Aubrey K. McClendon

*Chairman of the Board and Chief Executive Officer*

Tom L. Ward

*President and Chief Operating Officer*

Marcus C. Rowland

*Vice President - Finance and Chief Financial Officer*

J. Mark Lester

*Vice President - Exploration*

Steven C. Dixon

*Vice President - Exploration*

David M. Herritt

*Vice President - Drilling and Production*

Steven J. Clark

*Treasurer*

Thomas S. Price, Jr.

*Vice President - Corporate Development*

Ronald A. Lefaive

*Controller*



# Corporate Information

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## STOCK DATA

Fiscal Year Ended June 30, 1993	1993 Price Range	
	High	Low
Third Quarter (commencing February 4, 1993)	12 1/4	10 1/2
Fourth Quarter	12	8 7/8

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## COMMON STOCK

Chesapeake Energy Corporation common stock began trading February 4, 1993, and is listed on the NASDAQ National Market System under the symbol CSPK. At September 27, 1993, there were approximately 40 shareholders of record and 450 beneficial owners of the common stock.

## DIVIDENDS

The company's policy is to retain its earnings to support the growth of the company. Chesapeake's Board of Directors has not authorized the payment of cash dividends on its common stock.

## CORPORATE OFFICES

6104 North Western  
Oklahoma City, Oklahoma 73118  
(405) 848-8000

## INDEPENDENT PUBLIC ACCOUNTANTS

Price Waterhouse  
15 North Robinson, Suite 400  
Oklahoma City, Oklahoma 73102

## FORM 10-K

Stockholders may obtain, without charge, a copy of Chesapeake Energy Corporation's Form 10-K report as filed with the Securities and Exchange Commission. For copies or answers to questions about the company, you are invited to contact the Investor Relations department at the address of the corporate offices above.

## STOCK TRANSFER AGENT AND REGISTRAR

Liberty Bank & Trust Company of  
Oklahoma City, N.A.  
100 North Broadway Avenue  
Oklahoma City, Oklahoma 73102  
(405) 231-6764

*Communication concerning the transfer of shares, lost certificates, duplicate mailings or change of address notifications should be directed to the transfer agent.*





# *Chesapeake Energy Corporation*

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## *Financial Section*



**SECTION II**  
**SELECTED FINANCIAL DATA**

The following table sets forth selected consolidated financial data of the Company for each of the four fiscal years ended June 30, 1993. The data is derived from the financial statements of the Company which have been audited by Price Waterhouse, independent accountants. The data set forth in this table should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and related notes included elsewhere in this report.

	Year Ended June 30,			
	1990	1991	1992	1993
	<i>(\$ in thousands, except per share data)</i>			
<b>Statement of Operations Data:</b>				
Revenues:				
Oil and gas sales .....	\$ 389	\$ 4,334	\$10,520	\$11,602
Oil and gas service operations .....	197	1,961	7,656	5,526
Interest and other .....	38	148	542	880
Total .....	<u>624</u>	<u>6,443</u>	<u>18,718</u>	<u>18,008</u>
Costs and expenses:				
Production expenses and taxes .....	43	760	2,003	2,590
Oil and gas service operations .....	136	606	4,113	3,653
Depreciation, depletion and amortization of oil and gas properties .....	85	1,585	2,910	4,184
Depreciation and amortization of other assets .....	126	351	974	557
General and administrative, net .....	759	2,119	3,414	3,920
Provision for legal and other settlements .....	-	-	-	1,286
Interest and other .....	12	317	2,577	2,282
Total costs and expenses .....	<u>1,161</u>	<u>5,738</u>	<u>15,991</u>	<u>18,472</u>
Income (loss) before income taxes .....	(537)	705	2,727	(464)
Income tax expense (benefit) .....	-	243	1,337	(99)
Net income (loss) .....	<u>(\$ 537)</u>	<u>\$ 462</u>	<u>\$ 1,390</u>	<u>(\$ 365)</u>
Dividends on preferred stock .....	\$ -	\$ -	\$ -	\$ 385
Net income (loss) per common share .....	<u>(\$ .17)</u>	<u>\$ .15</u>	<u>\$ .45</u>	<u>(\$ .20)</u>
<b>Cash Flow Data:</b>				
Cash provided by (used in) operating activities .....	\$2,081	\$14,821	\$ 9,318	(\$ 1,499)
Cash used in investing activities .....	1,006	21,928	24,755	15,142
Cash provided by financing activities .....	133	9,247	12,779	20,802
<b>Balance Sheet Data: (at end of period)</b>				
Working capital (deficit) .....	(\$1,351)	(\$15,661)	(\$24,629)	(\$11,891)
Total assets .....	7,492	44,462	60,683	77,846
Long-term debt, net of current maturities .....	289	8,570	21,742	13,190
Stockholders' equity (deficit) .....	(655)	(1,559)	132	31,432



**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Overview**

*General.* In February 1993, the Company completed an initial public offering of 2,300,000 shares of its Common Stock. The offering allowed the Company to improve its financial condition through payment of its obligation to TCW and facilitated its lower cost, long-term lending arrangement with its principal secured lender, Union Bank. The offering also enabled the Company to increase the rate of development of its substantial undeveloped oil and gas reserve base.

During fiscal 1993, the Company participated in 37 gross wells (7.4 net), of which 32 were operated by the Company. In its primary development areas, the Giddings and Golden Trend Fields, the Company's finding costs were approximately \$.85 per Mcfe, and approximately \$1.07 per Mcfe for all areas in 1993. The Company added an estimated 9.1 net MMcfe of proved developed reserves as a result of this drilling, well in excess of its 4.3 net MMcfe of production. In fiscal 1993, the Company for the first time produced more natural gas than equivalent oil.

The following table sets forth certain operating data of the Company for the periods presented:

<b>OPERATING DATA</b>	<b>Year Ended June 30,</b>		
	<u>1991</u>	<u>1992</u>	<u>1993</u>
<b>Net Production Data:</b>			
Oil (MBbl) .....	163	374	276
Gas (MMcf) .....	646	1,252	2,677
Gas equivalent (MMcfe) .....	1,624	3,496	4,333
<b>Oil and Gas Sales (\$ in 000's):</b>			
Oil .....	\$3,284	\$ 8,170	\$ 5,576
Gas .....	1,050	2,350	6,026
Total oil and gas sales .....	<u>4,334</u>	<u>10,520</u>	<u>11,602</u>
<b>Average Sales Price:</b>			
Oil (\$ per Bbl) .....	\$20.15	\$ 21.85	\$ 20.20
Gas (\$ per Mcf) .....	1.59	1.88	2.25
<b>Oil and Gas Costs (\$ per Mcfe):</b>			
Production expenses and taxes .....	\$ .47	\$ .57	\$ .60
General and administrative, net .....	1.30	.98	.90
Depreciation, depletion and amortization .....	.98	.83	.97
<b>Net Wells Drilled:</b>			
Horizontal wells .....	7.7	11.3	3.0
Vertical wells .....	7.5	3.7	4.4
Net Wells at End of Period .....	15.2	29.4	33.1



Since inception, the Company has built its reserve base primarily by drilling new wells. Frequently, such new wells have been drilled under farmout or joint development agreements covering multiple potential locations. Once proven, this drilling has allowed the Company to add significant proved, but undeveloped reserves. The full development of its proved undeveloped reserves will require capital expenditures by the Company estimated to be approximately \$86 million.

Since February 1993, the Company has acquired approximately 30,000 gross (17,000 net) acres of leasehold in the Navasota River area. The Company believes this area may develop into a significant new producing asset, allowing the Company to expand its horizontal drilling activities. In June 1993, the Company entered into a participation agreement with Belco for the joint development of the Navasota River area. Subsequent to June 30, 1993, the Company began evaluation of the horizontal exploitation potential of the Sho-Vel-Tum field located in southern Oklahoma, and has entered into preliminary joint development agreements with Texaco and Mobil. The Company anticipates drilling two test wells within the next few months for evaluation purposes. The Navasota River and Sho-Vel-Tum projects reflect management's plans to increase the Company's level of exploratory drilling and employ its horizontal drilling expertise in less proven areas.

*Change in Accounting Method.* During the fourth quarter of fiscal 1993, the Company changed its method of accounting for its investment in oil and gas properties from the successful efforts method to the full cost method. The change in accounting method was based on a combination of business judgment and planning, improved comparability with similarly positioned independent oil and gas companies and provided an enhanced basis for measurement of the Company's performance. Management believes that the full cost method is preferable, and reflects the Company's evolving business plans which include a reduced emphasis on leasehold sales activities and certain service operations provided to third parties. In addition, the change more appropriately reflects the economic effects of the exploration for and development of the Company's extensive undeveloped leasehold position and its increased emphasis on drilling activities in less proven or unproven areas, such as in the Navasota River area and the Sho-Vel-Tum Field. Further, management believes that the full cost method is the predominant method of accounting used by comparable independent oil and gas companies.

The full cost method assumes that all costs, including direct general and administrative expenses, incurred to acquire and find oil and gas contribute to future revenues because even unsuccessful wells provide information about finding oil and gas. As a result, the financial statements are more representative of the total cost of finding reserves. The costs capitalized are amortized over time as the proved reserves are produced. Production costs are expensed as incurred. Auxiliary oil and gas operations, such as the promotion and sale of leasehold, sales of oil and gas producing properties and oil and gas equipment, management fees, overhead fees and other similar activities are generally accounted for as reductions in the carrying value of the oil and gas properties. Unamortized costs as reduced by related deferred taxes are subject to a ceiling which limits such amounts to the estimated present value of oil and gas reserves, reduced by operating expenses, future development costs and income taxes.

Had the Company continued reporting under the successful efforts method of accounting, it would have reported a loss for fiscal 1993 of approximately \$3.4 million, or \$1.00 per weighted average common share outstanding. The following unaudited financial information reflects on a quarterly basis for fiscal 1993 the Company's results of operations after giving effect to its change to the full cost method of accounting:



**RESULTS OF OPERATIONS**

	Quarter Ended			
	September 30, 1992	December 31, 1992	March 31, 1993	June 30, 1993
	<i>(In thousands, except per share data)</i>			
<b>Revenues:</b>				
Oil and gas sales .....	\$2,681	\$3,216	\$3,250	\$2,455
Oil and gas service operations .....	1,100	1,113	1,517	1,796
Interest and other .....	24	64	206	586
Total revenues .....	<u>3,805</u>	<u>4,393</u>	<u>4,973</u>	<u>4,837</u>
<b>Costs and expenses:</b>				
Production expenses and taxes .....	699	714	656	521
Oil and gas service operations .....	737	754	1,043	1,119
Depreciation, depletion and amortization of oil and gas properties .....	1,139	944	1,088	1,013
Depreciation and amortization of other assets .....	126	226	159	46
General and administrative, net .....	660	1,062	1,012	1,186
Provision for legal and other settlements .....	—	—	—	1,286
Interest and other .....	758	793	582	149
Total costs and expenses .....	<u>4,119</u>	<u>4,493</u>	<u>4,540</u>	<u>5,320</u>
Income (loss) before income taxes .....	(314)	(100)	433	(483)
Income tax expense (benefit) .....	<u>(89)</u>	<u>(31)</u>	<u>135</u>	<u>(115)</u>
Net income (loss) .....	<u>(\$ 225)</u>	<u>(\$ 69)</u>	<u>\$ 298</u>	<u>(\$ 368)</u>
Dividends on preferred stock .....	<u>\$ —</u>	<u>\$ 50</u>	<u>\$ 166</u>	<u>\$ 169</u>
Net income (loss) per common share .....	<u>(\$ .07)</u>	<u>(\$ .04)</u>	<u>\$ .03</u>	<u>(\$ .11)</u>
Weighted average common shares outstanding .....	<u>2,808</u>	<u>2,808</u>	<u>4,473</u>	<u>5,108</u>

**Results of Operations**

*General.* For the fiscal year ended June 30, 1993, the Company realized a net loss of \$365,000, or \$.20 per common share, on total revenues of \$18.0 million. This compares with net income of \$1.4 million, or \$.45 per share, on total revenues of \$18.7 million in fiscal 1992 and net income of \$462,000, or \$.15 per share, on total revenues of \$6.4 million in fiscal 1991. The loss in fiscal 1993 was largely a result of a \$1.3 million charge for legal expense and provision for litigation settlements. The higher earnings in fiscal 1992 as compared to fiscal 1991 reflect the Company's growth during the last half of fiscal 1992.

*Oil and Gas Sales.* During fiscal 1993, oil and gas sales increased approximately 10.3% to \$11.6 million versus \$10.5 million for fiscal 1992 and 168% from the fiscal 1991 amount of \$4.3 million. Likewise, production volumes increased to 4,333 MMcfe in fiscal 1993, a 24% increase over fiscal 1992's production of 3,496 MMcfe and a 167% increase over fiscal 1991's production of 1,624 MMcfe. The increases in production volumes reflect the Company's ongoing development and exploitation of its undeveloped oil and gas properties. The change in the mix between oil and gas production, as a percentage of total production during the three year period, reflects declines in fiscal 1993 in oil production through normal depletion from the Company's wells in the First Shot and Pearsall fields in Texas and significant additional gas production from the Company's wells in the Giddings, Golden Trend, East Iola, and N.W. Arapaho fields. The average gas price received for fiscal year 1993 was \$2.25 per Mcf, approximately 19.7% greater than the \$1.88 received during fiscal 1992 and 42% greater than the \$1.59 per Mcf received during fiscal 1991. Gas prices have continued to be subject to volatile swings over the three-year period; however, the continued improvement in the average price received for natural gas produced by the Company appears to be the result of favorable shifts in the demand/supply fundamentals for natural gas. Oil production sold by the Company during fiscal



1993 yielded an average price of \$20.20 per barrel representing a decrease of \$1.65, or 7.5%, from the average fiscal 1992 per barrel price. The average per barrel price received in fiscal 1991 of \$20.15 approximated the fiscal 1993 average price, although oil prices declined significantly in the fourth quarter of fiscal 1993.

*Oil and Gas Service Operations.* Revenues from oil and gas service operations totalled \$5.5 million in fiscal 1993, a decrease of \$2.2 million, or 28%, from the \$7.7 million reported in fiscal 1992 and a \$3.6 million, or 282%, increase over the fiscal 1991 amount of \$2.0 million. The related costs and expenses of these operations totalled \$3.7 million, \$4.1 million and \$606,000 for the three years ended June 30, 1993, 1992 and 1991, respectively. Gross profit from oil and gas service operations was 34% in fiscal 1993, which compares to 46% in fiscal 1992 and 69% in fiscal 1991. The gross profit derived from these operations is a function of drilling activity in the period, the related costs of materials and supplies utilized in the service operations performed and the related mix of operations performed within a period which impacts the average gross profit for all services provided. During fiscal 1992, the Company participated in a greater number of wells providing more third party contractual services which resulted in a higher level of service operations revenues and related costs and expenses than in fiscal 1993 or 1991.

As a result of the adoption of the full cost method of accounting, oil and gas service operations revenues and related costs and expenses for fiscal 1992 and 1991 as reflected in the financial statements included in this report decreased over those amounts previously reported under the successful efforts method of accounting. The differences in the amounts result primarily from differences inherent in the two accounting methods, and to a lesser extent from reclassifications. The full cost method requires the allocation of contractual service revenue to a reduction in the cost of the Company's oil and gas properties which reduces the service revenue included in current earnings. No such requirement exists under the successful efforts method. Further, as management shifts to a more vertically integrated exploration and production operation, many of the service operations performed by subsidiaries of the Company are now considered to be direct support of the Company's exploration and development activities rather than a separate profit center. As a result, the gross profit from certain of these contractual services are treated as reductions in the Company's investment in oil and gas properties while certain costs and expenses are reflected as general and administrative expenses under the full cost method of accounting.

*Interest and Other.* Interest and other income for fiscal 1993 was \$880,000 which compares to \$542,000 for fiscal 1992 and \$148,000 for fiscal 1991, respectively. Changes in this account result from varying factors including changes in interest rates, average cash balances and other factors.

*Production Expenses and Taxes.* Production expenses and taxes, which include lifting costs and production and excise taxes, increased to \$2.6 million in fiscal 1993 as compared to \$2.0 million in fiscal 1992 and \$760,000 in fiscal 1991. The upward trend is attributed to the combination of higher oil and gas production, combined with an overall increase in the average number of wells in which the Company maintains a working interest. On an Mcfe basis, production expenses and taxes increased to \$.60 per unit produced in 1993, as compared to \$.57 per unit produced in 1992 and \$.47 per unit produced in fiscal 1991. The Company anticipates that operating costs in fiscal 1994 will remain fairly consistent with the prior year, absent a significant change in the composition of its property base.

*Depreciation, Depletion and Amortization.* Depreciation, depletion and amortization ("DD&A") of oil and gas properties for fiscal 1993 was \$4.2 million, \$1.3 million higher than fiscal 1992's level of \$2.9 million, and \$2.6 million higher than fiscal 1991's amount of \$1.6 million. The average DD&A rate per MMcf, which rate is a function of capitalized costs and related underlying reserves in the periods presented, was \$.97, \$.83, and \$.98 in fiscal 1993, 1992 and 1991, respectively. Subject to the results of future acquisition, drilling and production activities, comparable DD&A rates are anticipated to be in effect for fiscal 1994. The upward trend in oil and gas DD&A expense primarily reflects the increased production levels which have occurred ratably over the three year period. Other depreciation and amortization totalled \$557,000, \$974,000 and \$351,000 in fiscal 1993, 1992 and 1991, respectively. The high amount in fiscal 1992 reflects nonrecurring charges. Depreciation of other assets is primarily related to the Company's service operations assets, and is expected to increase in fiscal 1994 with the addition of equipment in fiscal 1993.



*General and Administrative, Net.* General and administrative costs, which exclude amounts capitalized as direct oil and gas acquisition, exploration and development costs, totalled \$3.9 million, \$3.4 million and \$2.1 million in fiscal 1993, 1992 and 1991, respectively, reflecting a 15% increase in 1993 as compared to 1992 and a 185% increase in relation to amounts incurred in fiscal 1991. The upward trend in general and administrative costs during the three-year period is primarily attributed to personnel additions and related costs of operations necessitated by the growth of the Company during the period. Further, the increase in fiscal 1993 is partially attributed to non-capitalized travel, legal, accounting and engineering costs incurred in preparation for the Company's initial public offering of its Common Stock. The Company anticipates that general and administrative costs in fiscal 1994 will remain fairly consistent with the prior year, absent a significant change in the operations of the Company. As a result of the adoption of the full cost method of accounting, general and administrative costs for fiscal 1992 and 1991 as reflected in the financial statements included in this report increased over those amounts previously reported under the successful efforts method of accounting. The incremental increase in general and administrative expenses results primarily from differences inherent in the two accounting methods, the more significant of which are the treatment of administrative overhead reimbursements and the treatment of direct general and administrative expenses associated with property acquisition, exploration and development activities. Additionally, some expenses previously allocated to and reported as service operations costs and expenses have been reclassified as general and administrative costs.

*Provision for Legal and Other Settlements.* During the fourth quarter of 1993, the Company recorded a charge of \$1.3 million for legal and other settlements. This amount includes provisions for the settlement of three class action suits filed in the third quarter of fiscal 1993, related expenses, and other matters. No provision has been made for the Plotner Litigation as the Company has been indemnified by Messrs. McClendon and Ward against any liability for the judgment rendered therein and expenses for the appeal.

*Interest and Other.* Interest cost to the Company is a function of outstanding indebtedness and the average interest rate on that indebtedness. Interest and other costs totalled \$2.3 million in fiscal 1993 which compared to \$2.6 million in fiscal 1992. Fiscal 1993 interest costs decreased from the fiscal 1992 amount primarily as a result of the capitalization of approximately \$192,000 and changes in the Company's capital structure. Otherwise, interest costs were fairly constant between the two years. The fiscal 1991 interest and other balance of \$317,000 reflects lower average outstanding levels of indebtedness. Barring increases in interest rates or higher levels of borrowing, the amount of interest incurred in fiscal 1994 is anticipated to decrease as outstanding indebtedness is reduced.

*Income Tax Expense (Benefit).* The Company recorded an income tax benefit of \$99,000 on a pre-tax loss of \$464,000 for the fiscal year ended June 30, 1993. This compares with an income tax provision in fiscal 1992 of \$1.3 million on pre-tax income of \$2.7 million and \$243,000 of income tax accrued on \$705,000 of pre-tax earnings in fiscal 1991. The unusually high relationship of tax burden to financial pre-tax income in fiscal 1992 results from partnership losses incurred by Chesapeake Exploration Company prior to the formation of the Company which are included in financial income but for which no tax benefit is available to the Company.

## **Liquidity and Capital Resources**

*Financing Activities.* The Company's initial public offering in February 1993 provided the Company with net proceeds of \$25.2 million which were used to reduce indebtedness to TCW and other lenders, including reduction of accounts payable, and to provide working capital for the continued development of the Company's proved undeveloped oil and gas assets. By mid-April 1993, the Company had fully paid its indebtedness to TCW using proceeds from the Company's new bank credit facility and proceeds from the initial public offering.

In December 1992, the Company issued 576,923 shares of its 9% Convertible Preferred Stock to TCW in exchange for a \$7.5 million reduction in the Company's indebtedness to TCW. Previously, the Company had issued warrants to TCW to purchase 312,001 shares of Common Stock at an exercise price of \$4.17 per share. TCW was also granted registration rights with respect to shares of the Company's Common Stock issuable upon conversion of Preferred Stock and exercise of the warrants.



In April 1993, the Company entered into a \$15 million oil and gas reserve-based revolving credit facility with Union Bank. The facility's terms include interest at Union Bank's reference rate (6.0% at June 30, 1993) plus 1.5%, payable monthly, quarterly borrowing base reviews, commitment fees, covenants restricting the Company's ability to incur debt above certain limits without the bank's permission and other provisions consistent with normal energy lending practices. The borrowing base, which at June 30, 1993 was \$10.2 million, reduces monthly by an amount determined at each redetermination of the borrowing base (currently a \$275,000 monthly reduction). The Company is required to make principal payments equal to the amount by which the principal balance exceeds the borrowing base. The principal balance at June 30, 1993 was \$10.2 million. The revolver note matures September 1, 1994, but may, in the discretion of the bank, be extended by a period of one year. The Company has the option to convert the revolver note on September 1, 1994 to a term note with an amortization schedule acceptable to the Bank. The Union Bank loan is secured by mortgages on substantially all of the Company's producing oil and gas properties, together with accounts receivable, inventory, equipment and contract rights.

Effective December 31, 1992, the Company entered into a loan agreement with Belco pursuant to which Belco loaned \$2.5 million to the Company. As part of this transaction, Belco received warrants to purchase a maximum of 180,000 shares of Common Stock at an exercise price equal to \$9.60 per share. Belco also received certain registration rights for the shares issuable upon exercise of its warrants. The loan agreement was amended in September 1993, effective as of June 30, 1993.

The Belco loan bears interest at an annual rate of 9%, payable quarterly commencing January 1, 1993, and requires quarterly principal payments commencing in April 1995 through January 1998. The Company is required to make payments each time the Company commences a well in the Golden Trend Field in an amount equal to \$50,000 times the Company's original working interest in such well. During the six months ended June 30, 1993, the Company made principal payments to Belco of approximately \$75,000 pursuant to this arrangement. As of December 31, 1994, \$500,000 less the payments made during calendar 1994 is payable on principal. The Belco loan is secured by guaranties of Messrs. McClendon and Ward. The Belco loan agreement restricts the Company's ability to pay dividends other than preferred dividends and certain other contractual distributions and prohibits the Company from incurring additional long-term debt other than indebtedness incurred to reduce outstanding debt or incurred on a nonrecourse basis and secured by newly acquired assets. As a condition to other long-term borrowings, the Company is required to maintain a quick ratio of 1-to-1, a coverage ratio of 1.75-to-1 and a net worth ratio of 1-to-1. The Company must limit its annual general and administrative expenses to no more than \$5.0 million. In the event the Company raises additional capital, the Company is obligated to apply a portion of the net proceeds to reduce the Belco loan. At June 30, 1993, the principal balance of the Belco loan was \$2.4 million.

In December 1992 and January 1993, the Company entered into credit agreements with certain of its vendors which provided for the vendors to supply materials, supplies and services in connection with the Company's proposed drilling projects. On a quarterly basis, the Company may submit to each vendor a proposal for wells to be included in its drilling program for the ensuing quarter. If the vendor elects to participate, the Company will pay 50% of such vendor's invoices for each well drilled within 90 days of receipt. The remaining 50% is payable from an assignment of production from the wells included in the quarterly drilling program. The assignment of production to each vendor is based on the unpaid amount of the vendor's invoices compared to the total cost of the wells being drilled. After the vendor has received an amount equal to its unpaid invoice, plus interest at the prime rate of Chase Manhattan Bank N.A. plus 1%, its assignment of production is reduced by at least 80%. The vendor continues to receive this reduced amount until it has received up to two times its unpaid invoice. In some instances, the Company may be required to pay all unpaid amounts to such vendor to the extent unpaid after three years. At June 30, 1993, approximately \$1.6 million of credit was outstanding under these agreements.

At June 30, 1993, an additional \$6.8 million was owed to other vendors and financing entities pursuant to notes executed in fiscal 1992 and 1993. One such vendor note had a principal balance of \$2.5 million at June 30, 1993, accrues interest at 1% per annum, is collateralized by tubular goods and requires principal payments within 60 days after shipment of tubular goods. Secured notes payable to various other entities to



acquire oil service equipment had an aggregate balance of \$2.1 million at June 30, 1993. Interest on these notes varies from 6.5% to 18.4% per annum and principal payments are due in monthly installments through December 2000. Another of the Company's vendor notes had a principal balance of \$2.1 million at June 30, 1993. The Company is in default on this note, and the vendor commenced legal action to collect the balance of the note in April 1993. The note provided for interest at 10% per annum through October 1992 and 18% per annum thereafter and monthly principal payments of \$25,000 plus interest through June 1994, with the balance due on July 1, 1994. The note is guaranteed by Messrs. McClendon and Ward. The Company and the vendor have reached a preliminary agreement to modify the note as follows: (a) provide for monthly payments of \$100,000 plus interest, (b) change the date on which the interest rate will increase to 18% to January 31, 1994, (c) change the date of maturity to October 1, 1994, and (d) provide for past due principal and interest through September 1, 1993 plus \$100,000 to be paid by the Company upon execution of the modified note. The Company's consolidated balance sheet at June 30, 1993 reflects the expected modification of terms of this note.

*Working Capital Deficit.* The Company had a working capital deficit of \$11.9 million at June 30, 1993 compared to a working capital deficit of \$24.6 million at June 30, 1992. The reduction in the working capital deficit is attributable to cash proceeds received by the Company in its initial public offering of Common Stock. The working capital deficit at June 30, 1993, however, represented an increase of \$4.3 million over the Company's working capital deficit of \$7.6 million at March 31, 1993. This increase resulted from investments made by the Company for long-term assets, primarily development of oil and gas wells, which were financed by short-term debt, primarily accounts payable. On a successful efforts basis, the Company's working capital deficit at March 31, 1993, was \$1.4 million. The only difference between the two methods for such purpose is that the full cost method does not permit the Company to reflect non-producing leasehold to be resold as a current asset.

The Company's internally generated cash flow and existing capital resources should be sufficient to meet its operating needs, fund existing capital commitments, and service its outstanding debt in fiscal 1994. These resources will not be sufficient, however, to fund the level of capital spending required to develop the Company's proved undeveloped reserves. The Company has budgeted \$29.8 million to fund drilling and completion of 73 wells in fiscal 1994, \$33.5 million in fiscal 1995 to fund 52 wells and an additional \$22.6 million in fiscal 1996 to fund 29 wells. These amounts do not include expenditures for drilling and development of additional unproven locations. The Company is seeking additional capital to fund the budgeted activity in the form of debt, equity or a combination thereof, but there can be no assurance that such capital will be obtained, or if obtained, the terms that may apply. If the Company is unsuccessful in its capital raising efforts, the number of wells drilled will be less than budgeted. As a result, production, future net revenues and the present value of those future net revenues will be less than projected in the Williamson report. The discretionary nature of a significant portion of the Company's capital spending permits the Company to make adjustments to its budget based upon the availability of internally generated cash and external capital resources. The Company anticipates maintaining a capital expenditure program similar to fiscal 1993 for fiscal 1994 in the event additional capital is not obtained.

*Cash Flows from Operating and Investing Activities.* Cash used in operating activities was approximately \$1.5 million in fiscal 1993 compared to cash provided by operating activities in fiscal 1992 of \$9.3 million. This difference of \$10.8 million is attributable primarily to reduction in net income of approximately \$1.8 million and utilization of cash to reduce accounts payable.

The increase in cash used in operating activities and the Company's significant working capital deficit negatively impacted the Company's expenditures for development of oil and gas properties during fiscal 1993. In fiscal 1993, the Company expended \$15.1 million in investing activities, a decrease of \$9.7 from fiscal 1992. As a result of this decrease in drilling activity, trade accounts receivable declined \$401,000 from June 30, 1992 to June 30, 1993, reflecting the decrease in amounts due from participating industry partners. Approximately \$4.0 million of the \$6.2 million increase in revenues and royalties due others at June 30, 1993 was paid in July 1993. In August 1993, \$1.2 million of the \$1.6 million of the Company's accounts receivable from related parties was paid.



### **Inflation and Changes in Prices**

The Company's revenue and the value of its oil and gas properties have been and will be affected by changes in oil and gas prices. The Company's ability to obtain additional capital on attractive terms is also substantially dependent on oil and gas prices. Oil and gas prices are subject to significant seasonal and other fluctuations that are beyond the Company's ability to control or predict. Although certain of the Company's costs and expenses are affected by the level of inflation, inflation has not had a significant effect on the Company's results of operations during the past three fiscal years.

### **CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Effective September 14, 1992, the Company's Board of Directors engaged Price Waterhouse as the Company's principal independent accountants to replace Arthur Andersen & Co. ("Andersen"), who had resigned as the Company's independent accountants on June 18, 1992.

Andersen had been previously engaged by the Company to audit its financial statements from inception. Prior to this time, the financial statements of the Company had not been audited and reported on. Andersen did not complete its audit of the financial statements for any period during the term of its engagement or issue any audit reports. During the period of Andersen's engagement, there was no disagreement between the Company and Andersen on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedures, which, if not resolved to the satisfaction of Andersen would have caused Andersen to make reference to the subject matter of the disagreement in connection with its report. Andersen has indicated that, in addition, there was a difference of opinion between Andersen and the Company as to whether the Company would be able to continue to operate as a going concern considering its capitalization and financial resources at the time.



**FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**  
**Index to Consolidated Financial Statements and Consolidated Financial Statement Schedules**

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## REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders  
of Chesapeake Energy Corporation

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Chesapeake Energy Corporation and its subsidiaries (the "Company") at June 30, 1993 and 1992, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 1993, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

As discussed in Note 2 to the financial statements, the Company changed its method of accounting for its investment in oil and gas properties in fiscal 1993.

PRICE WATERHOUSE

Oklahoma City, Oklahoma  
September 24, 1993



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

A S S E T S

	June 30,	
	1993	1992
	<i>(\$ in thousands)</i>	
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents .....	\$ 4,851	\$ 690
Accounts receivable:		
Trade, net of allowance for doubtful accounts of \$584,000 and \$405,000 .....	9,987	10,388
Related parties .....	1,580	—
Inventory .....	3,404	1,740
Other .....	548	300
<b>TOTAL CURRENT ASSETS</b> .....	<b>20,370</b>	<b>13,118</b>
<b>PROPERTY AND EQUIPMENT:</b>		
Oil and gas properties, at cost based on full cost accounting:		
Evaluated oil and gas properties .....	56,181	45,729
Unevaluated properties and leaseholds .....	2,411	—
Less — accumulated depreciation, depletion and amortization .....	(8,276)	(4,091)
	50,316	41,638
Service properties, equipment, and other .....	9,152	6,857
Less — accumulated depreciation, depletion and amortization .....	(2,141)	(1,226)
	57,327	47,269
<b>OTHER ASSETS</b> .....	<b>149</b>	<b>296</b>
<b>TOTAL ASSETS</b> .....	<b>\$77,846</b>	<b>\$60,683</b>

L I A B I L I T I E S   A N D   S T O C K H O L D E R S '   E Q U I T Y

<b>CURRENT LIABILITIES:</b>		
Notes payable and current maturities of long-term debt .....	\$ 7,812	\$ 7,987
Accounts payable .....	9,663	20,143
Prepayments and other .....	2,158	3,150
Revenues and royalties due others .....	12,403	6,242
Income taxes payable .....	225	225
<b>TOTAL CURRENT LIABILITIES</b> .....	<b>32,261</b>	<b>37,747</b>
<b>LONG-TERM DEBT</b> .....	<b>13,190</b>	<b>21,742</b>
<b>DEFERRED INCOME TAXES</b> .....	<b>963</b>	<b>1,062</b>
<b>CONTINGENCIES AND COMMITMENTS (Note 4)</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, \$.01 par value, 1,153,846 shares authorized; 576,923 and 0 shares issued and outstanding at June 30, 1993, and June 30, 1992, respectively .....	6	—
Common stock, \$.01 par value, 20,000,000 shares authorized; 5,108,000 and 2,808,000 shares issued and outstanding at June 30, 1993, and June 30, 1992, respectively .....	51	28
Paid-in capital .....	32,704	683
Accumulated deficit .....	(1,329)	(579)
<b>TOTAL STOCKHOLDERS' EQUITY</b> .....	<b>31,432</b>	<b>132</b>
<b>TOTAL LIABILITIES &amp; STOCKHOLDERS' EQUITY</b> .....	<b>\$77,846</b>	<b>\$60,683</b>

*The accompanying notes are an integral part of these consolidated financial statements.*



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Years Ended June 30,		
	(\$ in thousands, except per share data)		
	1993	1992	1991
<b>REVENUES:</b>			
Oil and gas sales .....	\$11,602	\$10,520	\$4,334
Oil and gas service operations .....	5,526	7,656	1,961
Interest and other .....	880	542	148
Total revenues .....	<u>18,008</u>	<u>18,718</u>	<u>6,443</u>
<b>COSTS AND EXPENSES:</b>			
Production expenses and taxes .....	2,590	2,003	760
Oil and gas service operations .....	3,653	4,113	606
Oil & gas depreciation, depletion and amortization .....	4,184	2,910	1,585
Depreciation and amortization of other assets .....	557	974	351
General and administrative, net .....	3,920	3,414	2,119
Provision for legal and other settlements .....	1,286	-	-
Interest and other .....	2,282	2,577	317
Total cost and expenses .....	<u>18,472</u>	<u>15,991</u>	<u>5,738</u>
INCOME (LOSS) BEFORE INCOME TAXES .....	(464)	2,727	705
INCOME TAX EXPENSE (BENEFIT) .....	(99)	1,337	243
NET INCOME (LOSS) .....	<u>(\$ 365)</u>	<u>\$ 1,390</u>	<u>\$ 462</u>
<b>EARNINGS PER COMMON SHARE COMPUTATION:</b>			
NET INCOME (LOSS) .....	(\$ 365)	\$ 1,390	\$ 462
DIVIDENDS ON PREFERRED STOCK .....	385	-	-
NET INCOME (LOSS) AVAILABLE TO COMMON .....	<u>(\$ 750)</u>	<u>\$ 1,390</u>	<u>\$ 462</u>
NET INCOME (LOSS) PER COMMON SHARE .....	<u>(\$ .20)</u>	<u>\$ .45</u>	<u>\$ .15</u>
<b>WEIGHTED AVERAGE COMMON</b>			
SHARES OUTSTANDING .....	<u>3,728</u>	<u>3,101</u>	<u>3,101</u>

*The accompanying notes are an integral part of these consolidated financial statements.*



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended June 30.		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
NET INCOME (LOSS):	(\$ 365)	\$ 1,390	\$ 462
<b>ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES:</b>			
Depreciation, depletion and amortization	4,741	3,884	1,936
Deferred taxes	(99)	1,192	163
Amortization of loan costs	127	-	-
<b>CHANGES IN CURRENT ASSETS AND LIABILITIES:</b>			
(Increase) decrease in accounts receivable — trade	401	(840)	(6,785)
(Increase) decrease in accounts receivable — related parties	(1,580)	2,503	(3,213)
(Increase) decrease in inventory	834	1,088	(2,757)
(Increase) decrease in other current assets	(247)	(156)	(317)
Increase (decrease) in accounts payable, prepayments and other	(11,472)	(1,959)	22,381
Increase in revenues and royalties due others	6,161	2,071	2,871
Increase in income tax payable	-	145	80
Cash provided by (used in) operating activities	<u>(1,499)</u>	<u>9,318</u>	<u>14,821</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Development and acquisition of oil and gas properties	(16,382)	(27,879)	(22,677)
Proceeds from sale of equipment, leasehold and other	3,535	4,364	2,777
Other property and equipment additions	(2,295)	(1,240)	(2,028)
Cash used in investing activities	<u>(15,142)</u>	<u>(24,755)</u>	<u>(21,928)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuance of common stock	25,168	-	-
Proceeds from long-term borrowings	19,762	16,543	11,337
Payments on long-term borrowings	(23,487)	(3,774)	(753)
Other financing	(641)	-	-
Contributed capital	-	10	378
Capital withdrawals	-	-	(1,715)
Cash provided by financing activities	<u>20,802</u>	<u>12,779</u>	<u>9,247</u>
Net increase (decrease) in cash and cash equivalents	4,161	(2,658)	2,140
Cash and cash equivalents, beginning of period	690	3,348	1,208
Cash and cash equivalents, end of period	<u>\$ 4,851</u>	<u>\$ 690</u>	<u>\$ 3,348</u>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>			
<b>CASH PAYMENTS FOR:</b>			
Interest expense	\$ 2,520	\$ 2,166	\$ 291
Income taxes	\$ 56	\$ -	\$ -
<b>SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>			

During the year ended June 30, 1992, accounts receivable in the amount of \$1,049,000 were settled by an acceptance of an assignment of a working interest owner's working interest in specified wells, as defined. The balance of the trade receivable due from the industry partner was reclassified to oil and gas properties.

During the year ended June 30, 1992, the company executed note agreements with several vendors to formalize payment terms on approximately \$3,700,000 of accounts payable.

During the year ended June 30, 1993, notes payable in the amount of \$7,500,000 were converted to preferred stock.

On June 30, 1993, the Company became the legal and beneficial owner of certain oil and gas equipment. The total purchase price to be paid for the equipment is \$2,498,490. The purchase price will be paid by the Company during fiscal 1994.

*The accompanying notes are an integral part of these consolidated financial statements.*



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

	Years Ended June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
<b>PREFERRED STOCK</b>			
Balance, beginning of period	\$ —	\$ —	\$ —
Issuance of 576,923 shares of preferred stock	6	—	—
Balance, end of period	<u>6</u>	<u>—</u>	<u>—</u>
<b>COMMON STOCK</b>			
Balance, beginning of period	28	—	—
Issuance of 2,808,000 shares of common stock	—	28	—
Issuance of 2,300,000 shares of common stock	23	—	—
Balance, end of period	<u>51</u>	<u>28</u>	<u>—</u>
<b>PAID-IN CAPITAL</b>			
Balance, beginning of period	683	—	—
Issuance of preferred stock	7,494	—	—
Issuance of common stock	25,668	683	—
Offering expenses and other	<u>(1,141)</u>	<u>—</u>	<u>—</u>
Balance, end of period	<u>32,704</u>	<u>683</u>	<u>—</u>
<b>CONTRIBUTED CAPITAL</b>			
Balance, beginning of period	—	410	62
Capital contribution	—	301	348
Issuance of common stock	<u>—</u>	<u>(711)</u>	<u>—</u>
	<u>—</u>	<u>—</u>	<u>410</u>
<b>ACCUMULATED DEFICIT</b>			
Balance, beginning of period	(579)	(1,969)	(716)
Net income (loss)	(365)	1,390	462
Preferred dividends	(385)	—	—
Capital withdrawals	—	—	<u>(1,715)</u>
Balance, end of period	<u>(1,329)</u>	<u>(579)</u>	<u>(1,969)</u>
<b>TOTAL STOCKHOLDERS' EQUITY (DEFICIT)</b>	<u><u>\$31,432</u></u>	<u><u>\$ 132</u></u>	<u><u>(\$1,559)</u></u>

*The accompanying notes are an integral part of these consolidated financial statements.*



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

**1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Chesapeake Energy Corporation (the "Company"), a Delaware corporation, was incorporated in December 1991 for the purpose of combining (the "Combination") certain of the oil and gas exploration, oil and gas production and oil field service operations previously conducted by Chesapeake Operating, Inc. ("COI"), Chesapeake Exploration Company ("CEX"), Lindsay Oil Field Supply, Inc. and subsidiaries of those entities, (collectively referred to as the "Combined Entities"), along with certain office buildings, interests in oil and gas properties and related debt associated with these assets, all of which were beneficially owned by Aubrey K. McClendon and Tom L. Ward. The Combination was effective January 1, 1992 and the Company succeeded to all of the exploration and development operations and oil and gas assets of the Combined Entities. In addition, on May 1, 1991, interests in certain oil and gas properties owned by Chesapeake Investments ("CI"), which is wholly owned by Mr. McClendon and his family, and TLW Investments, Inc. ("TLW"), which is wholly owned by Mr. Ward, were transferred (the "Transfer") to CEX. CEX assumed certain liabilities related to such properties. The excess of historical net cost over the CI and TLW current payables relating to the assets transferred to CEX was recorded as a contribution from owners in the accompanying consolidated statements of stockholders' equity.

The Combination and Transfer were recorded on the basis of a reorganization of entities under common control at historical cost, in a manner similar to a pooling of interests. The accompanying consolidated financial statements give retroactive effect to the Combination and Transfer to reflect the historical results of operations of the assets that were acquired and liabilities assumed by the Company. The net income from the interest in oil and gas properties prior to the Transfer is reflected in the accompanying consolidated statements of operations with the offset reflected as capital withdrawals in the accompanying consolidated statements of stockholders' equity.

**Principles of Consolidation.** The accompanying consolidated financial statements include the accounts of the Combined Entities as described above. All significant intercompany accounts and transactions have been eliminated.

**Cash Equivalents.** For purposes of the statements of cash flows, the Company considers investments in all highly liquid debt instruments purchased with original maturities of three months or less to be cash equivalents.

**Inventory.** Inventory consists primarily of tubular goods and other lease and well equipment which the Company plans to utilize in its ongoing exploration and development activities and is carried at the lower of cost or market, on the specific identification method.

**Property and Equipment.** The Company follows the full cost method of accounting (see Note 2) under which all costs, including direct general and administrative expenses associated with property acquisition, exploration and development activities are capitalized and amortized on a composite unit-of-production method based on proved oil and gas reserves. The Company's oil and gas reserves are estimated annually by independent petroleum engineers. The average composite rates used for depreciation, depletion and amortization were \$0.97, \$0.83 and \$0.98 per equivalent Mcf in 1993, 1992 and 1991, respectively. Proceeds from the sale of properties are accounted for as reductions to capitalized costs unless such sales involve a significant change in the relationship between costs and the value of proved reserves or the underlying value of unproved properties in which case a gain or loss is recognized. Unamortized costs as reduced by related deferred taxes are subject to a ceiling which limits such amounts to the estimated present value of oil and gas reserves, reduced by operating expenses, future development costs and income taxes. The costs of unproved properties are excluded from amortization until the properties are evaluated.



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

**Other Property and Equipment.** Other property and equipment primarily consists of vehicles, oil and gas servicing equipment, office buildings, and office equipment. Major renewals and betterments are capitalized while the costs of repairs and maintenance are charged to expense as incurred. The costs of assets retired or otherwise disposed of and the applicable accumulated depreciation are removed from the accounts, and the resulting gain or loss is reflected in operations. Other property and equipment costs are depreciated on both straight-line and accelerated methods over the estimated useful lives of the assets, which range from 3 to 30 years.

**Capitalized Interest.** During 1993, interest of approximately \$192,000 was capitalized during periods of drilling, completing and construction of facilities.

**Service Operations.** Certain subsidiaries of the Company perform contractual services on wells the Company operates as well as for third parties. Oil and gas service operations revenues and costs and expenses reflected in the accompanying consolidated statements of operations include amounts derived from certain of the contractual services provided. The Company's economic interest in its oil and gas properties is not affected by the performance of these contractual services and all intercompany profits have been eliminated.

**Concentration of Credit Risk.** The Company operates exclusively in the oil and gas industry. The Company's joint interest billings and oil and gas sales receivables represent substantially all of the balance included in trade accounts receivable in the accompanying balance sheets.

**Income Taxes.** Except for CEX, the Combined Entities were C Corporations which filed separate income tax returns prior to the Combination. CEX is a partnership and, accordingly, its taxable income or loss for periods prior to the Combination was allocated to its individual partners and reported in their income tax returns. Subsequent to the Combination, the Company has filed a consolidated federal income tax return.

The Company has adopted Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes" and has stated its deferred income tax assets and liabilities under the provisions of this accounting standard for all periods presented.

**Net Income Per Share.** Primary earnings per share for all periods has been computed based upon the weighted average number of shares outstanding after giving retroactive effect to the 1.8 for 1 stock split, the 2,808,000 common shares issued in the Combination, the 2,300,000 common shares issued in the initial public offering, the common stock equivalents arising from the exercise of the warrants issued to the Trust Company of the West ("TCW") on July 2, 1992, the common stock equivalents arising from the exercise of the warrants issued to Belco Oil & Gas Corp. ("Belco") and the common stock equivalents arising from the exercise of the employee stock options granted in January 1993. Computations of primary and fully diluted earnings per share have not given effect to common stock equivalents or other contingent issuances for any period in which their inclusion would have the effect of increasing the earnings per share amount or decreasing the loss per share amount otherwise computed.

**Gas Imbalances.** The Company follows the "sales method" of accounting for its oil and gas revenue whereby the Company recognizes sales revenue on all oil or gas sold to its purchasers, regardless of whether the sales are proportionate to the Company's ownership in the property. A receivable or liability is recognized only to the extent that the Company has an imbalance on a specific property greater than the expected remaining life of the reservoir. The Company's net imbalance positions at June 30, 1993 and 1992 were not material.



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

**2. ACCOUNTING CHANGE**

During the fourth quarter of 1993, the Company changed its method of accounting for its investment in oil and gas properties from the successful efforts to full cost method. This change was made concurrent with planned changes in the Company's oil and gas operations described below and was predicated on a combination of business judgment and such planning.

Management is of the opinion that the full cost method of accounting is preferable and more appropriately reflects changes in the Company's evolving business plans including a reduced emphasis on leasehold sale activities, equipment sales and certain service operations provided to third parties, as well as more appropriately reflecting the economic effects of the exploration for and development of the Company's extensive undeveloped leasehold investment through increased emphasis on exploratory drilling activities. Further, management believes that the full cost method is the predominant method used by comparable independent oil and gas companies and will improve comparability of financial information with similarly positioned independent oil and gas companies.

The financial statements presented herein have given effect to the retroactive restatement of all prior periods as a result of this change in accounting method. The primary differences between the two accounting methods, as they relate to the Company, include the accounting for sales of oil and gas properties and oil and gas equipment, overhead and consulting fees, certain other services provided by the Company's subsidiaries and certain general and administrative expenses which are treated as adjustments to the carrying value of oil and gas properties under full cost and are recognized currently in the statement of operations under successful efforts. Additionally, the computation of depreciation, depletion and amortization of oil and gas properties is based on a composite unit-of-production method for full cost and a lease-by-lease unit-of-production method for successful efforts. If the Company had not changed from successful efforts to full cost, net income (loss) would have been (\$3,360,000), \$1,839,000, and \$952,000 for each of the years ended June 30, 1993, 1992, and 1991, respectively. Total revenues would have been \$25,614,000, \$22,894,000, and \$13,764,000, and total costs and expenses would have been \$29,853,000, \$20,025,000, and \$12,312,000 for each of the years ended June 30, 1993, 1992, and 1991, respectively. Earnings (loss) per common share under successful efforts would have been (\$1.00), \$.59, and \$.31, for each of the years ended June 30, 1993, 1992, and 1991, respectively.

**3. NOTES PAYABLE AND LONG-TERM DEBT**

Notes payable and long-term debt consist of the following:

	June 30,	
	1993	1992
	<i>(\$ in thousands)</i>	
Term note payable to Union Bank, interest of 7.5% per annum, collateralized by producing oil and gas properties, payable in monthly installments through September 1994 .....	\$10,211	\$ —
Note payable to Belco Oil & Gas Corp., interest at 9% per annum, collateralized by non-producing leasehold, interest is due in quarterly installments from April 1993 through January 1998, quarterly installments of principal are due from April 1995 through January 1998 .....	2,407	—
Note payable to a vendor, interest at 1% per annum, collateralized by oil and gas tubulars, payments are due 60 days from shipment of the tubulars .....	2,498	—
Note payable to a bank, interest at 7.75% per annum, collateralized by office buildings, payments due in monthly installments through May 1998 .....	777	—



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

	June 30,	
	1993	1992
Notes payable to vendors participating in the vendor financing programs, interest at 7% per annum, collateralized by interests in certain producing oil and gas properties, payable in monthly installments based on the production from certain oil and gas properties, as defined .....	1,620	—
Term note payable to Trust Company of the West ("TCW"), interest at 9% per annum plus a royalty interest in each of the wells drilled, collateralized by producing oil and gas properties, payable in monthly installments .....	—	6,750
Drilling note payable to TCW, interest at 9% per annum plus a royalty interest in each of the wells drilled, collateralized by oil and gas properties drilled under a Credit Agreement, payable in monthly installments .....	—	13,025
Notes payable to various entities to acquire non-producing leasehold, interest varies from 10% to 18% per annum, collateralized by non-producing leasehold or unsecured .....	—	1,777
Note payable to a vendor for oilfield equipment, annual interest at 10% through January 1994, and 18% thereafter, payments due in monthly installments of principal plus interest .....	2,084	2,384
Notes payable to various entities to acquire oil service equipment, interest varies from 6.5% to 18.4% per annum, collateralized by equipment, payments due in monthly installments through December 2000 .....	2,082	2,138
Notes payable to a bank for office buildings, interest at 8.5% per annum, collateralized by office buildings, payments due in monthly installments through March 31, 1993 .....	—	158
Notes payable to various vendors to refinance trade accounts payable, interest varies from 0% to 12% per annum, payments due through July 1994 .....	116	3,794
Other .....	68	115
Less loan origination costs, net of amortization .....	(861)	(412)
Total notes payable and long-term debt .....	21,002	29,729
Less — Current maturities .....	(7,812)	(7,987)
Notes payable and long-term debt, net of current maturities .....	<u>\$13,190</u>	<u>\$21,742</u>

The aggregate scheduled maturities of notes payable and long-term debt for the next five fiscal years ending June 30, 1998 and thereafter were as follows (in thousands of dollars):

1994 .....	\$ 7,812
1995 .....	9,743
1996 .....	2,559
1997 .....	67
1998 .....	62
After 1998 .....	759
	<u>\$21,002</u>



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

In April 1993 the Company entered into a \$15,000,000 oil and gas reserve-based reducing revolving credit facility with Union Bank. This loan is secured by the Company's interest in various producing oil and gas properties and requires the Company to make monthly payments of \$275,000 plus interest. Interest is calculated at the lender's base rate plus 1 1/2% per annum (7.5% at June 30, 1993). Terms of the credit facility include quarterly borrowing base reviews, commitment fees, maturity at September 1, 1994, covenants limiting the Company's ability to incur debt and restricting dividends, without the bank's permission, and other provisions consistent with normal energy lending practices. The outstanding principal balance of the credit facility at June 30, 1993 was \$10.2 million.

Effective December 31, 1992 the Company entered into a loan agreement with Belco Oil & Gas Corp. ("Belco") pursuant to which Belco loaned \$2.5 million to the Company. The terms of the agreement include restrictions on future indebtedness, limitations on the Company's right to pay dividends or redeem capital stock, and restrictions on the amount of general and administrative expenses that the Company may incur. As part of this transaction, Belco received warrants to purchase up to 180,000 shares of Common Stock at an exercise price equal to \$9.60 per share (see note 9). At June 30, 1993, the unpaid principal balance of the loan was \$2.4 million.

On September 24, 1993 the Company and Belco entered into the First Amendment to Loan Agreement ("First Amendment") which modified the mandatory payment terms of the original loan agreement, added mandatory prepayment terms on the loan in the event the Company makes any sale of equity securities or debt convertible into equity securities, and amended certain of its covenants including the ceiling on general and administrative expenses the Company may incur. The amendment to the mandatory prepayment provisions is effective as of January 1, 1994. All of the remaining provisions in the First Amendment are effective June 30, 1993.

At June 30, 1993 the Company was in default under a promissory note with a vendor dated July 13, 1992 with a June 30, 1993 balance of \$2.08 million. In April 1993, the vendor commenced legal action to collect the balance of the note. The Company and vendor have reached a preliminary agreement to modify the promissory note to restructure the terms as follows: (a) increase monthly payments from \$25,000 to \$100,000 plus interest, (b) change the date on which the interest rate will increase to 18% from November 1992 to January 1994, (c) change the date of maturity to October 1, 1994, and (d) provide for past due principal and interest through September 1, 1993 plus \$100,000 to be paid by the Company at closing. The accompanying consolidated balance sheets reflect the modification of terms of this promissory note as of June 30, 1993.

The Company has agreements with certain of its vendors under which the vendors have agreed to extend long-term credit for supplies, materials and services provided by such vendors to the Company in connection with current and future drilling projects. At June 30, 1993, approximately \$1.6 million of credit was outstanding under these agreements.

#### **4. CONTINGENCIES AND COMMITMENTS**

The Company is currently involved in certain litigation and has recorded a provision at June 30, 1993 for legal expenses and litigation settlements aggregating \$1,286,000. While it is not possible to determine the ultimate disposition of these matters, management, after consultation with legal counsel, is of the opinion that the final resolution of all currently pending or threatened litigation is not likely to have a material adverse effect on the consolidated financial position or results of operations of the Company when considering the aforementioned provision.



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

In February 1993, a \$2.15 million (plus costs and interest) judgment was entered against the Company and its two principal shareholders. The Company and the other defendants have appealed the judgment. The two principal shareholders have indemnified the Company against any liability with respect to the judgment and the appeal.

The Company, together with certain of its executive officers, its directors and others, are defendants in three class action suits based upon alleged misstatements in the Company's February 1993 prospectus used in connection with the initial public offering of its common stock. A Memorandum of Understanding has been executed by the parties, fully settling the claims against the defendants subject to approval by the court of a definitive settlement agreement. The settlement, if approved by the court, would require a \$485,000 payment by the Company and indemnification of the Company by its two principal shareholders for any liability resulting from the judgment described in the preceding paragraph and for post-judgment fees and expenses incurred by the Company. As of June 30, 1993, the Company has provided a reserve for its estimated cost of settlement.

The Company's subsidiary, COI, is a defendant in a pending action seeking approximately \$15 million in damages for alleged failure to drill wells under a farmout agreement entered into in 1991. COI asserts as a defense that it had the option, but not the obligation, to drill the wells and that, in any event, it was excused from drilling because of a lease cancellation action instituted by the plaintiff's lessor covering a substantial portion of the lands covered by the farmout agreement.

A subsidiary of the Company, COI, sold fractional undivided working interests in many of the wells it has drilled to oil and gas companies and individual investors. Offers and sales of such interests are generally subject to the registration and anti-fraud provisions of federal and state securities laws. None of the offers and sales of working interests made by COI were registered under the Securities Act or any state securities laws.

Various individuals and corporations who purchased fractional undivided working interests in specific oil and gas properties from COI and purchasers of interests from COI have asserted claims against the Company. As of September 24, 1993 there were no suits pending against the Company for securities violations arising out of such sales, although there can be no assurance that claims will not be asserted in the future.

The Company has employment contracts with its two principal shareholders and its chief financial officer which provide for annual base salaries, bonus compensation and various benefits. The contracts provide for the continuation of salary and benefits for the respective terms of the agreements in the event of termination of employment without cause. One agreement expires February 28, 1995, and the others expire June 30, 1995.

Due to the nature of the oil and gas business, the Company and its subsidiaries are exposed to possible environmental risks. The Company has implemented various policies and procedures to avoid environmental contamination and risks from environmental contamination. The Company is not aware of any potential environmental issues or claims.

**5. INCOME TAXES**

As discussed in Note 1, the Company has adopted SFAS No. 109, "Accounting for Income Taxes". The components of the income tax provision for each of the periods are as follows (in thousand of dollars):

	Years Ended June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
Current .....	\$ —	\$ 145	\$ 80
Deferred .....	(99)	1,192	163
TOTAL .....	<u>(\$ 99)</u>	<u>\$1,337</u>	<u>\$243</u>



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

The effective income tax rate differed from the computed "expected" federal income tax rate on earnings before income taxes for the following reasons:

	Years Ended June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
Computed "expected" income tax provision (benefit) . . . . .	(\$158)	\$ 927	\$240
Partnership operations prior to the Combination . . . . .	—	299	—
Other . . . . .	59	111	3
	(\$ 99)	\$1,337	\$243

Deferred income taxes are provided to reflect temporary differences in the basis of net assets for income tax and financial reporting purposes. The tax effected temporary differences and tax loss carryforwards which comprise deferred taxes are as follows:

	Years Ended June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
Accelerated depreciation, depletion and amortization of intangible drilling costs . . . . .	(\$6,295)	(\$2,449)	(\$163)
Tax loss carryforwards . . . . .	5,332	1,387	—
Total Noncurrent . . . . .	(\$ 963)	(\$1,062)	(\$163)

At June 30, 1993 the Company had an operating loss carryforward of approximately \$15.7 million for income tax purposes, available to offset future income taxes payable to the extent regular income taxes payable exceeds alternative minimum taxes payable. These loss carryforward amounts will expire during 2007 and 2008.

**6. RELATED PARTY TRANSACTIONS**

Certain directors, shareholders and employees of the Company have acquired working interests in certain of the Company's oil and gas properties. The owners of such working interests are required to pay their proportionate share of all costs. As of June 30, 1993, 1992 and 1991 the Company had accounts receivable from these directors, shareholders, and employees of \$1,580,000, \$0, and \$4,710,000. The aggregate average receivable balance due from these parties for fiscal 1993, 1992, and 1991 approximated \$1,153,000, \$3,779,000, and \$4,795,000, respectively.

A director serves as general counsel to the Company. During Fiscal 1993, 1992, and 1991, the Company incurred legal expenses of \$723,000, \$507,000, and \$132,000, respectively, for legal services provided by the law firm of which the director is a member.

The Company has assigned carried interests in oil and gas properties to certain of its employees and consultants. During fiscal 1992, the Company ceased assigning such interests.

Effective July 1, 1990, CI and TLW were engaged as consultants to the Company at a monthly fee of \$8,333 to each of CI and TLW, through June 30, 1991 and \$10,000 each month thereafter. The Company recorded \$200,000 and \$240,000 as general and administrative expense in the accompanying statements of operations during fiscal 1991 and 1992, respectively, related to these consulting arrangements. In the June 30, 1992 consolidated balance sheet, the Company recorded a total of \$160,000 payable to CI and TLW related to their consulting services. The consulting engagement terminated on July 1, 1992.

Beginning in January 1990, the Company leased two of its office buildings from CI and TLW at aggregate monthly rentals ranging from \$2,000 to \$20,000. During fiscal 1991 and 1992, the company recorded



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

\$57,300 and \$120,000, respectively, as general and administrative expense in the accompanying statements of operations related to these leases. These monthly charges ceased effective December 31, 1991, at which time CI and TLW transferred the buildings and certain furniture and fixtures to the Company, as part of the Combination for a total consideration of approximately \$1,290,000 which included assumption of certain indebtedness as well as the assumption of two notes payable to a bank, which were collateralized by the buildings. The balance of these notes payable of \$158,000 was recorded in notes payable and current maturities of long-term debt in the accompanying balance sheet at June 30, 1992. As of June 30, 1993, the notes had been fully paid.

**7. EMPLOYEE BENEFIT PLANS**

Effective October 1, 1989, the company established a 401(K) profit sharing plan (the "401(K) Plan"). Eligible employees may make voluntary contributions to the 401(K) Plan which are matched by the Company up to 2.5% of the employees' salary. The amount of employee contributions is limited as specified in the 401(K) Plan. The Company may, at its discretion, make additional contributions to the 401(K) Plan. The Company contributed \$44,000, \$17,000 and \$6,000 to the 401(K) Plan during the fiscal years ended June 30, 1993, 1992 and 1991, respectively.

**8. MAJOR CUSTOMERS**

Sales to individual customers constituting 10% or more of total revenue were as follows:

<u>Year</u>		<u>Amount</u> <i>(\$ in thousands)</i>	<u>Percent Revenue</u>
1993	Plains Marketing and Transportation, Inc.	2,579	22%
	GPM Gas Corporation	2,039	18%
	Mobil Oil Corporation	1,775	15%
	Total Petroleum, Inc.	1,380	12%
	Texaco Exploration & Production, Inc.	1,368	12%
1992	Plains Marketing and Transportation, Inc.	4,937	47%
1991	Plains Marketing and Transportation, Inc.	1,264	16%

Management believes that the loss of any of the above customers would not have a material impact on the Company's results of operations or its financial position.

**9. STOCKHOLDERS' EQUITY**

In February 1993, the company completed an initial public offering of 2,300,000 shares of its Common Stock at \$12 per share. The total offering proceeds were \$27.6 million with total net proceeds of the offering approximating \$25.2 million, of which \$12.8 million was used to reduce indebtedness, and the balance was used to fund operations and as working capital.

On December 4, 1992 the Company issued to TCW 576,923 shares of its Convertible Preferred Stock, in exchange for a \$7,500,000 reduction in the Company's debt to TCW. Each share of the Convertible Preferred Stock has a liquidation preference of \$13.00, accumulates dividends at an annual rate of \$1.17 per share cumulative from December 4, 1992 (to be paid quarterly commencing December 31, 1993) and is convertible at any time into a number of shares of Common Stock equal to the liquidation preference plus accumulated dividends of such share of Convertible Preferred Stock surrendered for conversion divided by a conversion price of \$9.60. Commencing December 31, 1993, accumulated dividends in arrears, if any, will accumulate additional dividends at a rate of 9% per annum. Should the Company fail to pay accumulated dividends on the Convertible Preferred Stock for a period of six consecutive calendar quarters, the holders



**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

of the Convertible Preferred Stock are entitled to elect one director to the Company's Board of Directors. Such right terminates, and such members are dismissed, when all accumulated and unpaid dividends on the Convertible Preferred Stock are subsequently paid. Pro forma per share data assuming full conversion of the Convertible Preferred Stock to common shares is not provided herein as the results are antidilutive.

In connection with the July 2, 1992 amendment to the TCW Credit Agreement, the Company issued to TCW a stock warrant granting TCW the right to purchase up to 312,001 shares of Common Stock at a price of \$4.17 per share. The term of the warrant expires in April 1996. The warrant provides for full price and antidilution protection.

The Company, the principal stockholders of the Company and TCW entered into a stockholders' agreement providing for various first rights of refusal and other provisions relating to the capital structure of the Company. The Company and TCW also entered into an agreement requiring the Company to register the Common Stock issued TCW pursuant to the warrants and the conversion of the Convertible Preferred Stock.

As discussed in Note 1, as part of the Combination, certain office buildings, interests in producing and nonproducing oil and gas properties, other property and related debt were contributed to the Company effective January 1, 1992. These contributions had no effect on consolidated stockholders' equity since the property contributed was recorded at historical costs totaling approximately \$2,528,000 in exchange for \$2,207,000 of existing accounts receivable from CI and TLW and assumption of \$321,000 in long-term debt. Such transaction is not reflected in the consolidated statement of cash flows.

The Transfer was consummated as a series of contributions to the Company and its subsidiaries. As a result, the Transfer was a taxable transaction to Messrs. McClendon and Ward to the extent the Company assumed liabilities in excess of Messrs. McClendon and Ward's bases in the assets transferred to the Company. The tax bases of assets acquired were adjusted to equal the liabilities assumed which resulted in a reduction of deferred income tax liabilities and an increase in contributions from owners of \$291,000 as reflected in the accompanying consolidated statements of stockholders' equity.

As part of the loan transaction with Belco (see Note 3), Belco received warrants to purchase a maximum of 180,000 shares of Common Stock at an exercise price of \$9.60 per share. Belco also received certain registration rights for the shares issuable upon exercise of the warrants.

In January 1993, the Company granted options to acquire an aggregate 226,800 shares of Common Stock at an exercise price of \$9.60 per share. The options granted were pursuant to two stock option plans, the Chesapeake Energy Corporation 1992 Incentive Stock Option Plan ("ISO") and the Chesapeake Energy Corporation 1992 Nonstatutory Stock Option Plan ("NQO"). The ISO plan is for employees of the Company and the NQO plan is for consultants and directors of the Company. In February 1993, the Company granted options to acquire an additional 59,500 shares of common stock at an exercise price of \$12 per share to directors of the Company.

A 1.8-for-1 stock split of the common stock during 1993 has been given retroactive effect in these financial statements.



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**10. DISCLOSURES ABOUT OIL AND GAS PRODUCING ACTIVITIES**

**Net Capitalized Costs.** Evaluated and unevaluated capitalized costs related to the Company's oil and gas producing activities are summarized as follows:

	June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
Oil and gas properties:			
Proved .....	\$56,181	\$45,729	\$19,982
Unproved .....	2,411	—	—
Total .....	<u>\$58,592</u>	<u>\$45,729</u>	<u>\$19,982</u>
Less accumulated depreciation, depletion and amortization .....	(8,276)	(4,091)	(1,130)
Net capitalized costs .....	<u>\$50,316</u>	<u>\$41,638</u>	<u>\$18,852</u>

Unproved properties not subject to amortization at June 30, 1993, consist mainly of lease acquisition costs. All of the balance in unevaluated properties at June 30, 1993, represents costs added during that fiscal year. The Company capitalized approximately \$192,000 of interest related to the average balance in wells in progress during fiscal 1993. There was no interest capitalized during fiscal 1992 and 1991, respectively. The Company will continue to evaluate its unevaluated properties; however, the timing of the ultimate evaluation and disposition of the properties has not been determined.

**Costs Incurred in Oil and Gas Producing Activities.** Costs incurred in oil and gas property acquisition, exploration and development activities, whether capitalized or expensed, are summarized as follows:

	June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
Property acquisition costs .....	\$ 2,340	\$ 2,233	\$ 8,455
Exploration costs .....	1,123	724	482
Development costs .....	9,384	26,553	12,281
Total .....	<u>\$12,847</u>	<u>\$29,510</u>	<u>\$21,218</u>

**Results of Operations from Oil and Gas Producing Activities (unaudited).** The Company's results of operations from oil and gas producing activities are presented below for the years ended June 30, 1993, 1992 and 1991, respectively. The following table includes revenues and expenses associated directly with the Company's oil and gas producing activities. It does not include any allocation of the Company's interest costs or general corporate overhead and, therefore, is not necessarily indicative of the contribution to consolidated net operating results of the Company's oil and gas operations.

	June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
Oil and gas sales .....	\$11,602	\$10,520	\$ 4,334
Production costs (a) .....	(2,590)	(2,003)	(760)
Depletion and depreciation .....	(4,184)	(2,910)	(1,585)
Imputed income tax provision (b) .....	(1,641)	(1,906)	(676)
Results of operations from oil and gas producing activities .....	<u>\$ 3,187</u>	<u>\$ 3,701</u>	<u>\$ 1,313</u>

(a) Production costs include lease operating expenses and production taxes.

(b) The imputed income tax provision is hypothetical and determined without regard to the Company's deduction for general and administrative expenses, interest costs and other income tax credits and deductions.



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**Oil and Gas Reserve Quantities (Unaudited).** The Reserve Information presented below is based upon reports prepared by the independent petroleum engineering firm of Lee Keeling & Associates, Inc. as of June 30, 1991 and by Williamson Petroleum Consultants, Inc. ("Williamson") as of October 1, 1992 (adjusted to June 30, 1992 by the Company) and June 30, 1993. The information is presented in accordance with regulations prescribed by the Securities and Exchange Commission. The Company emphasizes that reserve estimates are inherently imprecise. The Company's reserve estimates were generally based upon extrapolation of historical production trends, analogy to similar properties and volumetric calculations. Accordingly, these estimates are expected to change, and such changes could be material, as future information becomes available.

Proved oil and gas reserves represent the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. Proved developed oil and gas reserves are those expected to be recovered through existing wells with existing equipment and operating methods.

Presented below is a summary of changes in estimated reserves of the Company adjusted to June 30, 1992 by the Company based upon the report prepared by Williamson as of October 1, 1992.

	June 30, 1993		June 30, 1992		June 30, 1991	
	Oil (m bbl)	Gas (mmcf)	Oil (m bbl)	Gas (mmcf)	Oil (m bbl)	Gas (mmcf)
Proved reserves, beginning of year	11,147	68,618	3,212	17,334	969	5,052
Extensions, discoveries and other additions	1,576	15,078	10,140	60,745	2,418	12,872
Revisions of previous estimate	(2,793)	(118)	(1,843)	(8,222)	(12)	56
Production	(276)	(2,677)	(374)	(1,252)	(163)	(646)
Sale of reserves-in-place	(32)	(1,142)	—	—	—	—
Purchase of undeveloped reserves-in-place	—	4	12	13	—	—
Proved reserves, end of year	<u>9,622</u>	<u>79,763</u>	<u>11,147</u>	<u>68,618</u>	<u>3,212</u>	<u>17,334</u>
Proved developed reserves, end of year	<u>830</u>	<u>11,893</u>	<u>1,049</u>	<u>11,492</u>	<u>1,054</u>	<u>7,244</u>

**Standardized Measure of Discounted Future Net Cash Flows (Unaudited).** SFAS No. 69 prescribes guidelines for computing a standardized measure of future net cash flows and changes therein relating to estimated proved reserves. The Company has followed these guidelines which are briefly discussed below.

Future cash inflows and future production and development costs are determined by applying year-end prices and costs to the estimated quantities of oil and gas to be produced. Estimated future income taxes are computed using current statutory income tax rates including consideration for the current tax basis of the properties and related carryforwards, giving effect to permanent differences and tax credits. The resulting future net cash flows are reduced to present value amounts by applying a 10% annual discount factor.

The assumptions used to compute the standardized measure are those prescribed by the Financial Accounting Standards Board and, as such, do not necessarily reflect the Company's expectations of actual revenue to be derived from those reserves nor their present worth. The limitations inherent in the reserve quantity estimation process, as discussed previously, are equally applicable to the standardized measure computations since these estimates are the basis for the valuation process.



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The following summary sets forth the Company's future net cash flows relating to proved oil and gas reserves based on the standardized measure prescribed in SFAS No. 69:

	Years Ended June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
Future cash inflows .....	374,190	\$396,709	\$ 82,170
Future production costs .....	(72,691)	(58,403)	(20,414)
Future development costs .....	(86,383)	(71,087)	(17,414)
Future income tax provision .....	(37,248)	(63,668)	(8,226)
Future net cash flows .....	177,868	203,551	36,116
Less effect of a 10% discount factor .....	(58,124)	(77,799)	(14,062)
Standardized measure of discounted future net cash flows .....	<u>\$119,744</u>	<u>\$125,752</u>	<u>\$ 22,054</u>

The principal sources of change in the standardized measure of discounted future net cash flows are:

	Years Ended June 30,		
	1993	1992	1991
	<i>(\$ in thousands)</i>		
Standardized measure, beginning of year .....	\$125,752	\$ 22,054	\$ 4,694
Sales of oil and gas produced, net of production costs .....	(9,012)	(8,388)	(3,549)
Net changes in prices and production costs .....	(25,935)	8,394	1,844
Extensions and discoveries, net of production and development costs .....	21,579	151,296	16,849
Changes in future development costs .....	(4,154)	875	941
Development costs incurred during the period that reduced future development costs .....	7,233	11,115	4,435
Revisions of previous quantity estimates .....	(22,775)	(23,760)	(14)
Purchase of undeveloped reserves-in-place .....	(3)	103	-
Sales of reserves-in-place .....	(428)	-	-
Accretion of discount .....	16,453	2,781	616
Net change in income taxes .....	16,856	(33,019)	(4,277)
Changes in production rates and other .....	(5,822)	(5,699)	515
Standardized measure, end of year .....	<u>\$119,744</u>	<u>\$125,752</u>	<u>\$22,054</u>



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