

CHINA NORTH EAST PETROLEUM HOLDINGS LTD  
Form 10-Q  
September 07, 2010

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

FORM 10-Q

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

For the quarterly period ended June 30, 2010

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

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

Commission file number 001-34378

CHINA NORTH EAST PETROLEUM  
HOLDINGS LIMITED  
(Exact name of small business issuer as specified in its charter)

Nevada  
(State of other  
jurisdiction of  
incorporation or  
organization)

87-0638750  
(IRS Employer  
identification No.)

445 Park Avenue, New York, New York 10022  
(Address of principal executive offices)

(212) 307-3568  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerate filer, an accelerate filer, a non-accelerated filer, or a

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smaller reporting company. See the definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	<input type="radio"/>	Accelerated filer	<input type="radio"/>
Non-accelerated filer	<input type="radio"/>	Smaller reporting company	<input checked="" type="radio"/>

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

Number of shares of common stock outstanding as of August 29, 2010: 29,504,860

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## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

On one or more occasions, we may make forward-looking statements in this Quarterly Report on Form 10-Q regarding our assumptions, projections, expectations, targets, intentions or beliefs about future events. Words or phrases such as “anticipates,” “may,” “will,” “should,” “believes,” “estimates,” “expects,” “intends,” “plans,” “predicts,” “projects,” “will likely result,” “will continue” or similar expressions identify forward-looking statements. These forward-looking statements are only our predictions and involve numerous assumptions, risks and uncertainties, including, but not limited to, those listed below and those business risks and factors described elsewhere in this report and our other Securities and Exchange Commission (“SEC”) filings.

Forward-looking statements involve risks and uncertainties which could cause actual results or outcomes to differ materially from those expressed. We caution that while we make such statements in good faith and believe such statements are based on reasonable assumptions, including without limitation, management’s examination of historical operating trends, data contained in records and other data available from third parties, we cannot assure you that our projections will be achieved. Factors that may cause such differences include but are not limited to:

- Our expectation of continued growth in the demand for our oil;
- Our expectation that we will have adequate liquidity from cash flows from operations;
- A variety of market, operational, geologic, permitting, labor and weather related factors; and
- The other risks and uncertainties which are described below under “RISK FACTORS,” including, but not limited to, the following:

Unanticipated conditions may cause profitability to fluctuate; and  
Decreases in purchases of oil by our customer will adversely affect our revenues.

We have attempted to identify, in context, certain of the factors that we believe may cause actual future experience and results to differ materially from our current expectation regarding the relevant matter or subject area. In addition to the items specifically discussed above, our business and results of operations are subject to the uncertainties described under the caption “Risk Factors” which is a part of the disclosure included in Item 2 of this Report entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

From time to time, oral or written forward-looking statements are also included in our reports on Forms 10-K, 10-Q and 8-K, Proxy Statements on Schedule 14A, press releases, analyst and investor conference calls, and other communications released to the public. Although we believe that at the time made, the expectations reflected in all of these forward-looking statements are and will be reasonable, any or all of the forward-looking statements in this quarterly report on Form 10-Q, our reports on Forms 10-K and 8-K, our Proxy Statements on Schedule 14A and any other public statements that are made by us may prove to be incorrect. This may occur as a result of inaccurate assumptions or as a consequence of known or unknown risks and uncertainties. Many factors discussed in this Quarterly Report on Form 10-Q, certain of which are beyond our control, will be important in determining our future performance. Consequently, actual results may differ materially from those that might be anticipated from forward-looking statements. In light of these and other uncertainties, you should not regard the inclusion of a forward-looking statement in this Quarterly Report on Form 10-Q or other public communications that we might make as a representation by us that our plans and objectives will be achieved, and you should not place undue reliance on such forward-looking statements.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. However, your attention is directed to any further disclosures made on related

subjects in our subsequent annual and periodic reports filed with the SEC on Forms 10-K, 10-Q and 8-K and Proxy Statements on Schedule 14A.

Unless the context requires otherwise, references to “we,” “us,” “our,” the “Company” and “NEP” refer specifically to China North East Petroleum Holdings Limited and its subsidiaries.

PART I FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES (“NEP”)  
Condensed Consolidated Balance Sheets

	As of	
	June 30, 2010 (Unaudited)	December 31, 2009 (Audited)
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 45,666,012	\$ 28,693,132
Accounts receivable, net	23,985,519	16,231,369
Prepaid expenses and other current assets	1,606,725	678,349
<b>Total Current Assets</b>	<b>71,258,256</b>	<b>45,602,850</b>
<b>PROPERTY AND EQUIPMENT</b>		
Oil properties, net	42,476,204	45,777,428
Fixed assets, net	15,428,361	16,466,117
Oil properties under construction	175,742	69,395
<b>Total Property and Equipment</b>	<b>58,080,307</b>	<b>62,312,940</b>
LAND USE RIGHTS, NET	611,237	630,387
GOODWILL	1,645,589	1,645,589
DEFERRED TAX ASSETS	7,786,056	7,538,868
<b>TOTAL ASSETS</b>	<b>\$ 139,381,445</b>	<b>\$ 117,730,634</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 9,787,193	\$ 13,373,640
Current portion of secured debenture	-	5,625,000
Other payables and accrued expenses	990,229	1,165,494
Due to a related party	14,687	14,626
Due to a related company	27,906	144,796
Income tax and other taxes payable	7,680,841	4,930,202
Due to a stockholder	3,986,763	89,269
<b>Total Current Liabilities</b>	<b>22,487,619</b>	<b>25,343,027</b>
<b>LONG-TERM LIABILITIES</b>		
Secured debenture	-	4,875,000
Warrants	13,909,905	39,528,261
<b>Total Long-term Liabilities</b>	<b>13,909,905</b>	<b>44,403,261</b>
<b>TOTAL LIABILITIES</b>	<b>36,397,524</b>	<b>69,746,288</b>

<b>COMMITMENTS AND CONTINGENCIES</b>		
	-	-
<b>EQUITY</b>		
<b>NEP Stockholders' Equity</b>		
Common stock (\$0.001 par value, 150,000,000 shares authorized, 29,504,860 shares issued and outstanding as of June 30, 2010; 27,935,818 shares issued and outstanding as of December 31, 2009)	29,505	27,936
Additional paid-in capital	47,530,799	42,582,142
<b>Retained earnings (deficits)</b>		
Unappropriated	38,736,530	(7,995,947 )
Appropriated	2,524,055	2,524,055
Accumulated other comprehensive income	2,933,927	3,181,452
<b>Total NEP Stockholders' Equity</b>	<b>91,754,816</b>	<b>40,319,638</b>
Noncontrolling interests	11,229,105	7,664,708
<b>TOTAL EQUITY</b>	<b>102,983,921</b>	<b>47,984,346</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
	<b>\$ 139,381,445</b>	<b>\$ 117,730,634</b>

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



## CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES ("NEP")

## Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)

(Unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2010	2009 (Restated)	2010	2009 (Restated)
<b>REVENUE</b>				
Sales of crude oil	\$ 15,390,494	\$ 11,351,405	\$ 32,036,989	\$ 20,250,628
Drilling revenue	12,316,691	-	24,598,489	-
Total Revenue	27,707,185	11,351,405	56,635,478	20,250,628
<b>COST OF REVENUE</b>				
Production costs	872,747	1,152,199	2,091,990	1,666,599
Drilling costs	4,849,429	-	9,360,718	-
Depreciation, depletion and amortization of oil properties	2,131,933	2,235,413	3,743,038	5,315,043
Depreciation of drilling equipment	477,619	-	955,058	-
Amortization of land use rights	4,891	2,982	15,747	5,961
Government oil surcharge	2,507,920	580,375	5,002,638	618,167
Total Cost of Revenue	10,844,539	3,970,969	21,169,189	7,605,770
<b>GROSS PROFIT</b>	16,862,646	7,380,436	35,466,289	12,644,858
<b>OPERATING EXPENSES</b>				
Selling, general and administrative expenses	618,379	718,272	2,143,405	1,397,147
Professional fees	117,678	74,159	192,734	172,915
Consulting fees	224,750	72,589	224,750	69,995
Depreciation of fixed assets	96,042	70,986	191,422	139,801
Impairment of oil properties	-	6,789	-	13,832,356
Total Operating Expenses	1,056,849	942,795	2,752,311	15,612,214
<b>INCOME (LOSS) FROM OPERATIONS</b>	15,805,797	6,437,641	32,713,978	(2,967,356 )
<b>OTHER INCOME (EXPENSE)</b>				
Other expense	(38,201 )	(1,008 )	(76,173 )	(1,801 )
Interest expense	(1,162 )	(260,664 )	(24,734 )	(540,664 )
Amortization of deferred financing costs	-	-	-	(144,507 )
Amortization of discount on debenture	-	-	-	(670,492 )
Imputed interest expense	-	(37,669 )	-	(49,917 )
Interest income	23,458	4,668	46,620	19,764
Other income	10,811	-	10,811	-
Change in fair value of warrants	14,598,248	(12,731,750)	25,439,166	(12,078,045)
Loss on extinguishment of debt	-	-	-	(8,260,630 )
Total Other Income (Expense), net	14,593,154	(13,026,423)	25,395,690	(21,726,292)
	30,398,951	(6,588,782 )	58,109,668	(24,693,648)

NET INCOME (LOSS) BEFORE				
INCOME TAXES				
Income tax expense	(4,175,031 )	-	(8,775,101 )	-
NET INCOME (LOSS)	26,223,920	(6,588,782 )	49,334,567	(24,693,648)
Less: net loss (income) attributable to				
noncontrolling interests	(1,236,828 )	(710,839 )	(2,602,090 )	162,529
NET INCOME				
(LOSS) ATTRIBUTABLE TO NEP				
COMMON STOCKHOLDERS	24,987,092	(7,299,621 )	46,732,477	(24,531,119)
OTHER COMPREHENSIVE INCOME				
(LOSS)				
Total other comprehensive income	650,508	7,348	714,782	69,372
Less: foreign currency translation (gain)				
loss attributable to noncontrolling interests	106,691	(734 )	(962,307 )	(6,937 )
Foreign currency translation gain (loss)				
attributable to NEP common stockholders	757,199	6,614	(247,525 )	62,435
COMPREHENSIVE INCOME (LOSS)				
ATTRIBUTABLE TO NEP COMMON				
STOCKHOLDERS	\$ 25,744,291	\$ (7,293,007 )	\$ 46,484,952	\$ (24,468,684)
Net income (loss) per share				
- basic	\$ 0.85	\$ (0.35 )	\$ 1.60	\$ (1.18 )
- diluted	\$ 0.80	\$ (0.35 )	\$ 1.49	\$ (1.18 )
Weighted average number of shares				
outstanding during the period				
- basic	29,500,642	20,855,289	29,195,886	20,819,881
- diluted	31,157,614	20,855,289	31,398,739	20,819,881

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

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES  
Condensed Consolidated Statements of Cash Flows  
(Unaudited)

	For the six months ended June 30,	
	2010	2009 (Restated)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$49,334,567	\$(24,693,648)
Adjusted to reconcile net income (loss) to cash provided by operating activities:		
Depreciation, depletion and amortization of oil properties	3,743,038	5,315,043
Depreciation of drilling equipment	955,058	-
Depreciation of fixed assets	191,422	139,801
Amortization of land use rights	15,747	5,961
Amortization of deferred financing costs	-	144,507
Amortization of discount on debenture	-	670,492
Amortization of stock option compensation	224,750	554,194
Loss on extinguishment of debt	-	8,260,630
Change in fair value of warrants	(25,439,166)	12,078,045
Impairment of oil properties	-	13,832,356
Warrants issued for services	-	147,823
Stock-based compensation for employee service	1,010,000	405,000
Imputed interest expenses	-	49,917
Gain on disposal of fixed assets	(10,851 )	-
Changes in operating assets and liabilities		
(Increase) decrease in:		
Accounts receivable	(7,754,150 )	(853,723 )
Prepaid expenses and other current assets	(928,376 )	271,113
Value added tax recoverable	-	311,240
Deferred tax assets	(247,188 )	(3,494,798 )
Increase (decrease) in:		
Accounts payable	(3,586,447 )	(3,537,123 )
Other payables and accrued expenses	(175,265 )	59,027
Income tax and other taxes payable	2,750,639	(446,492 )
Net cash provided by operating activities	20,083,778	9,219,365
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of oil properties	(265,974 )	(790,110 )
Purchase of fixed assets	(42,533 )	(158,416 )
Additions to oil properties under construction	(106,347 )	-
Proceeds on disposal of fixed assets	11,519	-
Net cash used in investing activities	(403,335 )	(948,526 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Repayment of secured debenture	(10,500,000)	(1,770,000 )
Proceeds from exercise of stock warrants and options	3,474,672	1,200

Increase in amount due to a stockholder	3,897,494	2,998,194
Increase (decrease) in due to a related party	61	(51,652 )
Decrease in due to a related company	(116,890 )	-
Net cash (used in ) provided by financing activities	(3,224,663 )	1,177,742
<b>EFFECT OF EXCHANGE RATE ON CASH</b>	<b>537,100</b>	<b>(12,770 )</b>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>16,972,880</b>	<b>9,435,811</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>28,693,132</b>	<b>13,239,213</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$45,666,012</b>	<b>\$22,675,024</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid during the period for:		
Income tax expense	\$10,060,115	\$4,077,609
Interest expense	\$234,740	\$280,839

**SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:**

- On March 29, 2010, 400,000 shares of common stocks valued at \$3,232,000 were issued to the key management of Tiancheng,
- (1) of which the Company recognized \$202,000 and \$1,010,000 as staff compensation expenses included in selling, general and administrative expenses for the three and six months ended June 30, 2010, respectively.
- (2) In April 2010, a total of 29,865 shares of common stocks were issued in connection with cashless exercise of investor warrants.

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

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES  
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS AS OF JUNE 30, 2010  
(UNAUDITED)

NOTE 1 RESTATEMENT OF PREVIOUSLY REPORTED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

On February 23, 2010, China North East Petroleum Holdings Limited (the “Company”) determined that the Company’s financial statements as of June 30, 2009 and for the three and six months then ended should no longer be relied upon and should be restated as a result of certain non-cash errors contained therein regarding the accounting for: (i) warrants issued in conjunction with a secured debenture on February 28, 2008, which warrants should have been classified according to Accounting Standards Codification (“ASC”) 815-40 (formerly Emerging Issues Task Force (“EITF”) 00-19) as liability instruments rather than equity instruments; (ii) the change in the fair value of those warrants from the date of issuance through the end of the reporting period; (iii) effective interest expense arising from amortization of the discount to the carrying value of the secured debenture; (iv) the recording of warrants issued to investment consultants in connection with the issuance of the secured debenture as deferred financing costs instead of consulting fees; (v) the rate of amortization of deferred financing costs associated with the issuance of that secured debenture; (vi) compensation issued to employees in the form of stock; (vii) depreciation, depletion and amortization of oil properties; (viii) ceiling test reduction of the net carrying value of oil properties; (ix) income tax expense; (x) noncontrolling interests; and (xi) restructuring of the secured debenture on March 5, 2009, treated as an extinguishment of debt.

As a result, the accompanying unaudited condensed consolidated statements of operations and comprehensive income (loss), and cash flows as of June 30, 2009 and for the three and six months ended June 30, 2009 have been restated from the amounts previously reported. The information in the data table below represents only those statements of operations and comprehensive income (loss), and cash flows line items affected by the restatement.

STATEMENT OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS) INFORMATION

	For the three months ended June 30, 2009			For the six months ended June 30, 2009		
	As previously reported	Adjustments	As restated	As previously reported	Adjustments	As restated
Cost of Sales:						
Depletion, depreciation and amortization of oil properties	\$ 2,833,995	\$ (598,582)	\$ 2,235,413	\$ 5,458,249	\$ (143,206)	\$ 5,315,043
Operating Expenses:						
Selling, general and administrative expenses	610,754	107,518	718,272	1,183,337	213,810	1,397,147
Professional fees	153,032	(78,873)	74,159	225,048	(52,133)	172,915
Consulting fees	98,615	(26,026)	72,589	156,295	(86,300)	69,995
Impairment of oil properties	-	6,789	6,789	-	13,832,356	13,832,356

Other Income						
(Expense):						
Amortization of deferred financing costs	(74,140)	74,140	-	(148,279)	3,772	(144,507)
Amortization of discount on debenture	(509,355)	509,355	-	(1,002,058)	331,566	(670,492)
Change in fair value of warrants	-	(12,731,750)	(12,731,750)	-	(12,078,045)	(12,078,045)
Loss on extinguishment of debt	-	-	-	-	(8,260,630)	(8,260,630)
Income tax expense	(1,667,848)	1,667,848	-	(3,087,667)	3,087,667	-
Net income (loss)	3,302,451	(9,891,233)	(6,588,782)	5,986,549	(30,680,197)	(24,693,648)
Noncontrolling interests	(484,874 )	(225,965 )	(710,839 )	(897,619)	1,060,148	162,529
Net income (loss) attributable to NEP common stockholders	2,817,577	(10,117,198)	(7,299,621 )	5,088,930	(29,620,049)	(24,531,119)
Foreign currency translation gain attributable to NEP common stockholders	4,010	2,604	6,614	75,055	(12,620)	62,435
Comprehensive income (loss)	2,821,587	(10,114,594)	(7,293,007)	5,163,985	(29,632,669)	(24,468,684)
Net income (loss) per share -- Basic	0.14	(0.49 )	(0.35 )	0.24	(1.42)	(1.18)
Net income (loss) per share -- Diluted	0.13	(0.48)	(0.35)	0.24	(1.42)	(1.18)

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES  
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS AS OF JUNE 30, 2010  
(UNAUDITED)

NOTE 1 RESTATEMENT OF PREVIOUSLY REPORTED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

STATEMENT OF CASH FLOWS INFORMATION

	Six months ended June 30, 2009		
	As previously reported	Adjustments	As restated
Net income (loss)	\$ 5,088,930	\$ (29,782,578)	\$ (24,693,648)
Adjustments to reconcile net income (loss) to cash provided by operating activities:			
Depreciation, depletion and amortization of oil properties	5,458,249	(143,206)	5,315,043
Amortization of deferred financing costs	148,279	(3,772)	144,507
Amortization of discount on debenture	1,002,058	(331,566)	670,492
Amortization of stock option compensation	340,384	213,810	554,194
Change in fair value of warrants	-	12,078,045	12,078,045
Impairment of oil properties	-	13,832,356	13,832,356
Loss on extinguishment of debt	-	8,260,630	8,260,630
Warrants issued for services	206,602	(58,779)	147,823
Noncontrolling interests	897,619	(897,619)	-
Other payables and accrued liabilities	138,681	(79,654)	59,027
Deferred tax assets	(402,504)	(3,092,294)	(3,494,798)
Net cash provided by operating activities	9,223,992	(4,627)	9,219,365
Effect of exchange rate on cash	(17,397)	4,627	(12,770)

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES  
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS AS OF JUNE 30, 2010  
(UNAUDITED)

NOTE 2 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments consisting only of normal recurring accruals considered necessary to present fairly the Company's financial position at June 30, 2010 and December 31, 2009, the results of operations for the three and six months ended June 30, 2010 and 2009 and cash flows for the six months ended June 30, 2010 and 2009. The results for the three and six months ended June 30, 2010 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2010.

These financial statements should be read in conjunction with the Company's annual report on Form 10-K for the fiscal year ended December 31, 2009.

NOTE 3 ORGANIZATION

China North East Petroleum Holdings Limited ("North East Petroleum") was incorporated in Nevada on August 20, 1999 under the name of Draco Holding Corporation ("Draco").

Hong Xiang Petroleum Group Limited ("Hong Xiang Petroleum Group") was incorporated in the British Virgin Islands ("BVI") on August 28, 2003 as an investment holding company.

Song Yuan City Hong Xiang Petroleum Technical Services Co., Ltd. ("Hong Xiang Technical") was incorporated in the People's Republic of China ("PRC") on December 5, 2003 to provide technical advisory services to oil and gas exploration companies in the PRC.

During 2004, Hong Xiang Petroleum Group acquired a 100% ownership of Hong Xiang Technical.

During 2004, Hong Xiang Technical acquired a 100% interest in Song Yuan City Yu Qiao Qianan Hong Xiang Oil and Gas Development Co., Ltd. ("Hong Xiang Oil Development") which is engaged in the exploration and production of crude oil in the Jilin Oil Region, of the PRC. In December 2002, Hong Xiang Oil Development entered into an oil lease agreement with Song Yuan City Yu Qiao Oil and Gas Development Limited Corporation ("Yu Qiao") to develop the proven reserves in the Qian'an Oil Field Zone 112 (Qian'an 112) in Jilin Oil Region for 20 years.



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NOTE 3 ORGANIZATION (Continued)

During 2004, Draco executed a Plan of Exchange to acquire 100% of Hong Xiang Petroleum Group.

On July 26, 2006, the Company entered into a Joint Venture Agreement (the "JV Agreement") with a principal stockholder and a related party, hereafter referred to as the "Related Parties," to acquire oil properties for the exploration of crude oil in the PRC. Pursuant to the JV Agreement, the Company and the Related Parties are obligated to contribute \$1 million and \$121,000, respectively, to the registered capital of Song Yuan North East Petroleum Technical Service Co., Ltd. ("Song Yuan Technical"), and the Company and the Related Parties will each share 90% and 10% respectively of the equity and profit interests of Song Yuan Technical.

On June 1, 2005, Song Yuan Technical acquired from third parties 100% equity interest of LongDe Oil & Gas Development Co. Ltd. ("LongDe") at a consideration of \$120,773 in cash. LongDe is engaged in the exploration and production of crude oil in the Jilin Oil Region of the PRC.

On January 26, 2007, Song Yuan Technical acquired 100% of the equity interest of Yu Qiao for 10,000,000 shares of the Company's common stock having a fair value of \$3,100,000. Yu Qiao is engaged in the exploration and production of crude oil in Jilin Province, PRC and operates 3 oilfields with a total exploration area of 39.2 square kilometers. Pursuant to a 20-year exclusive Cooperative Exploration Contract (the "Oil Lease") which was entered into on May 28, 2002 with PetroChina Group, a corporation organized and existing under the laws of PRC ("PetroChina"), the Company has the right to explore, develop and extract oil at Qian'an 112, Da 34 and Gu 31 area.

After the acquisition of Yu Qiao, the oil lease agreement between Yu Qiao and Hong Xiang Oil Development was rescinded and Hong Xiang Technical and Hong Xiang Oil Development were dissolved in March 2007.

On September 25, 2009, Song Yuan Technical acquired from third parties 100% equity interest of Song Yuan Tiancheng Drilling Engineering Co., Ltd. ("Tiancheng") at a consideration of \$13,000,000 in cash. Tiancheng provides contract land drilling services to customers for exploration and production of crude oil in the PRC.

North East Petroleum, Hong Xiang Petroleum Group, Song Yuan Technical, LongDe, Yu Qiao and Tiancheng are hereinafter referred to as (the "Company").

NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation

The accompanying unaudited condensed consolidated financial statements as of June 30, 2010 include the unaudited financial statements of North East Petroleum and its wholly owned subsidiary, Hong Xiang Petroleum Group and 90% owned subsidiaries, Song Yuan Technical, LongDe, Yu Qiao and Tiancheng. The noncontrolling interests represent the minority shareholders' 10% share of the results of Song Yuan Technical, LongDe, Yu Qiao and Tiancheng.

The accompanying unaudited condensed consolidated financial statements as of June 30, 2009 include the unaudited financial statements of North East Petroleum and its wholly owned subsidiary, Hong Xiang Petroleum Group and 90% owned subsidiaries, Song Yuan Technical, LongDe and Yu Qiao. The noncontrolling interests represent the minority shareholders' 10% share of the results of Song Yuan Technical, LongDe and Yu Qiao.

All significant inter-company accounts and transactions have been eliminated in consolidation.

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CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES  
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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates include the value of the Company's oil reserve quantities which are the basis for the calculation of the depletion, depreciation and amortization of oil properties and impairments of oil properties and estimates of the fair value of warrants. Actual results could differ from those estimates.

Foreign currency translation and other comprehensive income

The reporting currency of the Company is the US dollar. The functional currency of Song Yuan Technical, LongDe, Yu Qiao and Tiancheng is the Chinese Renminbi ("RMB").

For the subsidiaries whose functional currencies are other than the US dollar, all assets and liabilities accounts were translated at the exchange rate on the balance sheet date; stockholder's equity is translated at the historical rates and items in the statement of operations items and statement of cash flows are translated at the average rate for the year. Translation adjustments resulting from this process are included in accumulated other comprehensive income in the statement of stockholders' equity. The resulting translation gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred. Accumulated other comprehensive income in the condensed consolidated balance sheets amounted to \$2,933,927 and \$3,181,452 as of June 30, 2010 and December 31, 2009, respectively. The balance sheet amounts with the exception of equity at June 30, 2010 were translated at 6.80860 RMB to \$1.00 USD. The average translation rates applied to income statement amounts for the six months ended June 30, 2010 was 6.83474 RMB to \$1.00 USD.

Cash and concentration of risk

The Company considers all highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents, for statement of cash flows purposes. Cash includes cash on hand and demand deposits in accounts maintained with state owned banks within the PRC and with banks in the United States.

The Company's cash equivalents are exposed to concentration of credit risk. The Company maintains balances at financial institutions which, from time to time, may exceed Federal Deposit Insurance Corporation insured limits for the banks located in the United States. Balances at financial institutions or state owned banks within the PRC are not covered by insurance. As of June 30, 2010 and December 31, 2009, the Company had deposits in excess of federally insured limits totaling \$ -0 - and \$9,307,837, respectively. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant risks on its cash in bank accounts.

Substantially all of the Company's operations are carried out in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in that country, and by the general state of that country's economy. The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in the United States. These

include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Revenue Recognition

Our oil production business records revenues from the sales of oil on a net basis when delivery to the customer (PetroChina) has occurred and title has transferred. This occurs when oil has been delivered to a PetroChina depot.

Pursuant to the Oil Lease entered into in 2002 and 2003 with PetroChina, each with twenty year terms, the Company is entitled to 80% of the Company's oil production for the first ten years and 60% of the Company's oil production for the remaining ten years. The Company receives payment for the net physical volume of oil delivered (either 80% or 60% by volume, depending upon the lease terms that are current at that point in time). The Company only records revenue for the production that the Company is entitled to.

Our oilfield drilling business (Tiancheng) records revenues from the sales of services that are generally sold based upon purchase orders or contracts with the customer that include fixed or determinable prices and that do not include right of return or other similar provisions or other significant post-delivery obligations. Revenue for services is recognized as the services are rendered and when collectibility is reasonably assured. Rates for services are typically priced on a per day, per meter, per man hour or similar basis. In certain situations, revenue is generated from transactions that may include multiple services under one contract or agreement. Revenue from these arrangements is recognized as each service is delivered based on their relative fair value.

Major customers

Our oil production business has only one customer – PetroChina's Jilin Refinery branch, located in Song Yuan City, Jilin Province, PRC. Pursuant to our lease agreements with PetroChina we are unable to sell our oil production to any other customer.

Our oilfield services business has one primary customer (PetroChina) but also serves other independent oil production companies located in Jilin and Heilongjiang provinces in the PRC.

Accounts receivables and allowance for doubtful accounts

Our oil production business bills PetroChina on a monthly basis, at month-end, for the oil that we delivered to PetroChina during that month. We receive payment from PetroChina approximately 10 to 20 days following the end of each month. We receive payment in full for the prior month, less a holdback in the first and second months of each calendar quarter for the amount of oil surcharge tax (if any) due to the PRC government for the respective month's oil sales. These oil surcharge tax holdbacks are paid to the Company with the normal monthly payment in the third month of each quarter, and therefore are timed to be received by us shortly before we are responsible for remitting the quarterly oil surcharge tax to the PRC government. Therefore, the amount we show as accounts receivable at the end of each reporting period will include the amounts due to us for sales in the prior month, as well as amounts of oil surcharge due for the two preceding months. We do not recognize any allowance for doubtful accounts, as PetroChina has always paid our invoices on a correct, consistent and timely basis.

Our oilfield services business bills customers according to the terms of each service contract. These contracts generally require downpayments of 30% of the drilling contract sum at the initiation of drilling services and payments

of the remaining 70% of the drilling contract sum in twelve monthly installments following the completion of drilling services.

#### Long-lived assets

The Company evaluates at least annually, more often when circumstances require, the carrying value of long-lived assets to be held and used. Impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amounts. In that event, a loss is recognized based on the amount by which the carrying amount exceeds the fair market value of the long-lived assets. No impairment was made for the three and six months ended June 30, 2010. For the three and six months ended June 30, 2009, impairment of oil properties was \$6,789 and \$13,832,356, respectively.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Financial instruments

The Company analyzes all financial instruments with features of both liabilities and equity under ASC 480-10 (formerly Statement of Financial Accounting Standards (“SFAS”) No. 150, “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity”), ASC 815-10 (formerly SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”) and ASC 815-40 (formerly EITF 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”). The warrants issued in conjunction with the issuance of the secured debenture in February 2008 are treated as liability instruments and will be marked to fair value as of each reporting date. Additionally, the Company analyzes registration rights agreements associated with any equity instruments issued to determine if penalties triggered for late filing should be accrued under ASC 825-20 (formerly FSP EITF 00-19-2, “Accounting for Registration Payment Arrangements”). (See Note 8, Registration Payment Arrangements Below).

Fair value of financial instruments

On January 1, 2008, the Company adopted ASC 820-10 (formerly SFAS No. 157, “Fair Value Measurements”), which defines fair value, establishes a three-level valuation hierarchy for disclosures of fair value measurement and enhances disclosures requirements for fair value measures. The three levels are defined as follow:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the assets or liability, either directly or indirectly, for substantially the full term of the financial instruments.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value.

The financial assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurement. The Company’s assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of the fair value of assets and liabilities and their placement within the fair value hierarchy levels

Assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 are summarized as follows (unaudited):

	Fair value measurement using inputs		
	Level 1	Level 2	Level 3
Liabilities:	\$ -	\$ -	\$ 13,909,905

Derivative instruments –			
Warrants			
Total	\$ -	\$ -	\$ 13,909,905

The Company determines the fair value of the warrants using a Black-Scholes option model using inputs that are derived from observable and unobservable data and are therefore considered Level 3 in the fair value hierarchy.

The carrying values of cash and cash equivalents, trade receivables and payables, and short-term bank loans and debts approximate their fair values due to the short maturities of these instruments.



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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock-Based Compensation

The Company follows ASC 718 (formerly SFAS No. 123R, "Share-Based Payments"). This Statement requires a company to measure the cost of services provided by employees in exchange for an award of equity instruments to be based on the grant-date fair value of the award. That cost will be recognized over the period during which services are received. Stock compensation for stock granted to non-employees has been determined in accordance with ASC 718 and ASC 505-50 (formerly EITF No. 96-18, "Accounting for Equity Instruments that are issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services"), as the fair value of the consideration received or the fair value of equity instruments issued, whichever is more reliably measured.

Property and equipment, net

The Company uses the full cost method of accounting for oil properties. As the Company currently maintains oil operations in only one country (the PRC), the Company has only one cost center. All costs incurred in the acquisition, exploration, and development of properties (including costs of surrendered and abandoned leaseholds, delay lease rentals, dry holes and overhead related to exploration and development activities) and the fair value of estimated future costs of site restoration, dismantlement, and abandonment activities are capitalized.

Investments in unproved properties, including capitalized interest costs, are not depleted pending determination of the existence of proved reserves. Unproved reserves are assessed periodically to ascertain whether impairment has occurred. Unproved properties whose costs are individually significant are assessed individually by considering the primary lease terms of the properties, the holding periods of the properties, and geographic and geologic data obtained relating to the properties. Where it is not practicable to assess individually the amount of impairment of properties for which costs are not individually significant, such properties are grouped for purposes of assessing impairment. The amount of impairment assessed is added to the costs to be amortized, or is reported as a period expense, as appropriate. As of June 30, 2010, the Company did not have any investment in unproved oil properties.

Under the full cost method of accounting, a ceiling test is performed each quarter. The full cost ceiling test is an impairment test to determine a limit, or ceiling, on the book value of oil properties. That limit is basically the after tax present value of the future net cash flows from proved crude oil reserves, excluding future cash outflows associated with settling asset retirement obligations that have been accrued on the balance sheet; using an average price over the prior 12-month period held flat for the life of production plus the lower of cost or fair market value of unproved properties. For the six months ended June 30, 2010 we used prices in effect on June 30, the end of period. If net capitalized costs of crude oil properties exceed the ceiling limit, we must charge the amount of the excess to earnings as an expense reflected in additional accumulated depreciation, depletion and amortization. This is called a "ceiling limitation write-down." Impairment of oil properties for the three and six months ended June 30, 2009, were \$6,789 and \$13,832,356, respectively. No impairment loss were recognized for the three and six months period ended June 30, 2010.

Gain or loss is not recognized on the sale of oil properties unless the sale significantly alters the relationship between capitalized costs and estimated proved oil reserves attributable to a cost center.

Depletion of proved oil properties is computed on the unit-of-production method, whereby capitalized costs, as adjusted for future development costs and asset retirement obligations, net of salvage, are amortized over the total estimated proved reserves. Furniture and fixtures, leasehold improvements, computer hardware and software, and other equipment are depreciated on the straight-line method, based upon estimated useful lives of the assets ranging from three to fifteen years.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Asset Retirement Obligations

ASC 410-20 (formerly SFAS No. 143, "Accounting for Asset Retirement Obligations") requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred with a corresponding increase in the carrying amount of the related long-lived asset. Subsequent to initial measurement, the asset retirement liability is required to be accreted each period to its present value. Capitalized costs are depleted as a component of the full cost pool using the unit-of-production method. Pursuant to our lease agreements with PetroChina, which terminate in 2022 and 2023, we do not recognize any asset retirement obligations, because at the end of the lease term we are obligated to hand over to PetroChina all of the physical assets we have erected on the leased properties, including all wells, facilities and equipment.

Income (loss) per share

The Company reports income (loss) per share in accordance with the provisions of ASC 260-10 (formerly SFAS No. 128, "Earnings Per Share"). ASC 260-10 requires presentation of basic and diluted income (loss) per share in conjunction with the disclosure of the methodology used in computing such income (loss) per share. Basic income (loss) per share excludes dilution and is computed by dividing income (loss) available to common stockholders by the weighted average common shares outstanding during the period. Diluted income (loss) per share takes into account the potential dilution that could occur if securities or other contracts to issue common stock were exercised and converted into common stock using the treasury method.

Income taxes

Income taxes are accounted for under the asset and liability method in accordance with ASC 740-10 (formerly SFAS No. 109, "Accounting for Income Taxes"). Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The Company provides valuation allowances against the net deferred tax asset for amounts that are not considered more likely than not to be realized.

The Company adopted ASC 740-10 (formerly FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48")), on January 1, 2007. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The adoption had no effect on the Company's financial statements.

Deferred tax is accounted for using the balance sheet liability method in respect of temporary differences arising from differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax basis used in the computation of assessable tax profit. In principle, deferred tax liabilities are recognized for all taxable temporary differences, and deferred tax assets are recognized to the extent that it is probably that taxable profit

will be available against which deductible temporary differences can be utilized. Deferred tax is calculated at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled. Deferred tax is charged or credited to profit or loss, except when it related to items credited or charged directly to equity, in which case the deferred tax is also dealt with in equity. Deferred tax assets and liabilities are offset when they relate to income taxes levied by the same taxation authority and the Company intends to settle its current tax assets and liabilities on a net basis. As of June 30, 2010 and December 31, 2009, the Company's deferred tax assets amounted to \$7,786,056 and \$7,538,868, respectively.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Value Added Tax

Sales revenue represents the invoiced value of oil, net of a value-added tax (“VAT”). All of the Company’s oil that is sold in the PRC is subject to a Chinese VAT at a rate of 17% on the gross sales price. This VAT may be offset by VAT paid by the Company on investment and operating costs associated with oil production. The Company records its net VAT Payable or VAT Recoverable balance in the financial statements. As of June 30, 2010, the Company had a net VAT Payable liability balance of \$776,172, compared with a net VAT Payable liability balance of \$123,190 as of December 31, 2009.

Segments

The Company operates in two segments: oil production and oilfield services (well drilling). Segment disclosure is presented in Note 13 “Segments.”

Recently issued accounting pronouncements

In January 2010, the FASB issued ASU 2010-03 Extract Activities- Oil and Gas Reserve Estimation and Disclosures. This ASU amends the “Extractive Industries- Oil and Gas” topic of the Codification to align the Oil and Gas reserve estimation and disclosure requirements in this Topic with the SEC Release No. 33-8995, “Modification of Oil and Gas Reporting Requirements (Final Rule). The amendments are effective for annual reporting periods ending on or after December 31, 2009, and the adoption of these provisions on December 31, 2009 did not have a material impact on our consolidated financial statements.

In January 2010, FASB issued ASU 2010-06 – Improving Disclosures about Fair Value Measurements (“ASU 2010-6”). ASU 2010-6 provides amendments to Subtopic 820-10 that requires separate disclosure of significant transfers in and out of Level 1 and Level 2 fair value measurements and the presentation of separate information regarding purchases, sales, issuances, and settlements for Level 3 fair value measurements. Additionally, ASU 2010-06 provides amendments to Subtopic 820-10 that clarifies existing disclosures about the level of disaggregation and inputs and valuation techniques. ASU 2010-06 is effective for financial statements issued for interim and annual periods ending after December 15, 2010. The Company does not expect the adoption of ASU 2010-06 to have a material impact on its consolidated results of operations or financial position.

In January 2010, FASB issued ASU 2010-02 Accounting and Reporting for Decreases in Ownership of a Subsidiary a Scope Clarification (“ASU 2010-02”). ASU 2010-02 addresses implementation issues related to the changes in ownership provisions in the Consolidation-Overall Subtopic (Subtopic 810-10) of the FASB Accounting Standards Codification, originally issued as FASB Statement No.160, Noncontrolling Interests in Consolidated Financial Statements. Subtopic 810-10 establishes the accounting and reporting guidance for noncontrolling interests and changes in ownership interests of a subsidiary. An entity is required to deconsolidate a subsidiary when the entity ceases to have a controlling financial interest in the subsidiary. Upon deconsolidation of a subsidiary, an entity recognizes a gain or loss on the transaction and measures any retained investment in the subsidiary at fair value. The gain or loss includes any gain or loss associated with the difference between the fair value of the retained investment in the subsidiary and its carrying amount at the date the subsidiary is deconsolidated. In contrast, an entity is required to account for a decrease in ownership interest of a subsidiary that does not result in a change of control of the

subsidiary as an equity transaction. ASU 2010-02 is effective for the Company starting January 3, 2010. The Company does not expect the adoption of ASU 2010-02 to have a material impact on the Company's consolidated results of operations or financial position.

In February 2010, FASB issued ASU 2010-09 Subsequent Events (Topic 855) Amendments to Certain Recognition and Disclosure Requirements ("ASU 2010-09"). ASU 2010-09 amends disclosure requirements within Subtopic 855-10. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. This change alleviates potential conflicts between Subtopic 855-10 and the SEC's requirements. ASU 2010-09 is effective for interim and annual periods ending after June 15, 2010. The Company does not expect the adoption of ASU 2010-09 to have a material impact on its consolidated results of operations or financial position.

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In March 2010, FASB issued ASU 2010-11 Scope Exception Related to Embedded Credit Derivatives (“ASU2010-11”). ASU 2010-11 clarifies the type of embedded credit derivative that is exempt from embedded derivative bifurcation requirements. Only one form of embedded credit derivative qualifies for the exemption—one that is related only to the subordination of one financial instrument to another. As a result, entities that have contracts containing an embedded credit derivative feature in a form other than such subordination may need to separately account for the embedded credit derivative feature. The amendments in this Update are effective for each reporting entity at the beginning of its first fiscal quarter beginning after June 15, 2010. Early adoption is permitted at the beginning of each entity’s first fiscal quarter beginning after issuance of this Update. The Management is currently evaluating the potential impact of ASU 2010-11 on our financial statements.

In April 2010, FASB issued ASU 2010-13 Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades. ASU 2010-13 addresses the classification of a share-based payment award with an exercise price denominated in the currency of a market in which the underlying equity security trades (“ASU 2010-13”). Topic 718 is amended to clarify that a share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity’s equity securities trades shall not be considered to contain a market, performance, or service condition. Therefore, such an award is not to be classified as a liability if it otherwise qualifies as equity classification. The amendments in this Update should be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010. The guidance should be applied by recording a cumulative-effect adjustment to the opening balance of retained earnings for all outstanding awards as of the beginning of the fiscal year in which the amendments are initially applied. Management is currently evaluating the potential impact of ASU 2010-13 on our financial statements.

#### Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

#### NOTE 5 SECURED DEBENTURE

The following is a summary of secured debenture at June 30, 2010 and December 31, 2009:

	June 30, 2010 (Unaudited)	December 31, 2009 (Audited)
Secured Debenture at 8% interest per annum, secured by 66% of the Company's equity interest in Song Yuan Technical and certain properties of the Company and 6,732,000 shares of common stock of the Company owned by a stockholder, due on February 28, 2012	\$-	\$ 10,500,000
Less: current maturities	-	(5,625,000 )
Long-term portion	\$-	\$ 4,875,000

On February 28, 2008, the Company entered into a Securities Purchase Agreement (the "Purchase Agreement") with Lotusbox Investments Limited (the "Investor"). Pursuant to the Purchase Agreement, the Company agreed to issue to the Investor an 8% Secured Debenture due 2012 (the "Debenture") in the aggregate principal amount of \$15,000,000, and agreed to issue to the Investor five-year warrants exercisable for up to (i) 1,200,000 shares of the Company's common stock at an initial exercise price equal to \$0.01 per share ("Class A Warrants"), (ii) 1,500,000 shares of the Company's common stock at an initial exercise price equal to \$3.20 per share ("Class B Warrants") and (iii) 2,100,000 shares of the Company's common stock at an initial exercise price equal to \$3.45 per share ("Class C Warrants"), with all warrant exercise prices being subject to certain adjustments. The Class B Warrants are subject to certain call rights by the Company. As additional security provided to the Investor, the Company also granted the Investor the right to purchase up to 24% of the registered capital of Song Yuan Technical at fair market value which right shall only become enforceable immediately on the date following the occurrence of an event of a payment default. Pursuant to Section 2(e) of the Series B and C Common Stock Purchase Warrant issued on February 28, 2008 (the "B Warrants" and "C Warrants") for the purchase of 3,600,000 shares of common stock of Company, the exercise price of the B Warrants and C Warrants have been reset to \$2.35 per share.



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NOTE 5 SECURED DEBENTURE (Continued)

The Company accounts for these warrants as liability instruments in accordance with paragraph 8 of EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially settled in, a Company's Own Stock." (now ASC 815-40). Upon issuance, the warrants were recorded at fair value of \$10,268,321, which was recognized as a discount to the carrying value of the debenture. The initial carrying value of the debenture, net of discount, was \$4,731,679.

On March 5, 2009, the Company and the Investor entered into Agreement No.1 to 8% Secured Debenture (the "Amendment" or the "restructuring") which amended the Debenture issued to the Investor on February 28, 2008 for the principal amount of \$15,000,000. Pursuant to the Amendment, the Investor agreed to extend the Company's requirement to effect a listing of its common stock on either the NYSE Alternext US LLC or NASDAQ until August 30, 2010, and the Company issued four-year warrants to the Investor to purchase up to (i) 250,000 shares of common stock at an exercise price of \$2 per share and (ii) 250,000 shares of common stock at an exercise price of \$2.35 per share. Also pursuant to the Amendment, the parties have agreed to amend the monthly principal repayment schedule of the Debenture. The Company treated this restructuring as an extinguishment of debt, as the net present value of cash flows projected to be paid by the Company to the Investor as a result of this Amendment exceed the net present value of cash flows projected to be paid by the Company to the Investor pursuant to the previously existing repayment schedule by greater than 10%. Therefore, the Company has accounted for this Amendment as an extinguishment and reissue of debt. Accordingly, the Company has recognized a loss on extinguishment of debt, effective March 5, 2009, of \$8,260,630, which comprised the remaining unamortized discount on the secured debenture prior to the Amendment date, plus the unamortized deferred financing fees on the secured debenture prior to the Amendment date, plus the fair value of the warrants issued to the Investor in conjunction with the Amendment.

As the restructuring is presumed to have the effect of reflecting fair market terms and conditions for the Amended secured debenture, the carrying value of the debenture is the remaining principal balance of the debenture and no discount is recognized. Changes in the fair value of the warrants will continue to be recognized as gain or loss in the period incurred.

In conjunction with the amendment of the terms of the secured debenture, the Company is obligated to file a registration statement registering the resale of shares of the Company's common stock issuable upon exercise of the Warrants on or before March 5, 2010 (the "Filing Date"). If this registration statement has not been declared effective by the Filing Date, on the 180th day following the Filing Date and each sixth month anniversary thereafter until the registration statement is declared effective, the Company must execute and deliver to the Investor new warrants to purchase up to a total of 62,500 on the same terms as the Warrants. During 2009, the Company repaid a total of \$3,750,000 of the principal amount outstanding on the secured debenture, which reduced the principal balance on the debenture to \$10,500,000 as of December 31, 2009. On January 13, 2010, the Company repaid the entire remaining balance of the debenture in the amount of \$10,500,000. As of June 30, 2010, there was no debenture outstanding.

Interest expense on the secured debenture for the three and six months ended June 30, 2010 and 2009 was \$1,162, \$260,664, \$24,734, and \$540,664, respectively.

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## NOTE 6 NET INCOME (LOSS) PER SHARE

The following is a reconciliation of the numerators and denominators used in computing basic and diluted net income per share (in thousands, except per share amounts):

	For the three months ended June 30,		For the six months ended June 30,	
	2010	2009	2010	2009
	(Unaudited)	(Unaudited) (Restated)	(Unaudited)	(Unaudited) (Restated)
Numberator				
Net income (loss) attributable to NEP common stockholders used in computing basis net income (loss) per share	\$ 24,987	\$ (7,300 )	\$ 46,732	\$ (24,531 )
Net income (loss) attributable to NEP common stockholders used in computing diluted net income (loss) per share	\$ 24,987	\$ (7,300 )	\$ 46,732	\$ (24,531 )
Denominator:				
Shares used in the computation of basic net income (loss) per share (weighted average common stock outstanding)	29,501	20,855	29,196	20,820
Dilutive potential common stock:				
Options and warrants	1,657	-	2,203	-
Shares used in the computation of diluted net income (loss) per share	31,158	20,855	31,399	20,820
Basic net income (loss) per share	\$ 0.85	\$ (0.35 )	\$ 1.60	\$ (1.18 )
Diluted net income (loss) per share	\$ 0.80	\$ (0.35 )	\$ 1.49	\$ (1.18 )

For the three and six months ended June 30, 2010, 160,000 options and 3,558,396 warrants were included in calculation of diluted shares while 451,638 warrants with exercise prices greater than the average fair market value of the Company's stock for the three months and six months ended June 30, 2010 of \$6.97 and \$8.10, respectively, were not included in the calculation because the effect is anti-dilutive.

## NOTE 7 COMMITMENTS AND CONTINGENCIES

## (A) Employee benefits

The full time employees of LongDe, Yu Qiao and Tiancheng are entitled to employee benefits including medical care, welfare subsidies, unemployment insurance and pension benefits through a Chinese government mandated multi-employer defined contribution plan. The Company is required to accrue for those benefits based on certain

percentages of the employees' salaries and make contributions to the plans out of the amounts accrued for medical and pension benefits. The Chinese government is responsible for the medical benefits and the pension liability to be paid to these employees.

(B) Commitments

The Company leases office spaces from a stockholder, land and office spaces from third parties under three operating leases which expire on September 20, 2023, June 30, 2015 and January 20, 2011 at annual rentals of \$183, \$19,020 and \$20,160, respectively.

As of June 30, 2010, the Company has outstanding commitments with respect to the above operating leases, which are due as follows:

2010	\$ 39,363
2011	3,448
2012	183
Thereafter	1,782
	\$ 44,776

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NOTE 7 COMMITMENTS AND CONTINGENCIES (Continued)

(C) Capital commitments

As of June 30, 2010, the Company had capital commitments totaling \$1,350,000 with a contractor to complete the drilling of 6 oil wells.

(D) Legal proceedings

The Company was recently involved in six purported legal actions, three of which are securities class actions and three of which are shareholder derivative actions, in the U.S. District Court for the Southern District of New York against the Company and certain officers and directors. The three class actions assert claims under the federal securities laws and the three derivative actions assert common law claims based on breach of duty. See Note 14 (“Subsequent events”).

NOTE 8 REGISTRATION PAYMENT ARRANGEMENTS

In conjunction with the March 5, 2009 modification of the Company’s secured debenture issued on February 28, 2008 (see Note 5, Secured Debenture, above) and the original issuance of the secured debenture, the Company entered into two Registration Rights Agreements which cover stock to be issued underlying warrants associated with both the modification and the issuance of the secured debenture. These Registration Rights Agreements provide for financial penalties in certain circumstances, including (i) if the registration statement covering the shares of common stock underlying the Original Warrants is not declared effective within 180 days of the date of the Registration Rights Agreement or (ii) after effectiveness, the registration statement ceases to remain continuously effective for more than 10 consecutive calendar days or more than 30 calendar days in any 30 calendar day period. The financial penalty equals to 1% of the aggregate purchase price paid for the Original Warrants subject to the registration rights up to a maximum of 10% of the principal amount of the debenture.

The Company analyzes these registration rights agreements to determine if penalties triggered for late filing should be accrued under ASC 825-20 (formerly FSP EITF 00-19-2, “Accounting for Registration Payment Arrangements”). The Company evaluates the potential likelihood of incurring these financial penalties, and the magnitude of the associated costs, on a probabilistic basis, as required under ASC 825-20. For the six months period ended June 30, 2010, the Company estimated that no financial penalties are likely to be incurred as a result of any of its registration obligations, and therefore no expense was accrued for anticipated future registration payments.

NOTE 9 STOCK-BASED COMPENSATION

During 2010, the Company granted to its employees 60,000 stock options qualified under the Company’s 2006 Stock Option/Stock Issuance Plan (the “2006 Plan”) to purchase Common Stock. As of June 30, 2010, stock options granted under the 2006 Plan to purchase 530,000 shares of its Common Stock (the “Options”) at an exercise price from \$2.94 to \$5.50 per share were outstanding. 25% of the 220,000 stock options shall vest upon grant and 25% shall vest every three months thereafter, and these stock options granted shall expire ten years after the grant date if unexercised at that time. 50% of the 310,000 stock options shall vest upon grant and 50% shall vest on the first anniversary of the grant date.

The 2006 Plan authorizes the issuance of up to 2,500,000 common stock equivalents (stock options, restricted stock, stock grants). As of June 30, 2010, the Company had 240,000 remaining share equivalents available for grant under the 2006 Plan. The Company settles employee stock option exercises with newly issued common shares.

The fair value of stock options granted was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Expected Life	Expected Volatility	Dividend Yield	Risk Free Interest Rate	Grant Date Fair Value
5 years	268% - 316%	0%	2.10% - 3.42%	\$2.94 - \$5.50

- Dividend Yield: The expected dividend yield is zero. The Company has not paid a dividend and does not anticipate paying dividends in the foreseeable future.
- Risk Free Rate: Risk-free interest rate of 2.10% - 3.42% was used. The risk-free interest rate was based on U.S. Treasury yields with a remaining term that corresponded to the expected term of the option calculated on the grant date.
- Expected Life: Because the Company has no historical share option exercise experience to estimate future exercise patterns, the expected life was determined using the simplified method as these awards meet the definition of "plain-vanilla."

Stock compensation expense is recognized based on awards expected to vest. There was no estimated forfeiture as the Company has a short history of issuing options. ASC 718-10 (formerly FAS No. 123R) requires forfeiture to be estimated at the time of grant and revised in subsequent periods, if necessary, if actual forfeitures differ from those estimates.

On January 28, 2010, 250,000 shares of stock options previously granted to one senior management member were exercised at \$4.50 per share, with an aggregate fair value of \$1,125,000 paid to the Company.

On March 29, 2010, 400,000 shares of common stocks of the Company with a fair value of approximately \$3,232,000 were granted to the key management team of Tiancheng, of which the Company recognized \$202,000 and \$1,010,000 as staff compensation expenses included in selling, general and administrative expenses for the three and six months ended June 30, 2010, respectively.

As of June 30, 2010, the total compensation cost related to stock options not yet recognized was \$2,251,033 and will be recognized over the next three years.

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## NOTE 9 STOCK-BASED COMPENSATION (Continued)

The following is a summary of the stock options activity:

	Number of Options Outstanding	Weighted- Average Exercise Price
Balance, December 31, 2009	350,000	\$ 4.18
Granted	60,000	5.50
Forfeited	-	-
Exercised	(250,000)	4.50
Balance, June 30, 2010	160,000	\$ 4.18

The following is a summary of the status of options outstanding at June 30, 2010:

Exercise Price	Outstanding Options Number	Average Remaining Contractual Life	Average Exercise Price	Exercisable Options Number	Weighted Average Exercise Price
\$4.05	40,000	7.90 years	\$4.05	40,000	\$4.05
\$2.94	60,000	8.90 years	\$2.94	60,000	\$2.94
\$5.50	60,000	9.92 years	\$5.50	15,000	\$5.50

## NOTE 10 STOCKHOLDERS' EQUITY

The Company's outstanding warrants as of June 30, 2010 is as follows:

	Date of issue	Exercise price	Outstanding Warrants
Warrant 1	February 28, 2008	\$2.35	2,100,000
Warrant 2	March 5, 2009	\$2.00	250,000
Warrant 3	March 5, 2009	\$2.35	250,000
Warrant 4	April 29, 2009	\$2.65	50,000
Warrant 5	September 15, 2009	\$6.00	748,396
Warrant 6	September 10, 2009	\$6.00	160,000
Warrant 7	December 11, 2009	\$8.10	58,910

Warrant December	\$8.10	392,728
8	17, 2009	
		4,010,034

The Company treats these warrants as liabilities under ASC 815-40 and accordingly records the warrants at fair value with changes in fair values recorded in the profit or loss until such time as the warrants are exercised or expire. The fair values were \$39,528,261 at December 31, 2009 and \$13,909,905 at June 30, 2010. For the three and six months ended June 30, 2010 and 2009, the Company recorded a gain of \$14,598,248, a loss of \$12,731,750, a gain of \$25,439,166 and a loss of 12,078,045, respectively, in changes in the fair value of the warrants in profit or loss.

The Company estimates the fair value of these warrants using the Black-Scholes option pricing model using the following assumptions:

	June 30, 2010
Market price and estimated fair value of common stock:	\$5.50
Exercise price:	\$2.00 - \$8.10
Remaining contractual life (years):	0.71 - 4.46
Dividend yield:	—
Expected volatility:	84% - 229%
Risk-free interest rate:	0.32% - 1.79%

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NOTE 10 STOCKHOLDERS' EQUITY (Continued)

Stock issuance

- (1) In January 2010, Series B Warrants issued with the secured debenture (Note 5) were exercised by one investor to purchase 867,438 shares of common stock at the exercise price of \$2.35 per share.
- (2) On March 23, 2010, an investor exercised warrants and purchased 21,739 shares of common stock at exercise price of \$6.00 per share. The Company received \$130,434 proceeds in connection with this transaction.
- (3) In April 2010, one investor exercised warrants to purchase 29,865 shares of common stock at the exercise price of \$6.00 per share.

NOTE 11 RELATED PARTY TRANSACTIONS

- (1) As of June 30, 2010, the Company owed a stockholder \$3,986,763 which is unsecured and repayable on demand. Imputed interest is computed at 5% per annum on the amount due.
- (2) As of June 30, 2010, the Company owed a related party \$14,687 which is unsecured and repayable on demand. Imputed interest is computed at 5% per annum on the amount due.
- (3) Total imputed interest expenses recorded as additional paid-in capital amounted to \$0, \$37,669, \$0 and \$49,917 for the three and six months ended June 30, 2010 and 2009, respectively.
- (4) The Company paid a stockholder \$3,512, \$7,023, \$0- and \$3,507 for leased office spaces for the three and six months ended June 30, 2010 and 2009, respectively.
- (5) As of June 30, 2010, the Company owed a related company \$27,906 which is unsecured and repayable on demand. Imputed interest is computed at 5% per annum on the amount due.

NOTE 12 OIL PROPERTIES

As of June 30, 2010, the Company's full cost pool did not exceed the ceiling limitation, based on average oil prices in the prior 12-month period. Therefore, the Company did not record any additional impairment expense related to our oil properties for the six months ended June 30, 2010. For the three and six months ended June 30, 2009, the Company recorded an impairment expense related to our oil properties of \$6,789 and \$13,832,356 respectively.

NOTE 13 SEGMENTS

The Company follows FASB ASC 280 – Segment Reporting, which requires that companies disclose segment data based on how management makes decision about allocating resources to segments and evaluating their performance.



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The Company operates in two reportable segments; exploration and production of crude oil (“Crude oil”) and contract land drilling of oil wells (“Contract drilling”). The accounting policies of the segments are the same as described in the summary of significant accounting policies. The Company evaluates segment performance based on income from operations. All inter-company transactions between segments have been eliminated. As a result, the components of operating income for one segment may not be comparable to another segment. The following is a summary of the Company’s segment information for the three and six months ended June 30, 2010 and 2009 ( in thousand):

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
<b>Revenue:</b>				
Crude oil	\$ 15,390	\$ 11,351	\$ 32,037	\$ 20,251
Contract drilling	12,317	-	24,598	-
<b>Total revenue</b>	<b>\$ 27,707</b>	<b>\$ 11,351</b>	<b>\$ 56,635</b>	<b>\$ 20,251</b>
<b>Gross profit:</b>				
Crude oil	\$ 9,880	\$ 7,380	\$ 21,199	\$ 12,645
Contract drilling	6,983	-	14,267	-
<b>Total gross profit</b>	<b>\$ 16,863</b>	<b>\$ 7,380</b>	<b>\$ 35,466</b>	<b>\$ 12,645</b>
<b>Income (loss) from operations:</b>				
Crude oil	\$ 8,934	\$ 6,438	\$ 18,678	\$ (2,967)
Contract drilling	6,872	-	14,036	-
<b>Total income (loss) from operations</b>	<b>15,806</b>	<b>6,438</b>	<b>32,714</b>	<b>(2,967)</b>
Corporate and other	14,593	(13,026)	25,396	(21,727)
<b>Net income (loss) before income taxes</b>	<b>\$ 30,399</b>	<b>\$ (6,588)</b>	<b>\$ 58,110</b>	<b>\$ (24,694)</b>

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NOTE 14 SUBSEQUENT EVENTS

The Company has evaluated subsequent events that have occurred through the issuance date of the financial statements in accordance with ASC 855-10.

The Company was recently involved in six purported legal actions, three of which are securities class actions and three of which are shareholder derivative actions, in the U.S. District Court for the Southern District of New York against the Company and certain officers and directors. The three class actions assert claims under the federal securities laws and the three derivative actions assert common law claims based on breach of duty.

The six actions are: (1) Rosado v. China North East Petroleum Holdings Limited, et al., 10 CV 4577 (MGC), filed June 11, 2010; (2) Weissmann v. China North East Petroleum Holdings Limited, et al., 10 CV 4775 (MGC), filed June 18, 2010; (3) Moore v. China North East Petroleum Holdings Limited, et al., 10 CV 5263 (MGC), filed July 9, 2010; (4) Strickland v. Hongjun, et al., 10 CV 5445 (RMB), filed July 19, 2010; (5) Drobner v. Hongjun, et al., 10 CV 6193 (No Judge has been assigned at this time), filed August 23, 2010; and (6) Nicoln v. Hongjun, et al., 10 CV 6344 (No Judge has been assigned at this time), filed August 24, 2010.

The time for the Company to respond formally to these lawsuits has not come. In addition, the complaints do not specify an amount of damages that plaintiffs seek. Because these matters are in very early stages, we cannot comment on whether an adverse outcome is probable or otherwise. While we believe we have meritorious defenses to each of these actions and intend to defend them vigorously, an adverse outcome in one or more of these matters could have a material adverse effect on its business, financial condition, results of operations or liquidity.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion and analysis of financial condition and results of operations should be read in conjunction with our financial statements and related notes included elsewhere in this report. This discussion contains forward-looking statements that involve risks, uncertainties and assumptions. Forward-looking statements can be identified by the fact that they do not relate strictly to historic or current facts. They use words such as “anticipate,” “estimate,” “project,” “intend,” “plan,” “believe” and other words and terms of similar meaning in connection with any discussion of future operating or financial performance. In particular, these include statements relating to:

- Deviations in and volatility of the market price of crude oil produced by us;
- Uncertainties in the estimation of proved reserves and in the projection of future rates of production;
- Timing and amount of production;
- The availability of, and our ability to raise additional capital resources and provide liquidity to meet cash flow needs;
- Fluctuations in foreign currency exchange rates and interest rates;
- Our ability to find, acquire, lease, develop, and produce from new properties; and
- The other risks and uncertainties which are described below under “RISK FACTORS.”

### OVERVIEW OF OUR BUSINESS

#### Overview

We are engaged in the exploration and production of crude oil in Northern China. We have an arrangement with PetroChina to sell our crude oil production for use in the China marketplace. We currently operate 289 producing wells located in four oilfields in Northern China and have plans for additional drilling projects.

In particular, through two of our subsidiaries, Song Yuan City Yu Qiao Oil and Gas Development Co. Ltd. (“Yu Qiao”) and Chang Ling Longde Oil and Gas Development Co. Ltd. (“LongDe”), we have entered into binding sales agreements with the PetroChina Group, whereby we sell our crude oil production for use in the China marketplace.

We currently operate 4 oilfields located in Northern China, which include:

#### Details of Oil and Gas Properties and Activities

Field	Acreage	Producing wells #	Proven Reserves (bbls)
Qian112	5,115	247	5,971,685
Da34	2,298	12	59,610
Gu31	1,779	12	73,800
He301	2,471	18	26,929
Total	11,663	289	6,132,024

Additionally, through our newly acquired subsidiary, Song Yuan Tiancheng Drilling Engineering Co. Ltd., we provide contract drilling and other oilfield services for state-owned and non-state-owned oil companies in Northern China.

The flowing chart illustrates our company's organizational structure:

### Organizational History

We were incorporated in the State of Nevada on August 20, 1999 under the name Draco Holding Corporation. On March 29, 2004, we executed an Agreement for Share Exchange with Hong Xiang Petroleum Group Limited, a corporation organized and existing under the laws of the British Virgin Islands ("Hong Xiang"), and the individual shareholders owning 100% of the outstanding common shares of Hong Xiang (the "Hong Xiang Shareholders").

Pursuant to the Agreement for Share Exchange, we issued 18,700,000 shares of our common stock to the Hong Xiang Shareholders in exchange for all of the shares of capital stock of Hong Xiang owned by the Hong Xiang Shareholders at closing, and Hong Xiang became our wholly-owned subsidiary. On June 28, 2004, we changed our name to China North East Petroleum Holdings Ltd.

During 2004, we acquired a 100% ownership in Song Yuan City Hong Xiang Petroleum Technical Services Co., Ltd. ("Hong Xiang Technical"), and Hong Xiang Technical in turn acquired a 100% interest in Song Yuan City Yu Qiao Qianan Hong Xiang Oil and Gas Development Co., Ltd. ("Hong Xiang Oil Development"), which was engaged in the exploration and production of crude oil in the Jilin region of the PRC.

As a result of the Yu Qiao acquisition discussed below, all operations, assets and liabilities of the Company's subsidiary Hong Xiang Oil Development were transferred to Yu Qiao on March 19, 2007. Since Hong Xiang Oil Development and Hong Xiang Technical were no longer necessary elements of the Company's corporate structure, and they were liquidated and dissolved.

### PetroChina Oil Leases

Pursuant to a 20-year exclusive Cooperative Oil Lease (the "Oil Lease"), entered into among PetroChina Group, Yu Qiao and the Company in May 2002, the Company has the right to explore, develop and produce oil at Qian'an 112 Oilfield. Pursuant to the Oil Lease, (i) PetroChina is entitled to 20% of the Company's oil production for the first ten years of the Oil Lease term and 40% of the Company's oil production for the remaining ten years of the Oil Lease term; and (ii) Yu Qiao is entitled to 2% of the Company's oil production as a management fee. The payment of management fee was stopped following the acquisition of Yu Qiao by the Company in 2007.

In May 2003, LongDe entered into a 20-year contract with PetroChina Group. Pursuant to the contract, LongDe has the right to explore, develop and produce oil at the Hetingbao 301 oilfield in the PRC. In addition, pursuant to the contract between PetroChina and LongDe, PetroChina is entitled to 20% of LongDe's output in the first ten years and 40% of LongDe's output thereafter until the end of the contract.

As the controlling shareholder of Yu Qiao, the Company has the rights to extract and develop Qian'an 112 and other oil fields under the contracts that Yu Qiao has entered into with PetroChina. These oilfields include the Daan 34 oilfield and Gudian 31 oilfield in Jilin Province.

#### Song Yuan Technical Joint Venture

On July 26, 2006, the Company entered into a joint venture agreement with Wang Hong Jun ("Mr. Wang"), the president and a stockholder of the Company and Ju Guizhi ("Ms. Ju"), mother of Mr. Wang, to contribute to the increased registered capital of Song Yuan North East Petroleum Technical Service Co. Ltd. ("Song Yuan Technical"). The purpose of Song Yuan Technical is to acquire oil and gas properties and to engage in the exploration of crude oil in the PRC. On December 20, 2006, Mr. Wang transferred his interest (4.5%) in Song Yuan Technical to Ms. Ju and as a result, the Company owns a 90% equity interest in Song Yuan Technical, and Ms. Ju owns the remaining 10% equity interest in Song Yuan Technical.

#### Acquisition of LongDe

In order to comply with certain PRC laws relating to foreign entities' ownership of oil and gas companies in the PRC, prior to March 17, 2008, Song Yuan Technical directly owned a 70% equity interest in LongDe, while Sun Peng and Ai Chang Shan, respectively, owned 10% and 20% of the equity interests in Long De in trust for Song Yuan Technical. On March 17, 2008, Song Yuan Technical acquired an additional 20% equity interest in LongDe, 10% from Sun Peng, and 10% from Ai Chang Shan. Accordingly, Song Yuan Technical now owns directly 90% of the equity interests in LongDe, with Ai Chang Shan holding the remaining 10% in trust for Song Yuan Technical. The acquisition of LongDe was made pursuant to the laws of the PRC. As a 90% owner of Song Yuan Technical, the Company effectively controls LongDe.

This beneficial ownership structure is governed by two trust agreements: (i) Trust Agreement dated October 8, 2006 by and between Song Yuan Technical and Ai Chang Shan, and (ii) Trust Agreement dated April 18, 2008 by and between Song Yuan Technical and Wang Hongjun. Pursuant to the first trust agreement, Ai Chang Shan holds 20% of the equity interest in Long De in trust for the benefit of Song Yuan Technical. On March 17, 2008, Ai Chang Shan entered into a transfer agreement whereby Ai Chang Shan transferred 10% of the equity interest of Long De held in trust pursuant to the trust agreement to Song Yuan Technical to be held directly by Song Yuan Technical. Currently under the trust agreement dated October 8, 2006, Ai Chang Shan holds 10% of the total equity interest of Long De in trust for the benefit of Song Yuan Technical. Pursuant to the second trust agreement, Wang Hongjun holds 10% of the total outstanding equity interest in LongDe in trust for the benefit of Song Yuan Technical.

#### Acquisition of Yu Qiao

The Company acquired a beneficial interest in 100% of the equity interest in Yu Qiao from Yu Qiao's shareholders, Ms. Ju (70%), Meng Xiangyun (20%) and Wang Bingwu (10%) on January 26, 2007. In order to comply with PRC laws, which restrict ownership of oil and gas companies by foreign entities, following the acquisition, Meng Xiangyun and Wang Pingwu held 20% and 10% of the equity interest, respectively, in Yu Qiao in trust for the benefit of Song Yuan Technical.

On March 17, 2008, the trust agreement with Meng Xiangyun was cancelled and the 20% equity interest in Yu Qiao held in trust by Meng Xiangyun was transferred to Song Yuan Technical. As a result of the termination of the trust agreement and the transfer, Song Yuan Technical became the direct owner of the 20% equity interest in Yu Qiao held in trust by Meng Xiangyun.

On April 18, 2008, the 10% equity interest in Yu Qiao held by Wang Pingwu in trust was transferred to the Company's President and Chairman, Wang Hongjun to hold in trust for the benefit of Song Yuan Technical.

Currently 90% of Yu Qiao is directly held by Song Yuan Technical and 10% of Yo Qiao is held in trust by Wang Hongjun for the benefit of Song Yuan Technical.

#### Acquisition of Tiancheng

On September 27, 2009, we acquired through Song Yuan Technical all of the beneficial ownership of all of the equity interest in Song Yuan Tiancheng Drilling Engineering Co., Ltd. or "Tiancheng." In order to comply with certain PRC laws, 5% of the equity interest in Tiancheng is held in trust by one of the Tiancheng selling stockholders for the benefit of Song Yuan Technical, while the other 95% of the equity interest in Tiancheng is held directly by Song Yuan Technical. Tiancheng provides oil drilling services. Tiancheng currently has eight drilling teams with the same number of rigs in house, which include two 4,000 meters rig (~13,000 feet depth), three 3,000 meters rigs (~9,800 feet depth) and three 2,000 meters rigs (~6,500 feet depth) respectively. Tiancheng has drilling contracts with PetroChina and other private oil companies to provide drilling and oilfield services.

#### Listing on the NYSE Amex LLC.

On June 15, 2009, the Company's common stock commenced trading on the NYSE Amex LLC ("AMEX"). Upon trading on AMEX, the Company changed its ticker symbol from "CNEH.OB" to "NEP".

#### Oil and Gas Properties and Activities

As of June 30, 2010, the Company had a total of 289 producing wells, including 247 producing wells at the Qian'an 112 oilfield, 18 producing wells at the Hetingbao 301 oilfield, 12 producing wells at the Daan 34 oilfield and 12 producing wells at the Gudian 31 oilfield.

All of the Company's crude oil production is sold to the PetroChina Group. The approximate distance of each of the Company's oil fields from the Jilin Refinery is as follows: the Qian'an 112 oilfield is four kilometers away; the Hetingbao 301 oilfield is three kilometers away; the Daan 34 oilfield is fifteen kilometers away and the Gudian Oilfield 31 is thirty kilometers away.

PetroChina pays the Company a price per barrel equal to the monthly mean price calculated from the Mean of Platts Singapore ("MOPS") daily price for sour, heavy Indonesian crude, as measured during the previous month. Platts is a leading global provider of energy and metals information that collects and publishes pricing data on a wide range of petroleum and non-petroleum commodity types. An independent provider, Platts serves the oil, natural gas, electricity, emissions, nuclear power, coal, petrochemical, shipping, and metals markets from 17 offices worldwide. Price paid to the Company is FOB at the local Jilin Province PetroChina oil storage depot. As the oil produced in China is heavy and sour, compared with light and sweet oil quoted as West Texas Intermediate ("WTI") and Brent, therefore, the oil price we receive from PetroChina generally is slightly discounted to the WTI or Brent price.

And the following table shows the difference between WTI and MOPS China in monthly oil price.

Month	Oil Sale Price	
	WTI	MOPS-China
Jan-10	78	73
Feb-10	76	76

March-10	81	71
Apr-10	84	75
May-10	74	80
Jun-10	75	76

25

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(Note: data references to Wall Street Journal, and MOPS China price is exchanged from RMB to USD at the exchange rate of 6.8376)

As noted in the table above, compared with WTI prices, the MOPS China price generally has a slight discount due to the lower oil quality and there is also one-month time lag between the prices.

PetroChina pays the Company for crude oil sold monthly in arrears, on approximately the 15th day after the end of each month. The amount paid to the Company in the first two months of each calendar quarter is decreased by the amount of oil surcharge tax the Company will owe to the PRC government at the end of that calendar quarter. PetroChina holds those amounts back from the Company until the end of each calendar quarter, and then pays those amounts to the Company with the balance due for crude oil deliveries in the final month of the quarter. For this reason, the Accounts Receivable balance at the end of each quarter is larger than the prior month's oil sales revenue, because it includes the oil surcharge tax amounts the Company owes for the first two months of the quarter.

### Operating Performance

Our operating performance is influenced by several factors, the most significant of which are the price we receive for our crude oil and the quantities of crude oil that we are able to produce. Global crude oil prices are the most important factor affecting the price that we receive for our crude oil production. The prices received for different grades of crude oil are based upon the world price of crude oil, which is then adjusted based upon the particular grade. Typically, light crude oil is sold at a premium, while heavy grades of crude (such as the type we produce from the four fields we operate) are discounted.

Our crude oil development and acquisition activities require substantial and continuing capital expenditures. Historically, the sources of financing to fund our capital expenditures have included:

- Cash flow from operations;
- Sales of equity securities;
- Loans from shareholders and third parties; and
- Extension of credit from our suppliers, including particularly our suppliers of well drilling and completion services.

For the three months ended June 30, 2010 (the "Current Quarter"), the sale price we received for our crude oil production averaged \$76.97 per barrel, compared with \$50.27 per barrel for the three months ended June 30, 2009 (the "Comparable Quarter"). For the six months ended June 30, 2010, the sale price we received for our crude oil production averaged \$75.17 per barrel, compared with \$45.16 per barrel for the same period ended a year ago.

Our oil producing activities are accounted for using the full cost method of accounting. Under this accounting method, we capitalize all costs incurred in connection with the acquisition of oil properties and the exploration for and development of oil reserves. These costs include lease acquisition costs, geological and geophysical expenditures, costs of drilling productive and non-productive wells (to date, all of the wells we have drilled have been productive wells), conversion of productive wells into production support infrastructure such as water-injection wells, and overhead expenses directly related to land and property acquisition and exploration and development activities. Proceeds from the disposition of oil properties are accounted for as a reduction in capitalized costs, with no gain or loss recognized unless a disposition involves a material change in the relationship between capitalized costs and reserves, in which case the gain or loss is recognized.

Depreciation of the capitalized costs of oil properties, including estimated future development costs, is based upon estimates of proved oil reserves and production. Unproved oil properties are not amortized, but are individually

assessed for impairment. The cost of any impaired property is transferred to the balance of oil properties being depleted. Reserve values are calculated annually, at our fiscal year-end, by a third-party geological consulting company, and are estimated in accordance with ASC Topic 932, “Extractive Activities - Oil and Gas”, (formerly FAS 19 – Financial Accounting and Reporting by Oil and Gas Producing Companies (as amended)), SEC Regulation S-K and Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934, and the SEC’s Industry Guide 2.

## Production, Average Sales Prices, and Production Costs

Our business operations are characterized by frequent, and sometimes significant, changes in the price we receive for the crude oil we produce and in the volumes of crude oil we produce. The following table shows selected operating data for the three and six months ended June 30, 2010 and 2009.

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Oil Output (Bbl)	198,776	225,043	426,402	447,134
Avg. Sale Price (\$/bbl)	\$ 76.97	\$ 50.27	\$ 75.17	\$ 45.16
Operating Revenue	\$ 27,707,185	\$ 11,351,405	\$ 56,635,478	\$ 20,250,628
Operating Expenses				
Production Costs	872,747	1,152,199	2,091,990	1,666,599
Drilling Cost	4,849,429	-	9,360,718	-
Depreciation, depletion and amortization of oil properties and drilling equipment	2,609,552	2,235,413	4,698,096	5,315,043
Amortization of land use rights	4,891	2,982	15,747	5,961
Oil Surcharge	2,507,920	580,375	5,002,638	618,167
Gross Profit	\$ 16,862,646	\$ 7,380,436	\$ 35,466,289	\$ 12,644,858

As shown in the above table, the appreciation of oil prices in 2010 compared with 2009 caused our revenues to increase substantially, even though the production of oil decreased slightly due to the raining season and flood in the second quarter.

The following table reflects the significant oil sale price fluctuation in China in the past 12 months.

Month	Oil Sale Price	
	RMB/Ton	USD/Bbl
Jan-10	3,670	73
Feb-10	3,820	76
Mar-10	3,586	71
Apr-10	3,761	75
May-10	4,054	80
Jun-10	3,837	76

(Note: 1 Ton = 7.38 Bbls, Exchange rate 1 USD = 6.8376 RMB)

## Contract Drilling Services

China North East Petroleum's newest subsidiary, Song Yuan Tiancheng Drilling Engineering Co. Ltd ("Tiancheng"), founded in December 2007, provides contract drilling and other oilfield services for state-owned and non-state-owned oil companies in Northern China.

Tiancheng is one of the four private contract drilling and service companies that has been qualified and licensed to operate in PetroChina's Jilin oilfield. Tiancheng has also been granted contracts to drill for PetroChina. Compared to the other three drilling companies operating in the Jilin oilfield, Tiancheng is the largest, in terms of the number of drilling rigs owned in house. Tiancheng was started with only two rigs at the end of 2007, and now has eight drilling teams with the same number of rigs, which include two 4,000 meters rig (capable drill down to ~13,000 feet depth), three 3,000 meters rigs (~9,800 feet) and three 2,000 meters rigs (~6,500 feet) respectively.

Tiancheng enters into drilling contracts with PetroChina and other private oil companies to provide oilfield drilling services, and generates revenue based on the depth of each well drilled for clients. Clients will typically pay 30% of the total projected drilling costs as a down payment to start the drilling process, and pay the remaining balance within 12 months according to the specific contract term.

In the first six months of 2010, Tiancheng has completed contracts to drill 111 wells. The total drilling depth accomplished this year is 173,237 meters (~568,363 feet), with the revenue of \$24,598,489 and net income of \$4,820,661 or \$0.22 in fully-diluted, pro forma EPS for the six months ended June 30, 2010. Tiancheng currently has more contracts are under negotiation to increase the utilization of rigs and continue to grow sales revenue.

## RESULTS OF OPERATIONS

### Three Months Ended June 30, 2010 Compared To Three Months Ended June 30, 2009

**Revenues.** Revenues for the Current Quarter were \$27,707,185 compared to \$11,351,405 for the Comparable Quarter, an increase of \$16,355,780, or 144%. This increase was due to revenue of \$12,316,691 from drilling services performed by Tiancheng during the Current Period as well as the increase of oil price drove up the oil sales revenue to \$15,390,494. The average oil price for the Current Quarter was \$76.97, a 53% increase from \$50.27 for the Comparable Quarter. Our output of crude oil for the Current Quarter was 198,776 barrels compared to 225,043 barrels for the Comparable Quarter, an decrease of 12%. This slightly decrease in production was mainly due to: (i) no additional wells were drilled in the Current Quarter; (ii) the unexpected flood resulted from heavy storm and earlier raining season.

**Cost of sales.** Cost of sales increased by 173%, from \$3,970,969 for the three months ended June 30, 2009 to \$10,844,539 for the three months ended June 30, 2010. The increase in cost of sales resulted primarily from drilling cost of \$4,849,429 as a result of our new drilling services operation, an increase in the oil surcharge paid to the PRC government, due to the increase in oil prices generally and costs associated in the increase in oil sales. For the Current Quarter, the Company paid an oil surcharge of \$2,507,920 to the PRC government as compared to \$580,375 paid for the Comparable Quarter. Under a regulation introduced in June 2006, a surcharge is imposed on the portion of the selling price of crude oil as set forth in the table below.

Crude Price	Surcharge Rate
\$/Bbl	
\$40-45	20%
\$45-50	25%
\$50-55	30%
\$55-60	35%
Above \$60	40%

For example, if the MOPS China oil price is \$57 per barrel, the oil surcharge is \$4.45 per barrel (\$1+\$1.25+\$1.5+\$0.7); if the oil price is \$75 per barrel, the oil surcharge is \$11.5 per barrel (\$1+\$1.25+\$1.5+\$1.75+\$6).

**Operating Expenses.** Operating expenses totaled \$1,056,849 for the Current Quarter, compared to \$942,795 for the comparable quarter, an increase of 12.1%. The increase was primarily due to the increase of our consulting fees from \$72,589 in the Comparable Quarter to \$224,750 in the Current Quarter as a result of our recent restatement of our

financial statements, plus an increase in the professional fees from \$74,159 in the Comparable Quarter to \$117,678 in the Current Quarter.

Other Income (Expense). Other income for the Current Quarter was \$14,593,154 compared to other expense of \$13,026,423 for the Comparable Quarter. This increase was primarily the result of the change in fair value of warrants.

Net Income. Net income for the Current Quarter is \$26,223,920 compared to net loss for the Comparable Quarter of \$6,588,782. The increase is primarily the result of the drilling revenue and [increase of oil sales price in the Current Quarter.

#### Six Months Ended June 30, 2010 Compared To Six Months Ended June 30, 2009

Revenues. Revenues for the six months ended June 30, 2010 were \$56,635,478 compared to \$20,250,628 for the six months ended June 30, 2009, an increase of \$36,384,850, or 180%. This increase was due to revenue of \$24,598,489 for the six months ended June 30, 2010 and this increase was due to the additional revenue generated from drilling services of Tiancheng during the Current Period as well as the increase of oil price drove up the oil sales revenue. The average oil price for the six months ended June 30, 2010 was \$75.17, a 66% increase from \$45.16 for the same period in 2009. Our output of crude oil for the six months ended June 30, 2010 was 426,402 barrels compared to 447,134 barrels for the same period in 2009, a decrease of 4.6%. This slightly decrease in production was mainly due to: (i) no additional wells were drilled in the Current Quarter; (ii) the unexpected flood resulted from heavy storm and earlier raining season.

Cost of sales. Cost of sales increased by \$13,563,419 or 178%, from \$7,605,770 for the six months ended June 30, 2009 to \$21,169,189 for the six months ended June 30, 2010. The increase in cost of sales resulted primarily from drilling cost of \$9,360,718 for the six months ended June 30, 2010 and a increase in the oil surcharge paid to the PRC government, due to the increase in oil prices generally. For the six months ended June 30, 2010, the Company paid an oil surcharge of \$5,002,638 to the PRC government as compared to \$618,167 paid for the same period in 2009. Under a regulation introduced in June 2006, a surcharge of 20% is imposed on the portion of the selling price of crude oil which exceeds \$40 per barrel and a surcharge of 40% is imposed on the portion of the selling price of crude oil which exceeds \$60 per barrel. This government oil surcharge tax is paid by the Company on a quarterly basis, following the end of each quarter.

Operating Expenses. Operating expenses totaled \$2,752,311 for the six months ended June 30, 2010, compared to \$15,612,214 for the six months ended June 30, 2009, a decrease of 82.4%. This decrease is primarily a result of a decrease of \$13,832,356 in impairment of oil properties from the Comparable Period as compared to none in the Current Period and a decrease of \$746,258 in selling, general and administrative costs ("SG&A") because we incurred less amount of non-cash charges associated with stock and option grant when compared to the same period of 2009. For the six months ended June 30, 2009, our SG&A costs increased largely due to non-cash charges associated with stock and option grants made to Directors and certain key employees, accordingly, SG&A expenses was higher than current period ended June 30, 2010.

Other Income (Expense). Other income for the six months ended June 30, 2010 was \$25,395,690 compared to other expenses of \$21,726,292 for the six months ended June 30, 2009. The increased is primarily the result of decrease of expenses associated with the impairment of oil properties, loss on extinguishment of debt and changes in the fair value of warrants.

Net Income. Net income was \$49,334,567 for the six months ended June 30, 2010 compared to net loss of \$24,693,648 for the same period in 2009. The increase was the result of the decrease of expense associated with the impairment of oil properties, loss on extinguishment of debt and the change in fair value of warrants.

#### LIQUIDITY AND CAPITAL RESOURCES

We have historically financed our operations and capital expenditures through cash flows from operations, the issuance of secured debt and the issuance of new shares of our common stock. Our capital resources consist primarily

of cash flows from our oil producing properties. Our level of earnings and cash flows depend upon many factors, including the price we receive for crude oil we produce.

As of June 30, 2010, the Company had cash and cash equivalents of \$45,666,012, other current assets of \$25,592,244 and current liabilities of \$22,487,619. For the six months ended June 30, 2010, our primary sources of liquidity were \$20,083,778 provided by operating activities. This cash balance of \$45,666,012 represents an increase of \$16,972,880 over our cash balance as of December 31, 2009.



Net cash provided by operating activities was \$20,083,778 for the six months ended June 30, 2010 compared to net cash provided by operating activities of \$9,219,365 for the same period in 2009. The increase in net cash provided by operating activities was the result of a number of changes in our operating accounts. Cash from operating activities increased due to a significant increase in net income to offset the higher change in fair value of warrants, higher cash payments of income and other taxes, also offset the increase in accounts receivable in the Current Period compared to the Comparable Period.

Net cash used in investing activities was \$403,335 for the six months ended June 30, 2010 compared to \$948,526 for the same period in 2009. This decrease is primarily due to no new wells have been drilled during the six months ended June 30, 2010.

Net cash used in financing activities was \$3,224,663 for the six months ended June 30, 2010 as compared to net cash provided by \$1,177,742 for the same period in 2009. This was primarily a result of the repayment of secured debenture to Lotusbox during the six months ended June 30, 2010.

The Company has paid for the development of its producing oil wells and oil wells under construction, along with its acquisition of an oil well drilling and servicing company, with cash from operations as well as by funds raised through the issuance of secured debt, common stock and warrants to purchase the Company's common stock. The Company is continually evaluating opportunities to expand production and grow the Company's operations. The Company may require additional resources to fully implement the Company's business plan and growth strategy. Our ability to obtain additional capital to achieve certain of these expansion goals will depend on market conditions, national and global economies and other factors beyond its control. We cannot assure you that the Company will be able to implement or capitalize on various financing alternatives or otherwise obtain required capital, the need for which could be substantial given the Company's business and development goals. However, the Company anticipates that cash flows from operations will be sufficient to fund continued development at the four oil fields it currently operates and to fund continued operations at its oil well drilling and servicing subsidiary.

#### Crude Oil Price Trends

Changes in crude oil prices significantly affect our revenues, financial condition and cash flows. Markets for crude oil have historically been volatile and we expect this trend to continue. Prices for crude oil typically fluctuate in response to relatively minor changes in supply and demand, market uncertainty, seasonal, economic, political and other factors beyond our control. Although we are unable to accurately predict the prices we receive for our oil, any significant or sustained decline in oil prices may materially adversely affect our financial condition, liquidity, ability to obtain future debt or equity financing and operating results.

#### Production Trends

Like all other oil exploration and production companies, we experience natural production declines at existing wells. We recognize that oil production from a given well naturally decreases over time and that a downward trend in our overall production could occur unless the natural declines are offset by additional production from new wells, investment in measures to increase the production from existing wells (such as CO<sub>2</sub> and water injection), or acquisitions of producing properties. If any production declines we experience are other than a temporary trend, and if we cannot economically replace our reserves, our results may be materially adversely affected and our stock price may decline. Our future growth will depend upon our ability to continue to add oil reserves in excess of our production at a reasonable cost.

We have achieved increased production and revenue from our four oilfields as a result of our significant investments in these areas. As of June 30, 2010, we have drilled 289 wells out of the 675 wells that we believe can be drilled in

our four oilfields. We anticipate that we will continue to drill new wells and increase production in these areas. We are also actively seeking additional oil fields that we can lease and operate.

#### Operating Expense Trends

Costs associated with oil well drilling, improvement (e.g. fracturing and water injection), and maintenance in the northeastern Chinese oil fields where we operate have remained relatively constant over the past year. Similarly, service rates charged by oil field service companies have remained relatively constant over the past year. We are also generally somewhat buffered from changes in world oil prices due to the impact of the government oil surcharge tax. When prices rise, the amount of oil surcharge tax that we are required to pay increases; conversely price declines reduce the amount of oil surcharge tax. In the Current Quarter, the approximate amount of oil surcharge tax we paid was \$5,002,638, as compared to \$618,167 in the Comparable Quarter.

## CRITICAL ACCOUNTING POLICIES

**Proved Reserves.** Proved oil and gas reserves, as defined by SEC Regulation S-X Rule 4-10(a) (2)(i), (2)(ii), (2)(iii), (3) and (4), are the estimated quantities of crude oil that geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions, i.e., prices and costs as of the date the estimate is made. Prices include consideration of changes in existing prices provided only by contractual arrangements, but not on escalations based upon future conditions.

The Company's estimates of proved reserves are made using available geological and reservoir data as well as production performance data. These estimates, made by the Company's engineers, are reviewed annually and revised, either upward or downward, as warranted by additional data. Revisions are necessary due to changes in, among other things, reservoir performance, prices, economic conditions and governmental restrictions. Decreases in prices, for example, may cause a reduction in some proved reserves due to reaching economic limits sooner.

**Properties and Equipment.** The Company uses the full cost method of accounting for exploration and development activities as defined by the SEC. Under this method of accounting, the costs of unsuccessful, as well as successful, exploration and development activities are capitalized as properties and equipment. This includes any internal costs that are directly related to exploration and development activities but does not include any costs related to production, general corporate overhead or similar activities. Gain or loss on the sale or other disposition of oil properties is not recognized, unless the gain or loss would significantly alter the relationship between capitalized costs and proved reserves of oil and natural gas attributable to a country. The application of the full cost method of accounting for oil properties generally results in higher capitalized costs and higher DD&A rates compared to the successful efforts method of accounting for oil properties.

## RECENT ACCOUNTING PRONOUNCEMENTS

In January 2010, the FASB issued ASU 2010-03 Extract Activities- Oil and Gas Reserve Estimation and Disclosures. This ASU amends the "Extractive Industries- Oil and Gas" topic of the Codification to align the Oil and Gas reserve estimation and disclosure requirements in this Topic with the SEC Release No. 33-8995, "Modification of Oil and Gas Reporting Requirements (Final Rule)", discussed below. The amendments are effective for annual reporting periods ending on or after December 31, 2009, and the adoption of these provisions on December 31, 2009 did not have a material impact on our consolidated financial statements.

In January 2010, FASB issued ASU 2010-06 – Improving Disclosures about Fair Value Measurements ("ASU 2010-6"). ASU 2010-06 provides amendments to Subtopic 820-10 that requires separate disclosure of significant transfers in and out of Level 1 and Level 2 fair value measurements and the presentation of separate information regarding purchases, sales, issuances, and settlements for Level 3 fair value measurements. Additionally, ASU 2010-06 provides amendments to Subtopic 820-10 that clarifies existing disclosures about the level of disaggregation and inputs and valuation techniques. ASU 2010-06 is effective for financial statements issued for interim and annual periods ending after December 15, 2010. The Company does not expect the adoption of ASU 2010-06 to have a material impact on its consolidated results of operations or financial position.

In January 2010, FASB issued ASU 2010-02 Accounting and Reporting for Decreases in Ownership of a Subsidiary a Scope Clarification ("ASU 2010-02"). ASU 2010-02 addresses implementation issues related to the changes in ownership provisions in the Consolidation-Overall Subtopic (Subtopic 810-10) of the FASB Accounting Standards Codification, originally issued as FASB Statement No.160, Noncontrolling Interests in Consolidated Financial Statements. Subtopic 810-10 establishes the accounting and reporting guidance for noncontrolling interests and changes in ownership interests of a subsidiary. An entity is required to deconsolidate a subsidiary when the entity ceases to have a controlling financial interest in the subsidiary. Upon deconsolidation of a subsidiary, an entity

recognizes a gain or loss on the transaction and measures any retained investment in the subsidiary at fair value. The gain or loss includes any gain or loss associated with the difference between the fair value of the retained investment in the subsidiary and its carrying amount at the date the subsidiary is deconsolidated. In contrast, an entity is required to account for a decrease in ownership interest of a subsidiary that does not result in a change of control of the subsidiary as an equity transaction. ASU 2010-02 is effective for the Company starting January 3, 2010. The company does not expect the adoption of ASU 2010-02 to have a material impact on the Company's consolidated results of operations or financial position.

In February 2010, FASB issued ASU 2010-09 Subsequent Events (Topic 855) Amendments to Certain Recognition and Disclosure Requirements ("ASU 2010-09"). ASU 2010-09 amends disclosure requirements within Subtopic 855-10. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. This change alleviates potential conflicts between Subtopic 855-10 and the SEC's requirements. ASU 2010-09 is effective for interim and annual periods ending after June 15, 2010. The Company does not expect the adoption of ASU 2010-09 to have a material impact on its consolidated results of operations or financial position.

In April 2010, FASB issued ASU2010-13 Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades. ASU 2010-13 addresses the classification of a share-based payment award with an exercise price denominated in the currency of a market in which the underlying equity security trades (“ASU 2010-13”). Topic 718 is amended to clarify that a share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity’s equity securities trades shall not be considered to contain a market, performance, or service condition. Therefore, such an award is not to be classified as a liability if it otherwise qualifies as equity classification. The amendments in this Update should be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010. The guidance should be applied by recording a cumulative-effect adjustment to the opening balance of retained earnings for all outstanding awards as of the beginning of the fiscal year in which the amendments are initially applied. Management is currently evaluating the potential impact of ASU2010-13 on our financial statements.

In March 2010, FASB issued ASU 2010-11 Scope Exception Related to Embedded Credit Derivatives (“ASU2010-11”). ASU 2010-11 clarifies the type of embedded credit derivative that is exempt from embedded derivative bifurcation requirements. Only one form of embedded credit derivative qualifies for the exemption—one that is related only to the subordination of one financial instrument to another. As a result, entities that have contracts containing an embedded credit derivative feature in a form other than such subordination may need to separately account for the embedded credit derivative feature. The amendments in this Update are effective for each reporting entity at the beginning of its first fiscal quarter beginning after June 15, 2010. Early adoption is permitted at the beginning of each entity’s first fiscal quarter beginning after issuance of this Update. The Management is currently evaluating the potential impact of ASU 2010-11 on our financial statements.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Not required.

### ITEM 4T. CONTROLS AND PROCEDURES

#### Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this Quarterly Report on Form 10-Q (the “Evaluation Date”). The purpose of this evaluation is to determine if, as of the Evaluation Date, our disclosure controls and procedures were operating effectively such that the information, required to be disclosed in our Securities and Exchange Commission (“SEC”) reports (i) was recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the Evaluation Date, our disclosure controls and procedures were not operating effectively.

#### Limitations on the Effectiveness of Disclosure Controls and Procedures

Disclosure controls and procedures and other procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported, within the time period specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure.

#### Deficiencies Relating to Internal Controls over Financial Reporting

We recently completed an internal review of our financial reporting. As a result of this review, management and the audit committee concluded that the impact of certain non-cash accounting and disclosure errors on previously issued financial statements was material and required a restatement. The audit committee of our board of directors engaged an outside consulting firm to assist in its investigation of financial reporting revisions. Our investigation found that a number of factors at the Company contributed to the need to restate certain financial reports in order to correct non-cash accounting errors, including the following:

- the Company lacked adequate internal guidance or training on the reporting of certain non-cash accounting topics, such as warrant accounting, calculation of the ceiling test value of its oil properties, calculation of depreciation, depletion and amortization of oil properties, evaluation of the conditions which trigger the accounting treatment of a restructuring of terms of a liability as an extinguishment of debt, and accounting for stock issued to employees as compensation;
- the Company lacked adequate internal controls over the calculation methodologies used in calculation of depreciation, depletion and amortization, and of the ceiling test value, on its oil properties.

As part of its investigation, the audit committee proposed a number of recommendations, including the following:

- provide periodic training for employees on accounting and financial reporting practices, particularly with respect to oil industry measurements and disclosures;
- retain an outside consulting firm with expertise in financial accounting and oil industry accounting and disclosure matters, to assist the management team with its preparation of quarterly and annual financial reports; and
- institute and cultivate a culture of excellence with respect to accounting and financial reporting practices to ensure that the foregoing contributing factors do not recur.

The board of directors has accepted the recommendations proposed by the audit committee, and the board of directors implemented and resolved to continue to implement all of the recommendations.

Consequently, we have revised our financial reports for the periods from March 31, 2008 to September 30, 2009. This report, as well as specific information regarding its impact, is discussed in Note 1, "Restatement" to the Consolidated Financial Statements. Restatement of previously issued financial statements to reflect the correction of a misstatement is an indicator of the existence of a material weakness in internal control over financial reporting as defined in the Public Company Accounting Oversight Board's Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." We have identified deficiencies in our internal controls that did not prevent the misstatement of certain non-cash accounting items. These deficiencies, which

we believe constituted a material weakness in our internal control over financial reporting, included inadequate training and understanding of the SEC and accounting rules for booking certain non-cash accounting items, including items specific to oil industry reporting. In light of the determination that previously issued financial statements should be restated, our management concluded that a material weakness in internal control over financial reporting existed as of September 30, 2009 and disclosed this matter to the audit committee, and our independent registered public accounting firm.

## Remedial Actions

Our management, at the direction of our board of directors, is actively working to improve the control environment and to implement controls and procedures that will ensure the integrity of our financial statement preparation process.

We have implemented the following actions to mitigate weaknesses identified:

- we have retained an outside consulting firm with specialized knowledge in financial accounting and specific knowledge of oil industry accounting to assist us with the review and restatement of the financial statements in question.

We intend to implement the following additional actions in 2010:

- implement formal and informal training programs, particularly with respect to the accounting for non-cash items;
- continue our retention of an outside consulting firm to assist us with a review of financial report preparation.

## Evaluation of Disclosure Control and Procedures

Our Chief Executive Officer and our Chief Financial Officer, with the participation of other members of our senior management, reviewed and evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. In making this evaluation, the Chief Executive Officer and the Chief Financial Officer considered the issues discussed above, together with the remedial steps we have taken. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, because of the material weakness discussed above, as of June 30, 2010, our disclosure controls and procedures were not effective in recording, processing, summarizing and reporting information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934 (the "Exchange Act").

## Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-(f) of the Exchange Act. Under the supervision and with the participation of management, including our Chief Executive Officer, and our Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2009 based on the framework in Internal Control-Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our evaluation under the framework in Internal Control-Integrated Framework, our management concluded we did not maintain effective controls over our financial reporting for the periods from March 31, 2008 to December 31, 2009, and these ineffective controls constituted a material weakness. As a result of this material weakness, our financial statements for the quarters ended March 31, 2008, June 30, 2008, September 30, 2008, March 31, 2009, June 30, 2009, and September 30, 2009, and the year ended December 31, 2008 were restated. These restatements affected certain non-cash items, including accounting for warrants, the Company's proved oil properties, depreciation, depletion and amortization of oil properties, the ceiling test write-down of oil properties accounts, and accounting for the effect of a restructuring of a liability. Because of this material weakness, management has concluded that, as of December 31, 2009, we did not maintain effective internal control over financial reporting, based on the criteria established in Internal Control-Integrated Framework issued by the COSO.



Management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2009 has not been audited by Baker Tilly Hong Kong Limited (successor to Jimmy Cheung & Co.), an independent registered public accounting firm, as stated in their report which is included herein.

#### Changes in Internal Control Over Financial Reporting

During 2010, we implemented the following actions to improve our control environment and to implement controls and procedures that will ensure the integrity of our financial reporting process:

- we have retained an outside consulting firm with specialized knowledge in financial accounting and specific knowledge of oil industry accounting to assist us with the review and restatement of the financial statements in question.

We intend to implement the following additional actions in 2010:

- implement formal and informal training programs, particularly with respect to the accounting for non-cash items; and
- continue our retention of an outside consulting firm to assist us with a review of financial report preparation.

Except as discussed above, there has not been any change in our internal control over financial reporting that occurred during our quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The Company is involved in a variety of claims, suits, investigations and proceedings that arise from time to time in the ordinary course of its business, including actions with respect to contracts and other matters. These actions may be commenced by a number of different constituents, including competitors, partners, clients, current or former employees, government and regulatory agencies, stockholders, and representatives of the locations in which we do business. The following is a discussion of some of the more significant legal matters involving the Company.

Recently, purported shareholders of the Company filed six purported legal actions, three of which are securities class actions and three of which are shareholder derivative actions, in the U.S. District Court for the Southern District of New York against the Company and certain officers and directors. The three class actions assert claims under the federal securities laws and the three derivative actions assert common law claims based on breach of duty.

The six actions are: (1) Rosado v. China North East Petroleum Holdings Limited, et al., 10 CV 4577 (MGC), filed June 11, 2010; (2) Weissmann v. China North East Petroleum Holdings Limited, et al., 10 CV 4775 (MGC), filed June 18, 2010; (3) Moore v. China North East Petroleum Holdings Limited, et al., 10 CV 5263 (MGC), filed July 9, 2010; (4) Strickland v. Hongjun, et al., 10 CV 5445 (RMB), filed July 19, 2010; (5) Drobner v. Hongjun, et al., 10 CV 6319 (No Judge has been assigned at this time), filed August 23, 2010; and (6) Nicoln v. Hongjun, et al., 10 CV 6344 (No Judge has been assigned at this time), filed August 24, 2010.

The time for the Company to respond formally to these lawsuits has not come. In addition, the complaints do not specify an amount of damages that plaintiffs seek. Because these matters are in very early stages, we cannot comment on whether an adverse outcome is probable or otherwise. While we believe we have meritorious defenses to each of these actions and intend to defend them vigorously, an adverse outcome in one or more of these matters could have a

material adverse effect on its business, financial condition, results of operations or liquidity.

ITEM 1A. RISK FACTORS

There has been no material change in the Company's risk factors as previously disclosed in the Company's Annual Report on Form 10-K filed with the SEC on March 30, 2009 and as amended and filed on September 1, 2010.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. (REMOVED AND RESERVED)

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit No.	Description
31.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

China North East Petroleum Holdings  
Limited

September 7, 2010

By:                   /s/ Jingfu Li  
                          Jingful Li  
                          Acting Chief Executive Officer  
                          (Principal Executive Officer and  
                          Principal Financial Officer)

EXHIBIT INDEX

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