

CHINA NORTH EAST PETROLEUM HOLDINGS LTD
Form 10-Q
November 16, 2009

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 September 30, 2009

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

For the transition period from _____ to _____

Commission file number 000-49846

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 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 November 12, 2009: 25,852,181

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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 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

| | September 30, 2009 (Unaudited) | December 31, 2008 (Audited) |
|---|--------------------------------------|-----------------------------------|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 33,158,348 | \$ 13,239,213 |
| Accounts receivable, net | 6,509,440 | 4,230,080 |
| Prepaid expenses and other current assets | 3,987,771 | 781,121 |
| Value added tax recoverable | - | 311,240 |
| Total Current Assets | 43,655,559 | 18,561,654 |
| PROPERTY AND EQUIPMENT | | |
| Oil and gas properties, net | 65,847,281 | 70,193,852 |
| Fixed assets, net | 13,820,768 | 1,684,377 |
| Oil and gas properties under construction | - | 714,629 |
| Total Property and Equipment | 79,668,049 | 72,592,858 |
| LAND USE RIGHTS, NET | 641,204 | 36,198 |
| GOODWILL | 1,645,589 | - |
| DEFERRED FINANCING COSTS, NET | 716,680 | 939,098 |
| TOTAL ASSETS | \$ 126,327,081 | \$ 92,129,808 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 8,178,864 | \$ 10,985,894 |
| Current portion of secured debenture, net of discount | 3,971,112 | 1,489,126 |
| Other payables and accrued liabilities | 5,677,494 | 742,264 |
| Due to related parties | 14,625 | 66,262 |
| Income tax and other taxes payable | 5,598,835 | 3,710,870 |
| Due to a stockholder | 5,602,176 | 738 |
| Total Current Liabilities | 29,043,106 | 16,995,154 |
| LONG-TERM LIABILITIES | | |
| Accounts payable | 9,347,865 | 13,944,903 |
| Secured debenture, net of discount | 2,815,879 | 6,594,700 |
| Deferred tax payable | 64,465 | 762,405 |
| Total Long-term Liabilities | 12,228,209 | 21,302,008 |
| TOTAL LIABILITIES | 41,271,315 | 38,297,162 |
| COMMITMENTS AND CONTINGENCIES | - | - |
| EQUITY | | |
| NEP Stockholders' Equity | | |

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Common stock (\$0.001 par value, 150,000,000 shares authorized,
25,119,619 shares issued and outstanding as of
September 30, 2009; 20,784,080 shares issued and
outstanding as of December 31, 2008)

| | | |
|--|----------------|---------------|
| | 25,120 | 20,784 |
| Additional paid-in capital | 39,934,062 | 21,384,816 |
| Deferred stock compensation | (641,250) | (1,248,750) |
| Retained earnings | | |
| Unappropriated | 33,677,718 | 24,536,079 |
| Appropriated | 1,372,999 | 1,372,999 |
| Accumulated other comprehensive income | 3,365,741 | 3,253,068 |
| Total NEP Stockholders' Equity | 77,734,390 | 49,318,996 |
| Noncontrolling interests | 7,321,376 | 4,513,650 |
| TOTAL EQUITY | 85,055,766 | 53,832,646 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 126,327,081 | \$ 92,129,808 |

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 Operations and Comprehensive Income

| | (Unaudited) | | (Unaudited) | |
|--|------------------------------|---------------|-----------------------------|---------------|
| | Three months ended September | | Nine months ended September | |
| | 2009 | 2008 | 2009 | 2008 |
| | 30 | 30 | 30 | 30 |
| NET SALES | \$ 14,403,921 | \$ 19,060,007 | \$ 34,654,549 | \$ 44,051,519 |
| COST OF SALES | | | | |
| Production costs | 1,103,163 | 895,155 | 2,769,762 | 2,390,432 |
| Depreciation of oil and gas properties | 2,824,981 | 3,774,327 | 8,283,230 | 8,155,321 |
| Amortization of land use rights | 2,982 | 2,975 | 8,943 | 8,743 |
| Government oil surcharge | 1,655,000 | 4,480,955 | 2,273,167 | 9,865,655 |
| Total Cost of Sales | 5,586,126 | 9,153,412 | 13,335,102 | 20,420,151 |
| GROSS PROFIT | 8,817,795 | 9,906,595 | 21,319,447 | 23,631,368 |
| OPERATING EXPENSES | | | | |
| Selling, general and administrative expenses | 749,204 | 793,479 | 1,932,541 | 1,339,404 |
| Professional fees | 98,261 | 42,850 | 323,309 | 140,180 |
| Consulting fees | 142,332 | 91,926 | 298,627 | 319,764 |
| Depreciation of fixed assets | 69,947 | 50,445 | 209,748 | 160,930 |
| Total Operating Expenses | 1,059,744 | 978,700 | 2,764,225 | 1,960,278 |
| INCOME FROM OPERATIONS | 7,758,051 | 8,927,895 | 18,555,222 | 21,671,090 |
| OTHER INCOME (EXPENSE) | | | | |
| Other income | 7,134 | 809 | 7,134 | 66,651 |
| Other expense | (20,780) | (2,000) | (22,581) | (107,601) |
| Interest expense | (236,931) | (296,761) | (777,595) | (721,805) |
| Amortization of deferred financing cost | (74,139) | (74,140) | (222,418) | (172,992) |
| Amortization of discount on debenture | (513,415) | (486,803) | (1,515,473) | (1,135,874) |
| Imputed interest expense | (70,210) | (16,794) | (120,127) | (49,535) |
| Interest income | 25,141 | 4,238 | 44,905 | 34,204 |
| Total Other Expense, net | (883,200) | (871,451) | (2,606,155) | (2,086,952) |
| NET INCOME BEFORE INCOME TAXES | 6,874,851 | 8,056,444 | 15,949,067 | 19,584,138 |
| Income tax expense | (2,186,156) | (2,390,961) | (5,273,823) | (5,695,498) |
| NET INCOME | 4,688,695 | 5,665,483 | 10,675,244 | 13,888,640 |
| Less: net income attributable to noncontrolling interests | (635,986) | (711,301) | (1,533,605) | (1,687,394) |
| NET INCOME ATTRIBUTABLE TO NEP COMMON STOCKHOLDERS | 4,052,709 | 4,954,182 | 9,141,639 | 12,201,246 |
| OTHER COMPREHENSIVE INCOME | | | | |
| Total other comprehensive income | 41,798 | 152,651 | 125,193 | 2,020,632 |
| Less: foreign currency translation gain attributable to noncontrolling interests | (4,180) | (15,265) | (12,520) | (202,063) |
| Foreign currency translation gain attributable to NEP common stockholders | 37,618 | 137,386 | 112,673 | 1,818,569 |

COMPREHENSIVE INCOME
 ATTRIBUTABLE TO NEP COMMON
 STOCKHOLDERS

| | | | | | | | | |
|--|----|------------|----|------------|----|------------|----|------------|
| | \$ | 4,090,327 | \$ | 5,091,568 | \$ | 9,254,312 | \$ | 14,019,815 |
| Net income per share | | | | | | | | |
| - basic | \$ | 0.19 | \$ | 0.25 | \$ | 0.43 | \$ | 0.63 |
| - diluted | \$ | 0.17 | \$ | 0.24 | \$ | 0.41 | \$ | 0.62 |
| Weighted average number of shares outstanding during the period | | | | | | | | |
| - basic | | 21,780,364 | | 19,987,123 | | 21,143,560 | | 19,480,284 |
| - diluted | | 24,025,976 | | 20,676,711 | | 22,266,408 | | 19,642,216 |

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

For the nine months ended September 30, 2009 and 2008 (Unaudited)

| | 2009 | 2008 |
|--|--------------|--------------|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$9,141,639 | \$12,201,246 |
| Adjusted to reconcile net income to cash provided by operating activities: | | |
| Depreciation of oil and gas properties | 8,283,230 | 8,155,321 |
| Depreciation of fixed assets | 209,748 | 160,930 |
| Amortization of land use rights | 8,943 | 8,743 |
| Amortization of deferred financing costs | 222,418 | 172,992 |
| Amortization of discount on debenture | 1,515,473 | 1,135,874 |
| Amortization of stock option compensation | 475,207 | 163,402 |
| Warrants issued for services | 280,737 | 154,171 |
| Noncontrolling interests | 1,533,605 | 1,687,394 |
| Stocks issued for consulting services | 88,000 | 27,125 |
| Stock-based compensation for employee services | 607,500 | 168,750 |
| Imputed interest expense | 120,127 | 49,535 |
| Gain on disposal of fixed assets | (7,134) | - |
| Changes in operating assets and liabilities | | |
| (Increase) decrease in: | | |
| Accounts receivable | (2,279,360) | (5,742,601) |
| Prepaid expenses and other current assets | (3,206,650) | (1,863,807) |
| Value added tax recoverable | 311,240 | 651,905 |
| Deferred tax assets | - | (209,102) |
| Increase (decrease) in: | | |
| Accounts payable | (7,404,068) | (3,458,626) |
| Other payables and accrued expenses | 242,706 | (195,033) |
| Income tax and other taxes payable | 1,242,325 | 4,918,065 |
| Deferred tax payable | (697,940) | (543,100) |
| Net cash provided by operating activities | 10,687,746 | 17,643,184 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchase of oil and gas properties | (3,053,668) | (18,300,636) |
| Purchase of fixed assets | (185,369) | (668,233) |
| Additions to oil and gas properties under construction | - | (649,786) |
| Proceeds from disposal of fixed assets | 28,656 | - |
| Cash outflow from acquisition of a subsidiary (Note 4) | (7,837,926) | - |
| Net cash used in investing activities | (11,048,307) | (19,618,655) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from issuance and sale in a public offering of common stock and warrants, net | 17,276,003 | - |
| Payment of deferred financing costs | - | (1,186,229) |
| Proceeds from issuance of secured debenture | - | 15,000,000 |
| Repayment of secured debenture | (2,500,000) | (750,000) |
| Proceeds from exercise of stock warrants | 1,200 | 12,000 |
| Increase in amount due to a stockholder | 5,601,438 | 660,153 |
| Decrease in amounts due to related parties | (51,637) | (2,644,819) |

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| | | |
|---|--------------|--------------|
| Net cash provided by financing activities | 20,327,004 | 11,091,105 |
| EFFECT OF EXCHANGE RATE ON CASH | (47,308) | (1,428,255) |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 19,919,135 | 7,687,379 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 13,239,213 | 74,638 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$33,158,348 | \$7,762,017 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for: | | |
| Income tax expense | \$5,975,876 | \$4,932,518 |
| Interest expense | \$540,664 | \$721,805 |

SUPPLEMENTAL DISCLOSURE FOR NON-CASH OPERATING ACTIVITIES:

During 2009, the Company issued 15,000 S-8 shares of common stock valued at \$66,000 for consulting services.

During 2009, the Company issued 5,000 S-8 shares of common stock valued at \$22,000 for consulting services.

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 SEPTEMBER 30, 2009
(UNAUDITED)

NOTE 1 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 September 30, 2009, the results of operations for the three and nine months ended September 30, 2009 and 2008 and cash flows for the nine months ended September 30, 2009 and 2008. The results for the three and nine months ended September 30, 2009 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2009.

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, 2008, previously filed with the Securities and Exchange Commission on March 30, 2009.

FASB Launches New Accounting Standards Codification

In June 2009 the Financial Accounting Standards Board ("FASB") issued FASB Accounting Standards Codification ("Codification") as the single source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities effective for interim and annual periods ending after September 15, 2009. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. The Codification supersedes all existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in the Codification have become non-authoritative.

Following the Codification, FASB will not issue new standards in the form of Statements, FASB Staff Positions ("FSP") or Emerging Issues Task Force ("EITF") Abstracts. Instead, it will issue Accounting Standards Updates, which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification.

GAAP is not intended to be changed as a result of the FASB's Codification, but it will change the way the guidance is organized and presented. As a result, these changes will have a significant impact on how companies reference GAAP in their financial statements and in their accounting policies. The Trust has adopted the Codification in this quarterly report by using plain English to describe FASB broad topic references.

NOTE 2 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.

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CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL
STATEMENTS AS OF SEPTEMBER 30, 2009
(UNAUDITED)

NOTE 2 ORGANIZATION (CONTINUED)

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.

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 and gas 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% of the 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”).

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL
STATEMENTS AS OF SEPTEMBER 30, 2009
(UNAUDITED)

NOTE 3 PRINCIPLES OF CONSOLIDATION

The accompanying unaudited condensed consolidated financial statements for 2009 include the unaudited financial statements of North East Petroleum and its wholly owned subsidiary, Hong Xiang Petroleum Group and 90% equity interest owned subsidiaries, Song Yuan Technical, LongDe, Yu Qiao and Tiancheng (collectively, “the Company”). 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 for 2008 include the unaudited financial statements of North East Petroleum and its wholly owned subsidiary, Hong Xiang Petroleum Group and 90% equity interest 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.

NOTE 4 BUSINESS COMBINATION

On September 25, 2009, Song Yuan Technical entered into a Share Transfer Agreement (the “Agreement”) with the stockholders (“Selling Stockholders”) of Tiancheng. Pursuant to the Agreement, Song Yuan Technical acquired all of the Selling Stockholders’ interest in Tiancheng at a consideration of US\$13,000,000 (the “Purchase Price”) for 100% of the equity in Tiancheng held by the Selling Stockholders. The Purchase Price is payable in two installments. The first installment of US\$6,500,000 is due within 15 days from the date of execution of the Agreement and the second installment of US\$6,500,000 is due within 15 days after the completion of the registration of the transfer of title of 95% of the equity interest in Tiancheng with the local Industry and Commerce Bureau and the establishment of a trust holding 5% of the equity interest in Tiancheng by one of the Selling Stockholders for the benefit of Song Yuan Technical. The trust is established in order to comply with certain laws of the People’s Republic of China.

On September 27, 2009, the Selling Stockholders completed the registration of the transfer of title of 95% of the equity interest in Tiancheng to Song Yuan Technical and the establishment of the trust.

Tiancheng is engaged in providing contract land drilling services to customers for exploration and production of crude oil in the PRC.

The preliminary allocation of the net assets acquired is as follows:

| | |
|---|--------------|
| Cash and cash equivalents | \$645,533 |
| Property and equipment, net | 12,178,235 |
| Land use rights, net | 613,867 |
| Goodwill | 1,645,589 |
| Total assets | 15,083,224 |
| Less: Other payables and accrued expenses | (175,983) |
| Income tax and other taxes payable | (645,640) |
| Noncontrolling interests | (1,261,601) |

| | |
|----------------------|--------------|
| Total purchase price | \$13,000,000 |
|----------------------|--------------|

As of September 30, 2009, \$8,483,459 was paid to the Selling Stockholders and the remaining outstanding balance of \$4,516,541 was included in Other Payables and Accrued Expenses (See note 7).

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CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL
STATEMENTS AS OF SEPTEMBER 30, 2009
(UNAUDITED)

NOTE 4 BUSINESS COMBINATION (CONTINUED)

Analysis of the net outflow of cash and cash equivalents in respect of the business combination is as follows:

| | |
|--|-------------|
| Consideration paid | \$8,483,459 |
| Less: cash and cash equivalents acquired | (645,533) |
| Net cash outflow | \$7,837,926 |

The acquisition of Tiancheng was accounted for as a purchase under ASC Topic 805 Business Combinations (formerly SFAS No. 141(revised 2007), Business Combinations). Accordingly, the operating results of Tiancheng have been included in the consolidated statements of operation and comprehensive income after the effective date of the acquisition of September 25, 2009.

The following table reflects the unaudited pro forma combined results of operations for the three and nine months ended September 30, 2009, assuming the acquisition of Tiancheng had occurred and was completed at the beginning of 2009.

| | Three months ended September 30, 2009 | Nine months ended September 30, 2009 |
|----------------------|--|---|
| Revenues | \$ 19,931,524 | \$ 49,355,004 |
| Net income | \$ 5,794,685 | \$ 13,962,300 |
| Net income per share | | |
| - basic | \$ 0.27 | \$ 0.66 |
| - diluted | \$ 0.24 | \$ 0.63 |

NOTE 5 PREPAID EXPENSES AND OTHER CURRENT ASSETS

Prepaid expenses and other current assets at September 30, 2009 and December 31, 2008 consist of the following:

| | September 30, 2009 (Unaudited) | December 31, 2008 (Audited) |
|--|--------------------------------------|-----------------------------------|
| Prepaid expenses | \$ 353,259 | \$ 690,838 |
| Deposits paid to suppliers | 85,528 | 50,330 |
| Deposits paid for purchase of drilling equipment | 3,363,753 | - |
| Other receivables | 185,231 | 39,953 |
| | \$ 3,987,771 | \$ 781,121 |

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NOTE 6 FIXED ASSETS

The following is a summary of fixed assets at September 30, 2009 and December 31, 2008:

| | September 30, 2009 (Unaudited) | December 31, 2008 (Audited) |
|-----------------------------------|--------------------------------------|-----------------------------------|
| Buildings | \$ 2,095,441 | \$ 1,075,061 |
| Drilling rigs and equipment | 12,584,971 | - |
| Furniture, fixtures and equipment | 300,570 | 224,180 |
| Motor vehicles | 1,478,528 | 1,064,636 |
| | 16,459,510 | 2,363,877 |
| Less: accumulated depreciation | (2,638,742) | (679,500) |
| Fixed assets, net | \$ 13,820,768 | \$ 1,684,377 |

Depreciation expense for the nine months ended September 30, 2009 and the year ended December 31, 2008 was \$209,748 and \$229,434 respectively.

NOTE 7 OTHER PAYABLES AND ACCRUED EXPENSES

Other payables and accrued expenses at September 30, 2009 and December 31, 2008 consist of the following:

| | September 30, 2009 (Unaudited) | December 31, 2008 (Audited) |
|--|--------------------------------------|-----------------------------------|
| Other payables | \$ 496,363 | \$ 494,553 |
| Due to former stockholders of Tiancheng for acquisition of the subsidiary | 4,516,541 | - |
| Accrued professional fees | 175,414 | 117,335 |
| Other accrued expenses | 489,176 | 130,376 |
| | \$ 5,677,494 | \$ 742,264 |

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NOTE 8 SECURED DEBENTURE

The following is a summary of secured debenture at September 30, 2009 and December 31, 2008:

| | September 30, 2009 (Unaudited) | December 31, 2008 (Audited) |
|---|--------------------------------------|-----------------------------------|
| 8% Secured Debenture, net of unamortized discount of \$4,963,009 as of September 30, 2009 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 | \$ 6,786,991 | \$ 8,083,826 |
| | 6,786,991 | 8,083,826 |
| Less: current maturities | (3,971,112) | (1,489,126) |
| Long-term portion | \$ 2,815,879 | \$ 6,594,700 |

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 issued to the Investor an 8% Secured Debenture due 2012 (the "Debenture") in the aggregate principal amount of \$15,000,000, and issued 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. The Company also granted the Investor an option to purchase up to 24% of the registered capital of Song Yuan Technical at a fair market value which option shall vest immediately on the date following the occurrence of an event of 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.

On March 5, 2009, the Company and the Investor entered into Amendment No.1 to 8% Secured Debenture (the "Amendment") 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 AMEX 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.

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NOTE 8 SECURED DEBENTURE (CONTINUED)

The Company accounts for 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. The beneficial conversion feature associated with the secured debenture is measured at its intrinsic value after allocation between the warrant and the debenture and before transaction costs in accordance with EITF 00-27, Application of Issue 98-5 to Certain Convertible Instruments. Debt proceeds are first allocated to the warrant (as it is mark-to-market, fair-value liability instrument) and the remaining proceeds are allocated to the debt. The debenture will be accreted to liquidation value over two years, using the effective interest rate method.

The Company has recorded a cost of \$8,101,160 for the beneficial conversion feature granted to the Investor. The beneficial conversion feature is reflected as a discount to the carrying value of the debenture and is being amortized as an interest expense over the term of the debenture.

Interest expense on the secured debenture for the three and nine months ended September 30, 2009 was \$236,931 and \$777,595 respectively.

Discount amortized on the secured debenture for the three and nine months ended September 30, 2009 was \$513,415 and \$1,515,473 respectively.

NOTE 9 NET INCOME 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):

| | Nine months ended September 30, | |
|--|---------------------------------|-----------|
| | 2009 | 2008 |
| Numerator: | | |
| Net income attributable to NEP common stockholders used in computing basis net income per share | \$ 9,142 | \$ 12,201 |
| Net income attributable to NEP common stockholders used in computing diluted net income per share | \$ 9,142 | \$ 12,201 |
| Denominator: | | |
| Shares used in the computation of basic net income per share (weighted average common stock outstanding) | 21,144 | 19,480 |
| Dilutive potential common stock: | | |
| Options and warrants | 1,122 | 144 |
| Shares used in the computation of diluted net income per share | 22,266 | 19,624 |
| Basic net income per share | \$ 0.43 | \$ 0.63 |
| Diluted net income per share | \$ 0.41 | \$ 0.62 |

For the nine months ended September 30, 2009, options to purchase 370,000 shares of common stock and warrants to purchase 960,000 shares of common stock with exercise prices greater than the average fair market value of the Company's stock of \$3.16 were not included in the calculation because the effect is anti-dilutive.

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NOTE 9 NET INCOME PER SHARE (CONTINUED)

| | Three months ended September 30, | |
|--|----------------------------------|----------|
| | 2009 | 2008 |
| Numerator: | | |
| Net income attributable to NEP common stockholders used in computing basis net income per share | \$ 4,053 | \$ 4,954 |
| Net income attributable to NEP common stockholders used in computing diluted net income per share | \$ 4,053 | \$ 4,954 |
| Denominator: | | |
| Shares used in computation of basic net income per share (weighted average common stock outstanding) | 21,780 | 19,987 |
| Dilutive potential common stock: | | |
| Options and warrants | 2,246 | 690 |
| Shares used in computation of diluted net income per share | 24,026 | 20,677 |
| Basic net income per share | \$ 0.19 | \$ 0.25 |
| Diluted net income per share | \$ 0.17 | \$ 0.24 |

For the three months ended September 30, 2009, warrants to purchase 960,000 shares of common stock with exercise prices greater than the average fair market value of the Company's stock of \$4.81 were not included in the calculation because the effect is anti-dilutive.

NOTE 10 COMMITMENTS AND CONTINGENCIES

(A) Lease commitment

The Company leases office spaces from a stockholder, land and office spaces from third parties under four operating leases which expire on September 20, 2023, December 31, 2009, January 20, 2011 and January 31, 2010 at annual rental of \$183, \$5,850, \$19,013 and \$20,160 respectively.

As of September 30, 2009, the Company had outstanding commitments with respect to the above operating leases, which are due as follows:

| | |
|------------|----------|
| 2009 | \$11,302 |
| 2010 | 20,876 |
| 2011 | 1,768 |
| 2012 | 183 |
| Thereafter | 1,967 |
| | \$36,096 |

(B) Capital commitments

As of September 30, 2009, the Company had commitments for capital expenditure of \$9,426,000 with a contractor to complete the drilling of 43 oil wells.

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NOTE 11 STOCK-BASED COMPENSATION

From May 2008 to May 2009, the Company granted to its employees, stock options qualified under the Company's 2006 Stock Option/Stock Issuance Plan to purchase Common Stock. As of September 30, 2009, stock options granted under the Company's 2006 Stock Option/Stock Issuance Plan to purchase 470,000 shares of its Common Stock (the "Options") at an exercise prices from \$2.94 to \$4.50 per share were outstanding. 25% of the 160,000 stock options shall vest upon grant and 25% shall vest every three months thereafter, these stock options granted shall expire ten years after the grant date. 50% of the 310,000 stock options shall vest upon grant and 50% shall vest on the first anniversary of the grant date.

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 |
|---------------|---------------------|----------------|-------------------------|-----------------------|
| 1 to 2 years | 102% to 173% | 0% | 0.49% to 2.66% | \$2.94 to \$4.50 |

- 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 0.49% to 2.66% 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 granted 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" options under the rules prescribed by Staff Accounting Bulletin No. 107.

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. SFAS 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.

As of September 30, 2009, 470,000 stock options with a fair value of approximately \$1,218,848 were granted to staff, of which the Company recognized \$475,207 as staff compensation expenses included in selling, general and administrative expenses for the nine months ended September 30, 2009.

As of September 30, 2009, the total compensation cost related to stock options not yet recognized was \$406,662 and these will be recognized over the next twelve months.

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NOTE 11 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, 2008 | 410,000 | \$ 4.43 |
| Granted | 60,000 | \$ 2.94 |
| Forfeited | - | - |
| Exercised | - | - |
| Balance, September 30, 2009 | 470,000 | \$ 4.24 |

The following is a summary of the status of options outstanding at September 30, 2009:

| Exercise Price | Outstanding Options | | Exercisable Options | | |
|-------------------|---------------------|---|------------------------------|---------|---------------------------------------|
| | Number | Average Remaining Contractual Life | Average Exercise Price | Number | Weighted Average Exercise Price |
| \$4.05 | 60,000 | 8.67 years | \$4.05 | 60,000 | \$4.05 |
| \$4.50 | 40,000 | 8.88 years | \$4.50 | 40,000 | \$4.50 |
| \$4.50 | 310,000 | 8.88 years | \$4.50 | 310,000 | \$4.50 |
| \$2.94 | 60,000 | 9.67 years | \$2.94 | 30,000 | \$2.94 |

NOTE 12 STOCKHOLDERS' EQUITY

(A) Changes in Equity

The following table summarizes the changes in equity for the nine months ended September 30, 2009 (in thousands):

| | NEP Common Stockholders | Noncontrolling Interests | Total |
|---|----------------------------|-----------------------------|-----------|
| Total equity as of December 31, 2008 | \$ 49,319 | \$ 4,513 | \$ 53,832 |
| Common stock | 4 | - | 4 |
| Additional paid-in capital | 18,549 | - | 18,549 |
| Deferred stock compensation | 608 | - | 608 |
| Net income | 9,142 | 1,534 | 10,676 |
| Other comprehensive income | 113 | 12 | 125 |
| Share of net assets on acquisition of Tiancheng | - | 1,262 | 1,262 |
| Total equity as of September 30, 2009 | \$ 77,735 | \$ 7,321 | \$ 85,056 |

(B) Stock issuances

- (1) On May 8, 2009, the Company issued 120,000 shares of common stock to a consultant who exercised the Class A Warrants at the exercise price of \$0.01 per share.

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NOTE 12 STOCKHOLDERS' EQUITY (CONTINUED)

(B) Stock issuances (Continued)

- (2) On July 16, 2009, the Company issued 15,000 S-8 shares of common stock to a consultant for consulting services. The stock was valued at the closing price on the date of grant of \$4.40 per share, yielding an aggregate fair value of \$66,000. The Company recognized expense of \$66,000 for the nine months ended September 30, 2009.
- (3) On July 16, 2009, the Company issued 5,000 S-8 shares of common stock to a consultant for consulting services. The stock was valued at the closing price on the date of grant of \$4.40 per share, yielding an aggregate fair value of \$22,000. The Company recognized expense of \$22,000 for the nine months ended September 30, 2009.
- (4) On July 27, 2009, the Company issued 65,007 shares of its common stock to a consultant at a volume weighted average price of \$4.1474 per share pursuant to a cashless exercise option in place of the consultant exercising all of his Class B Warrants for 150,000 shares of common stock at \$2.35 per share.
- (5) On August 10, 2009, the Company issued 130,532 shares of its common stock to a consultant at a volume weighted average price of \$6.21 per share pursuant to a cashless exercise option in place of the consultant exercising all of his Class C Warrants for 210,000 shares of common stock at \$2.35 per share.
- (6) On September 15, 2009, the Company entered into a Securities Purchase Agreement with several investors. The Securities Purchase Agreement relates to the issuance and sale in a public offering by the Company of an aggregate of 4,000,000 shares of its common stock, at a price of \$4.60 per share and warrants to purchase up to an additional 800,000 shares of common stock (See note 12(C)4). The Company received gross proceeds of approximately \$18.4 million before placement agent fees and other expenses.

(C) Issuance of warrants

- (1) On February 28, 2008, the Company issued to a consultant five-year warrants exercisable for up to (i) 120,000 shares of the Company's common stock at an initial exercise price equal to \$0.01 per share ("Class A Warrants"), (ii) 150,000 shares of the Company's common stock at an initial exercise price equal to \$3.20 per share ("Class B Warrants") and (iii) 210,000 shares of the Company's common stock at an initial exercise price equal to \$3.45 ("Class C Warrants"), with all warrant exercise prices being subject to certain adjustments. The exercise prices of Class B Warrants and Class C Warrants were subsequently revised to \$2.35 per share. The Class B Warrants are subject to certain call rights. The Company's stock was trading at \$2.93 at the time of issuance of warrants. The warrants have been determined to have a total market value of \$788,306 using the Black-Scholes option pricing model with market value per common stock of \$2.13, \$1.48 and \$1.48 for Class A Warrants, Class B Warrants and Class C Warrants respectively, an exercise period of 2 years and a volatility of 158%, 82% and 82% respectively. The Company recognized \$49,945 and \$147,306 as consulting expenses for the three and nine months ended September 30, 2009 respectively.

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NOTE 12 STOCKHOLDERS' EQUITY (CONTINUED)

(C) Issuance of warrants (Continued)

- (2) Pursuant to an engagement agreement with effect from February 28, 2008 for a term of two years, the Company issued to a law firm for legal services at rates lower than its billing rate a warrant for 100,000 shares of the common stock of the Company at an exercise price equal to \$2.15 per share. This warrant may be exercised until January 1, 2013. The Company's stock was trading at \$2.14 at the time of issuance of the warrant. The warrant shall be exercisable as of the effective date of the engagement agreement. The warrant has been determined to have a market value of \$158,420 using the Black-Scholes option pricing model with market value per common stock of \$1.58, an exercise period of 2 years and a volatility of 158%. The Company recognized \$19,803 and \$125,416 as professional fees for the three and nine months ended September 30, 2009 respectively.
- (3) Pursuant to a consulting agreement with effect from April 29, 2009 for a term of two years, the Company issued to a consultant for investor relations consulting services a four-year warrant for 50,000 shares of the common stock of the Company at an exercise price equal to \$2.65 per share. The Company's stock was trading at \$1.90 at the time of issuance of the warrant. The warrant shall be exercisable as of the effective date of the consulting agreement. The warrant has been determined to have a market value of \$38,472 using the Black-Scholes option pricing model with market value per common stock of \$0.77, an exercise period of 2 years and a volatility of 92%. The Company recognized \$4,809 and \$8,015 as consulting expenses for the three and nine months ended September 30, 2009 respectively.
- (4) Pursuant to the Securities Purchase Agreement with effect from September 15, 2009, the Company issued to several investors warrants to purchase up to 800,000 shares of its common stock. The warrants are exercisable beginning six months after their initial issuance at an exercise price of \$6.00 per share until March 15, 2011. The exercise price and number of shares issuable upon exercise are subject to adjustment in the event of stock splits or dividends, business combinations, sale of assets or other similar transactions. The Company's stock was trading at \$5.03 at the time of issuance of the warrant. The warrant has been determined to have a market value of \$1,440,522 using the Black-Scholes option pricing model with market value per common stock of \$1.80, an exercise period of 1 year and a volatility of 107%. The Company recognized \$1,440,522 as additional paid-in capital for the nine months ended September 30, 2009.
- (5) Pursuant to an engagement agreement with effect from September 10, 2009, the Company issued to a placement agent a five-year warrant for 80,000 shares of the common stock of the Company at an exercise price equal to \$6.00 per share as placement agent fees. The Company's stock was trading at \$5.13 at the time of issuance of the warrant. The warrant shall be exercisable as of the effective date of the engagement agreement. The warrant has been determined to have a market value of \$231,547 using the Black-Scholes option pricing model with market value per common stock of \$2.89, an exercise period of 2 years and a volatility of 117%. The Company recognized \$231,547 as additional paid-in capital for the nine months ended September 30, 2009.
- (6) Pursuant to a consulting agreement with effect from September 10, 2009, the Company issued to a consultant for financial advisory services on the placement of 4 million shares of common stock a five-year warrant for 80,000 shares of the common stock of the Company at an exercise price equal to \$6.00 per share. The Company's stock was trading at \$5.13 at the time of issuance of the warrant. The warrant shall be

exercisable as of the effective date of the engagement agreement. The warrant has been determined to have a market value of \$231,547 using the Black-Scholes option pricing model with market value per common stock of \$2.89, an exercise period of 2 years and a volatility of 117%. The Company recognized \$231,547 as additional paid-in capital for the nine months ended September 30, 2009.

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NOTE 13 RELATED PARTY TRANSACTIONS

- (1) As of September 30, 2009, the Company owed a stockholder \$5,602,176 which is unsecured and repayable on demand. Imputed interest is computed at 5% per annum on the amount due.
- (2) As of September 30, 2009, the Company owed a related party \$14,625 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 \$70,210 and \$120,127 for the three and nine months ended September 30, 2009 respectively.
- (4) The Company paid a stockholder \$877 and \$4,384 for leased office spaces for the three and nine months ended September 30, 2009 respectively.

NOTE 14 SEGMENTS

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 nine months ended September 30, 2009 and 2008 (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---------------------------------------|----------------------------------|------------------|--------------------------------------|-----------------------------------|
| | 2009 | 2008 | 2009 | 2008 |
| Revenues: | | | | |
| Crude oil | \$ 14,404 | \$ 19,060 | \$ 34,655 | \$ 44,052 |
| Contract drilling | - | - | - | - |
| Total revenues | \$ 14,404 | \$ 19,060 | \$ 34,655 | \$ 44,052 |
| Gross profit: | | | | |
| Crude oil | \$ 8,818 | \$ 9,907 | \$ 21,319 | \$ 23,631 |
| Contract drilling | - | - | - | - |
| Total gross profit | \$ 8,818 | \$ 9,907 | \$ 21,319 | \$ 23,631 |
| Income from operations: | | | | |
| Crude oil | \$ 8,534 | \$ 9,510 | \$ 20,579 | \$ 22,661 |
| Contract drilling | - | - | - | - |
| Total income from operations | 8,534 | 9,510 | 20,579 | 22,661 |
| Corporate and other | (1,659) | (1,454) | (4,630) | (3,077) |
| Net income before income taxes | \$ 6,875 | \$ 8,056 | \$ 15,949 | \$ 19,584 |
| | | | September 30, 2009 (Unaudited) | December 31, 2008 (Audited) |
| Total assets | | | | |
| Crude oil | | | \$ 104,648 | \$ 90,023 |
| Contract drilling | | | 18,264 | - |
| Intangible assets, net | | | 1,646 | - |
| Corporate and other | | | 1,769 | 2,107 |
| | | | \$ 126,327 | \$ 92,130 |

NOTE 15 CONCENTRATIONS AND RISKS

During 2009, 99% and 1% of the Company's assets were located in the PRC and the United States respectively.

During 2009, 100% of the Company's revenues were derived from one customer located in the PRC. The Oil Lease requires the Company to sell crude oil to PetroChina only.

The accounts receivable from PetroChina as of September 30, 2009 was \$6,509,440.

NOTE 16 RECLASSIFICATIONS

Certain reclassifications have been made in the condensed consolidated financial statements for the nine months ended September 30, 2008 to conform to the current period's presentation.

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NOTE 17 THE EFFECT OF RECENTLY ISSUED ACCOUNTING STANDARDS

On December 31, 2008, the SEC published the revised rules and interpretations updating its oil and gas reporting requirements. Many of the revisions are updates to definitions in existing oil and gas rules to make them consistent with the petroleum resources management system, which is a widely accepted standard for the management of petroleum resources that was developed by several industry organizations. Key revisions include the ability to include nontraditional resources in reserves, the use of new technology for determining reserves, permitting disclosure of probable and possible reserves, and changes to the pricing used in determining reserves. To determine reserves companies must use a 12-month average price. The Company is required to comply with the amended disclosure requirement for registration statements filed after January 1, 2010, and for annual reports for fiscal years ending on or after December 15, 2009. Early adoption is not permitted. The Company is currently assessing the impact that the adoption will have on the Company's disclosures, operating results, financial position and cash flows.

In December 2008, the FASB issued Staff Position No. FAS 132(R)-1 "Employers' Disclosures about Postretirement Benefit Plan Assets" ("FSP FAS 132(R)-1") (ASC Topic 715-20-65). FSP FAS 132(R)-1 (ASC Topic 715-20-65) requires more detailed disclosures about employers' plan assets in a defined benefit pension or other postretirement plan, including employers' investment strategies, major categories of plan assets, concentrations of risk within plan assets, and inputs and valuation techniques used to measure the fair value of plan assets. FSP FAS 132(R)-1 (ASC Topic 715-20-65) also requires, for fair value measurements using significant unobservable inputs (Level 3), disclosure of the effect of the measurements on changes in plan assets for the period. The disclosures about plan assets required by FSP FAS 132(R)-1 (ASC Topic 715-20-65) must be provided for fiscal years ending after December 15, 2009. As this pronouncement is only disclosure-related, it will not have an impact on the financial position and results of operations.

In May 2009, the FASB issued a new statement that establishes general standards of accounting for, and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The new statement, located in ASC Topic 855 Subsequent Events (formerly SFAS 165, Subsequent Events) requires entities to disclose the date through which subsequent events were evaluated as well as the rationale for why that date was selected, that is, whether that date represents the date the financial statements were issued or were available to be issued. The new statement is effective for interim or annual periods ending after June 15, 2009, which was the quarter ending June 30, 2009 for the Company. The adoption of this new statement did not have a material impact on our consolidated financial statements.

In June 2009, the FASB issued SFAS No. 166 "Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140" ("SFAS 166") (ASC Topic 810). SFAS 166 (not part of the codification yet) amends various provisions of SFAS No. 140 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125" by removing the concept of a qualifying special-purpose entity and removes the exception from applying FIN 46(R) to variable interest entities that are qualifying special-purpose entities; limits the circumstances in which a transferor derecognizes a portion or component of a financial asset; defines a participating interest; requires a transferor to recognize and initially measure at fair value all assets obtained and liabilities incurred as a result of a transfer accounted for as a sale; and requires enhanced disclosure; among others. SFAS 166 will be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Early adoption is not permitted. This guidance will be codified under FASB ASC

Topic 860, "Transfers and Servicing" when it becomes effective. The Company does not expect the standard to have any impact on the Company's financial position.

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NOTE 17 THE EFFECT OF RECENTLY ISSUED ACCOUNTING STANDARDS (CONTINUED)

In June 2009, the FASB issued SFAS No. 167 “Amendments to FASB Interpretation No. 46(R)” (“SFAS 167”) (not part of the codification yet). SFAS 167 amends FASB Interpretation No. 46 (Revised December 2003) “Consolidation of Variable Interest Entities—an interpretation of ARB No. 51” (FIN 46(R)) to require an enterprise to perform an analysis to determine whether the enterprise’s variable interest or interests give it a controlling financial interest in a variable interest entity; to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity; to eliminate the quantitative approach previously required for determining the primary beneficiary of a variable interest entity; to add an additional reconsideration event for determining whether an entity is a variable interest entity when any changes in facts and circumstances occur such that holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity’s economic performance; and to require enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise’s involvement in a variable interest entity. SFAS 167 will be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Early adoption is not permitted. This guidance will be codified under FASB ASC Topic 810, “Consolidation” when it becomes effective. The Company does not expect the standard to have any impact on the Company’s financial position.

In August 2009, the FASB issued ASU No. 2009-05 “Measuring Liabilities at Fair Value”, now codified under FASB ASC Topic 820, “Fair Value Measurements and Disclosures”, (“ASU 2009-05”) which amends Fair Value Measurements and Disclosures – Overall (ASC Topic 820-10) to provide guidance on the fair value measurement of liabilities. This update requires clarification for circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques: 1) a valuation technique that uses either the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as an asset; or 2) another valuation technique that is consistent with the principles in ASC Topic 820 such as the income and market approach to valuation. The amendments in this update also clarify that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. This update further clarifies that if the fair value of a liability is determined by reference to a quoted price in an active market for an identical liability, that price would be considered a Level 1 measurement in the fair value hierarchy. Similarly, if the identical liability has a quoted price when traded as an asset in an active market, it is also a Level 1 fair value measurement if no adjustments to the quoted price of the asset are required. This update is effective for our fourth quarter 2009. Management does not expect this new guidance to have a material impact on the Company’s consolidated financial statements.

In October 2009, the FASB issued ASU 2009-13, “Multiple-Deliverable Revenue Arrangements”, now codified under FASB ASC Topic 605, “Revenue Recognition”, (“ASU 2009-13”). ASU 2009-13 requires entities to allocate revenue in an arrangement using estimated selling prices of the delivered goods and services based on a selling price hierarchy. The amendments eliminate the residual method of revenue allocation and require revenue to be allocated using the relative selling price method. ASU 2009-13 should be applied on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. Management is currently evaluating the potential impact of ASU2009-13 on our financial statements.

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NOTE 17 THE EFFECT OF RECENTLY ISSUED ACCOUNTING STANDARDS (CONTINUED)

In October 2009, the FASB issued ASU 2009-14, "Certain Arrangements That Include Software Elements, now codified under FASB ASC Topic 985, "Software", ("ASU 2009-14"). ASU 2009-14 removes tangible products from the scope of software revenue guidance and provides guidance on determining whether software deliverables in an arrangement that includes a tangible product are covered by the scope of the software revenue guidance. ASU 2009-14 should be applied on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. Management is currently evaluating the potential impact of ASU 2009-14 on our financial statements.

In October, 2009, the FASB issued ASU 2009-15, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing", now codified under FASB ASC Topic 470 "Debt", ("ASU 2009-15"), and provides guidance for accounting and reporting for own-share lending arrangements issued in contemplation of a convertible debt issuance. At the date of issuance, a share-lending arrangement entered into on an entity's own shares should be measured at fair value in accordance with Topic 820 and recognized as an issuance cost, with an offset to additional paid-in capital. Loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs. The amendments also require several disclosures including a description and the terms of the arrangement and the reason for entering into the arrangement. The effective dates of the amendments are dependent upon the date the share-lending arrangement was entered into and include retrospective application for arrangements outstanding as of the beginning of fiscal years beginning on or after December 15, 2009. Management is currently evaluating the potential impact of ASU 2009-15 on our financial statements.

NOTE 18 SUBSEQUENT EVENTS

During October 2009, the Company repaid \$5,046,000 due to a stockholder.

On October 9, 2009, the Company issued 632,562 shares of common stock to the Investor for the partial exercise of Series B Warrants issued by the Company to the Investor on February 28, 2008 at the exercise price of \$2.35 per share. The payment of the aggregate exercise price of \$1,486,521 was made in the form of cancellation of repayment of principal and interest accrued as of September 30, 2009 pursuant to the 8% Secured Debenture issued to the Investor on February 28, 2008 as amended on March 5, 2009.

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 259 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 | 227 | 5,292,591 |
| Da34 | 2,298 | 7 | 13,240 |
| Gu31 | 1,779 | 7 | 95,729 |
| He301 | 2,471 | 18 | 52,232 |
| Total | 11,663 | 259 | 5,453,792 |

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. 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 company 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 LongDe in trust for Song Yuan Technical. On March 17, 2008, Song Yuan Technical additionally acquired an additional 20% equity interest in LongDe, of which it acquired a 10% of the equity interest in LongDe from Sun Peng, and 10% of the equity interest in LongDe from Ai Chang Shan. Accordingly, Song Yuan Technical now owns directly 90% of the equity interests in LongDe, with Ai ChangShan 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.

Acquisition of Yu Qiao

On January 26, 2007, the Company, through its 90% owned subsidiary Song Yuan Technical, acquired beneficial ownership of all of the interests in Yu Qiao from Ms. Ju. In consideration for such acquisition, the Company issued to Ms. Ju an aggregate of 10 million shares of its common stock (the "Acquisition Shares"), having a market value of approximately U.S.\$3.1 million. However, on June 29, 2007, the Company, Mr. Wang and Ms. Ju entered into an agreement pursuant to which, among other things, all of the Acquisition Shares were contributed to the Company.

In order to comply with certain PRC laws relating to foreign entities' ownership of oil and gas company in the PRC, the former owners of Yu Qiao, Wang Pingwu and Meng Xiangyun, held 10%, and 20% of the equity interests, respectively, in Yu Qiao in trust for the benefit of Song Yuan Technical. The laws of the PRC govern the agreements by which the Company acquired Yu Qiao and by which the former owners of Yu Qiao hold equity interests in trust. See "Regulations Affecting Our Business" under "Risk Factors." Subsequently, on March 17, 2008, Song Yuan Technical acquired from Meng Xiangyun the 20% equity interest which he had held in Yu Qiao. Accordingly, Song Yuan Technical currently directly holds a 90% equity interest in Yu Qiao, while Wang Hongjun holds a 10% equity interest in Yu Qiao in trust for the benefit of Song Yuan Technical. Thus, the Company, through Song Yuan Technical, currently effectively controls 90% of the equity interests in Yu Qiao, while the remaining 10% equity interests in Yu Qiao is effectively controlled by Ms. Ju.

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 seven drilling teams with the same number of rigs in house, which include one 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. Two of its seven drilling teams have received approvals issued by the Qualification Administrative Committee of China National Petroleum Corporation (PetroChina) and another three drilling teams are expected to be granted such approval by the end of the year when the Committee conducts the annual inspection on the qualification certificates for drilling for PetroChina oilfields. Tiancheng has existing drilling contracts with PetroChina and other private oil companies to provide drilling and oilfield services.

The acquisition of Tiancheng was accounted for as a purchase under ASC Topic 805 Business Combinations (formerly SFAS No. 141(revised 2007), Business Combinations). Accordingly, the operating results of Tiancheng have been included in the consolidated statements of operation and comprehensive income after the effective date of the acquisition of September 25, 2009.

The following table reflects the unaudited pro forma combined results of operations for the three and nine months ended September 30, 2009, assuming the acquisition of Tiancheng had occurred and was completed at the beginning of 2009.

| | Three months ended September 30, 2009 | Nine months ended September 30, 2009 |
|----------------------|--|---|
| Revenues | \$ 19,931,524 | \$ 49,355,004 |
| Net income | \$ 5,794,685 | \$ 13,962,300 |
| Net income per share | | |
| - basic | \$ 0.27 | \$ 0.66 |
| - diluted | \$ 0.24 | \$ 0.63 |

For more financial information about the Tiancheng acquisition, please refer to the financial statement Note 4 Business Combination section.

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 September 30, 2009, the Company had a total of 259 producing wells, including 227 producing wells at the Qian'an 112 oilfield, 18 producing wells at the Hetingbao 301 oilfield, 7 producing wells at the Daan 34 oilfield and 7 producing wells at the Gudian 31 oilfield. Additionally, we have 3 wells under construction in Qian'an 112 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 |
| Jul-08 | 133 | 116 |
| Aug-08 | 116 | 119 |
| Sep-08 | 103 | 101 |
| Oct-08 | 76 | 85 |
| Nov-08 | 57 | 68 |
| Dec-08 | 41 | 45 |
| Jan-09 | 41 | 41 |
| Feb-09 | 39 | 38 |
| Mar-09 | 47 | 41 |
| Apr-09 | 49 | 46 |
| May-09 | 59 | 52 |
| Jun-09 | 69 | 54 |
| Jul-09 | 64 | 63 |
| Aug-09 | 71 | 61 |
| Sep-09 | 69 | 69 |

(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 September 30, 2009 (the “Current Quarter”), the sale price we received for our crude oil production averaged \$64.33 per barrel, compared with \$111.90 per barrel for the three months ended September 30, 2008 (the “Comparable Quarter”). For the nine months ended September 30, 2009, the sale price we received for our crude oil production averaged \$51.53 per barrel, compared with \$103.60 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 nine months ended September 30, 2009 and September 30, 2008.

| | Three months ended September 30 | | Nine months ended September 30 | |
|--------------------------|------------------------------------|---------------|-----------------------------------|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| Oil Output (Bbl) | 224,750 | 172,730 | 671,352 | 422,788 |
| Avg. Sale Price (\$/bbl) | \$ 64.33 | \$ 111.90 | \$ 51.53 | \$ 103.60 |
| Operating Revenue | \$ 14,403,921 | \$ 19,060,007 | \$ 34,654,549 | \$ 44,051,519 |
| Operating Expenses | | | | |
| Production Costs | \$ 1,103,163 | \$ 895,155 | \$ 2,769,762 | \$ 2,390,432 |
| Depreciation | \$ 2,824,981 | \$ 3,774,327 | \$ 8,283,230 | \$ 8,155,321 |
| Amortization | \$ 2,982 | \$ 2,975 | \$ 8,943 | \$ 8,743 |
| Oil Surcharge | \$ 1,655,000 | \$ 4,480,955 | \$ 2,273,167 | \$ 9,865,655 |
| Gross Profit | \$ 8,817,795 | \$ 9,906,595 | \$ 21,319,447 | \$ 23,631,368 |

As shown in the above table, the significant decline of oil prices in 2009 compared with 2008 caused our revenues to decrease substantially. However, increases in our production output partially offset the impact of this decline in oil prices.

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 |
| Jul-08 | 5854 | 116 |
| Aug-08 | 6026 | 119 |
| Sep-08 | 5095 | 101 |
| Oct-08 | 4280 | 85 |
| Nov-08 | 3423 | 68 |
| Dec-08 | 2267 | 45 |
| Jan-09 | 2078 | 41 |
| Feb-09 | 1941 | 38 |
| Mar-09 | 2051 | 41 |
| Apr-09 | 2302 | 46 |
| May-09 | 2603 | 52 |
| Jun-09 | 2708 | 54 |
| Jul-09 | 3180 | 63 |
| Aug-09 | 3064 | 61 |
| Sep-09 | 3475 | 69 |

(Note: 1 Ton = 7.38 Bbls, Exchange rate 1 USD = 6.8376 RMB as of 9/30/2009)

As noted in the table above, oil prices have declined significantly from their August 2008 levels. The decline in commodity prices has caused us to reduce our 2009 level of drilling activity and spending.

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 seven drilling teams with the same number of rigs, which include one 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. Two of its seven drilling teams have received approvals issued by the Qualification Administrative Committee of China National Petroleum Corporation (PetroChina) and another three drilling teams are expected to be granted such approval by the end of the

year when the Committee conducts the annual inspection on the qualification certificates for drilling in PetroChina oilfields.

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.

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In the first nine months of 2009, Tiancheng has completed contracts to drill 80 shallow wells, which include 74 wells for state-owned PetroChina Jilin Branch and six wells for non-state-owned Daqing Shunwei Energy Development Co. Ltd. The total drilling depth accomplished this year is 105,896 meters (~347,428 feet), with the revenue of \$14,700,455 and net income of \$4,820,661 or \$0.22 in fully-diluted, pro forma EPS for nine months ended September 30, 2009. Tiancheng currently has existing contracts to drill 86 additional wells, and more contracts are under negotiation to increase the utilization of rigs and continue to grow sales revenue.

RESULTS OF OPERATIONS

Three Months Ended September 30, 2009 Compared To Three Months Ended September 30, 2008

Revenues. Revenues for the Current Quarter were \$14,403,921 compared to \$19,060,007 for the Comparable Quarter, a decrease of \$4,656,086, or 24%. This decrease was due to a decrease in the average price we received for our crude oil. The average oil price for the Current Quarter was \$64.33, a 43% decrease from \$111.90 for the Comparable Quarter. Our output of crude oil for the Current Quarter was 224,219 barrels compared to 172,730 barrels for the Comparable Quarter, an increase of 30%, which substantially offset the impact of lower oil prices. This increase in production was mainly due to: (i) an increase in the number of producing wells from 218 in the Comparable Quarter to 259 in the Current Quarter; (ii) refracturing and other technical improvements made to the existing wells; and (iii) implementation of a water injection network, which helped to maintain production levels at certain of our existing wells.

Cost of sales. Cost of sales decreased by 39%, from \$9,153,412 for the three months ended September 30, 2008 to \$5,586,126 for the three months ended September 30, 2009. The decrease in cost of sales resulted primarily from a decrease in the oil surcharge paid to the PRC government, due to the decline in oil prices generally. For the Current Quarter, the Company paid an oil surcharge of \$1,655,000 to the PRC government as compared to \$4,480,955 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 |
|-------------|----------------|
| \$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 \$1,059,744 for the Current Quarter, compared to \$978,700 for the Comparable Quarter, an increase of 8%. This increase is primarily a result of an increase in consulting fee from \$91,926 in the Comparable Quarter to \$142,332 in the Current Quarter, as well as an increase in professional fees from \$42,850 in the Comparable Quarter to \$98,261 in the Current Quarter as a result of recent business development activities.

Other Income (Expense). Other expenses increased from \$871,451 for the Comparable Quarter to \$883,200 for the Current Quarter. This increase is primarily the result of increase in other expense which increased from \$2,000 in the Comparable Quarter to \$20,780 in the current quarter.

Net Income. Net income decreased by 18%, from \$4,954,182 for the Comparable Quarter to \$4,052,709 for the Current Quarter, primarily as a result of the decrease in average selling price and increased non-cash expenses as described above.

Nine Months Ended September 30, 2009 Compared To Nine Months Ended September 30, 2008

Revenues. Revenues for the nine months ended September 30, 2009 were \$34,654,549 compared to \$44,051,519 for the nine months ended September 30, 2008, a decrease of \$9,396,970, or 21%. This decrease was due to a decrease in the average price we received for our crude oil. The average oil price for the nine months ended September 30, 2009 was \$51.53, a 50% decrease from \$103.60 for the same period in 2008. Our output of crude oil for the nine months ended September 30, 2009 was 671,352 barrels compared to 422,788 barrels for the same period in 2008, an increase of 59%, which substantially offset the impact of lower oil prices. This increase in production was mainly due to: (i) an increase in the number of producing wells, (ii) refracturing and other technical improvements made to the existing wells; and (iii) implementation of a water injection network, which helped to maintain production levels at certain of our existing wells.

Cost of sales. Cost of sales decreased by 35%, from \$20,420,151 for the nine months ended September 30, 2008 to \$13,335,102 for the nine months ended September 30, 2009. The decrease in cost of sales resulted primarily from a decrease in the oil surcharge paid to the PRC government, due to the decline in oil prices generally. For the nine months ended September 30, 2009, the Company paid an oil surcharge of \$2,273,167 to the PRC government as compared to \$9,865,655 paid for the same period in 2008. 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 \$2,764,225 for the nine months ended September 30, 2009, compared to \$1,960,278 for the nine months ended September 30, 2008, an increase of 41%. This increase is primarily a result of an increase of approximately \$593,137 in selling, general and administrative costs ("SG&A"). SG&A costs increased largely due to non-cash charges associated with stock and option grants made to Directors and certain key employees in the second and third quarters of 2008. Amortization of the discount on the debenture was recognized for only seven out of nine months in the Comparable Period, versus the full nine months in the Current Period, which accounts for the increase. In addition, professional fees increased from \$140,180 in the Comparable Quarter to \$323,309 in the Current Quarter due to the Company's recent business development activities.

Other Income (Expense). Other expenses increased from \$2,086,952 for the nine months ended September 30, 2008 to \$2,606,155 for the nine months ended September 30, 2009. This increase is primarily the result of increase in amortization of the discount on debenture which increased from \$1,135,874 in the Comparable Quarter to \$1,515,473 in the Current Quarter.

Net Income. Net income decreased by 25% from \$12,201,246 for the nine months ended September 30, 2008 to \$9,141,639 for the nine months ended September 30, 2009, primarily as a result of the decrease in average selling price and increased non-cash expenses as described above.

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 September 30, 2009, the Company had cash and cash equivalents of \$33,158,348, other current assets of \$10,497,211 and current liabilities of \$29,043,106. For the nine months ended September 30, 2009, our primary sources of liquidity were \$10,687,746 provided by operating activities and \$20,327,004 in cash provided by financing activities. This cash balance of \$33,158,348 represents an increase of \$10,483,324 over our cash balance as of June 30, 2009 and an increase of \$19,919,135 over our cash balance as of December 31, 2008.

Net cash provided by operating activities was \$10,687,746 for the nine months ended September 30, 2009 compared to net cash provided by operating activities of \$17,643,184 for the same period in 2008. The decrease in net cash provided by operating activities was the result of a number of changes in our operating accounts. Cash from operating activities decreased due to a reduction in net income and higher cash payments of income and other taxes. Also the decrease in accounts receivable and increase in accounts payable in the Current Period compared to the Comparable Period caused the reduction.

Net cash used in investing activities was \$11,048,307 for the nine months ended September 30, 2009 compared to \$19,618,655 for the same period in 2008. This decrease is primarily due to the significant decrease in purchase of oil

and gas properties of \$15,246,968 during the nine months ended September 30, 2009.

Net cash provided by financing activities was \$20,327,004 for the nine months ended September 30, 2009 as compared to \$11,091,105 for the same period in 2008. This was primarily a result of the financing by the issuance and sale in a public offering by the Company of an aggregate of 4,000,000 shares of its common stock on September 15, 2009, at a price of \$4.60 per share and warrants to purchase up to an additional 800,000 shares of common stock. The Company received gross proceeds of approximately \$18.4 million before placement agent and other expenses.

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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.

Capital Commitments

As of September 30, 2009, the Company had commitments for capital expenditure of \$9,426,000 with a contractor to complete the drilling of 43 oil wells.

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 CO₂ 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 September 30, 2009, we have drilled 262 wells out of the 675 wells that we believe can be drilled in our four oilfields. Of these, 259 are produced oil in the Current Quarter and 3 are the wells under construction. 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 \$7.36 per barrel, as compared to \$25.94 per barrel 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 and gas 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 and gas properties generally results in higher capitalized costs and higher DD&A rates compared to the successful efforts method of accounting for oil and gas properties.

RECENT ACCOUNTING PRONOUNCEMENTS updated

On December 31, 2008, the SEC published the revised rules and interpretations updating its oil and gas reporting requirements. Many of the revisions are updates to definitions in existing oil and gas rules to make them consistent with the petroleum resources management system, which is a widely accepted standard for the management of petroleum resources that was developed by several industry organizations. Key revisions include the ability to include nontraditional resources in reserves, the use of new technology for determining reserves, permitting disclosure of probable and possible reserves, and changes to the pricing used in determining reserves. To determine reserves companies must use a 12-month average price. The Company is required to comply with the amended disclosure requirement for registration statements filed after January 1, 2010, and for annual reports for fiscal years ending on or after December 15, 2009. Early adoption is not permitted. The Company is currently assessing the impact that the adoption will have on the Company's disclosures, operating results, financial position and cash flows.

In December 2008, the FASB issued Staff Position No. FAS 132(R)-1 "Employers' Disclosures about Postretirement Benefit Plan Assets" ("FSP FAS 132(R)-1") (ASC Topic 715-20-65). FSP FAS 132(R)-1 (ASC Topic 715-20-65) requires more detailed disclosures about employers' plan assets in a defined benefit pension or other postretirement plan, including employers' investment strategies, major categories of plan assets, concentrations of risk within plan assets, and inputs and valuation techniques used to measure the fair value of plan assets. FSP FAS 132(R)-1 (ASC Topic 715-20-65) also requires, for fair value measurements using significant unobservable inputs (Level 3), disclosure of the effect of the measurements on changes in plan assets for the period. The disclosures about plan assets required by FSP FAS 132(R)-1 (ASC Topic 715-20-65) must be provided for fiscal years ending after December 15, 2009. As this pronouncement is only disclosure-related, it will not have an impact on the financial position and results of operations.

In May 2009, the FASB issued a new statement that establishes general standards of accounting for, and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be

issued. The new statement, located in ASC Topic 855 Subsequent Events (formerly SFAS 165, Subsequent Events) requires entities to disclose the date through which subsequent events were evaluated as well as the rationale for why that date was selected, that is, whether that date represents the date the financial statements were issued or were available to be issued. The new statement is effective for interim or annual periods ending after June 15, 2009, which was the quarter ending June 30, 2009 for the Company. The adoption of this new statement did not have a material impact on our consolidated financial statements.

In June 2009, the FASB issued SFAS No. 166 “Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140” (“SFAS 166”) (ASC Topic 810). SFAS 166 (not part of the codification yet) amends various provisions of SFAS No. 140 “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125” by removing the concept of a qualifying special-purpose entity and removes the exception from applying FIN 46(R) to variable interest entities that are qualifying special-purpose entities; limits the circumstances in which a transferor derecognizes a portion or component of a financial asset; defines a participating interest; requires a transferor to recognize and initially measure at fair value all assets obtained and liabilities incurred as a result of a transfer accounted for as a sale; and requires enhanced disclosure; among others. SFAS 166 will be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Early adoption is not permitted. This guidance will be codified under FASB ASC Topic 860, “Transfers and Servicing” when it becomes effective. The Company does not expect the standard to have any impact on the Company’s financial position.

In June 2009, the FASB issued SFAS No. 167 “Amendments to FASB Interpretation No. 46(R)” (“SFAS 167”) (not part of the codification yet). SFAS 167 amends FASB Interpretation No. 46 (Revised December 2003) “Consolidation of Variable Interest Entities—an interpretation of ARB No. 51” (FIN 46(R)) to require an enterprise to perform an analysis to determine whether the enterprise’s variable interest or interests give it a controlling financial interest in a variable interest entity; to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity; to eliminate the quantitative approach previously required for determining the primary beneficiary of a variable interest entity; to add an additional reconsideration event for determining whether an entity is a variable interest entity when any changes in facts and circumstances occur such that holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity’s economic performance; and to require enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise’s involvement in a variable interest entity. SFAS 167 will be effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Early adoption is not permitted. This guidance will be codified under FASB ASC Topic 810, “Consolidation” when it becomes effective. The Company does not expect the standard to have any impact on the Company’s financial position.

In August 2009, the FASB issued ASU No. 2009-05 “Measuring Liabilities at Fair Value”, now codified under FASB ASC Topic 820, “Fair Value Measurements and Disclosures”, (“ASU 2009-05”) which amends Fair Value Measurements and Disclosures – Overall (ASC Topic 820-10) to provide guidance on the fair value measurement of liabilities. This update requires clarification for circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques: 1) a valuation technique that uses either the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as an asset; or 2) another valuation technique that is consistent with the principles in ASC Topic 820 such as the income and market approach to valuation. The amendments in this update also clarify that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. This update further clarifies that if the fair value of a liability is determined by reference to a quoted price in an active market for an identical liability, that price would be considered a Level 1 measurement in the fair value hierarchy. Similarly, if the identical liability has a quoted price when traded as an asset in an active market, it is also a Level 1 fair value measurement if no adjustments to the quoted price of the asset are required. This update is effective for our fourth quarter 2009. Management does not expect this new guidance to have a material impact on the Company’s consolidated financial statements.

In October 2009, the FASB issued ASU 2009-13, “Multiple-Deliverable Revenue Arrangements”, now codified under FASB ASC Topic 605, “Revenue Recognition”, (“ASU 2009-13”). ASU 2009-13 requires entities to allocate revenue in

an arrangement using estimated selling prices of the delivered goods and services based on a selling price hierarchy. The amendments eliminate the residual method of revenue allocation and require revenue to be allocated using the relative selling price method. ASU 2009-13 should be applied on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. Management is currently evaluating the potential impact of ASU2009-13 on our financial statements.

In October 2009, the FASB issued ASU 2009-14, “Certain Arrangements That Include Software Elements, now codified under FASB ASC Topic 985, “Software”, (“ASU 2009-14”). ASU 2009-14 removes tangible products from the scope of software revenue guidance and provides guidance on determining whether software deliverables in an arrangement that includes a tangible product are covered by the scope of the software revenue guidance. ASU 2009-14 should be applied on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. Management is currently evaluating the potential impact of ASU 2009-14 on our financial statements.

In October, 2009, the FASB issued ASU 2009-15, “Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing”, now codified under FASB ASC Topic 470 “Debt”, (“ASU 2009-15”), and provides guidance for accounting and reporting for own-share lending arrangements issued in contemplation of a convertible debt issuance. At the date of issuance, a share-lending arrangement entered into on an entity’s own shares should be measured at fair value in accordance with Topic 820 and recognized as an issuance cost, with an offset to additional paid-in capital. Loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs. The amendments also require several disclosures including a description and the terms of the arrangement and the reason for entering into the arrangement. The effective dates of the amendments are dependent upon the date the share-lending arrangement was entered into and include retrospective application for arrangements outstanding as of the beginning of fiscal years beginning on or after December 15, 2009. Management is currently evaluating the potential impact of ASU 2009-15 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 operating effectively.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting that occurred during the third quarter of fiscal year 2009 that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

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.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

| Exhibit No. | Description |
|-------------|---|
| 31.1 | Certification of Principal Executive 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. |
| 31.2 | Certification of 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 pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of 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

November 16, 2009

By: /s/ Wang Hongjun
Wang Hongjun
President
(Principal Executive Officer)

November 16, 2009

/s/ Zhang Yang
Zhang Yang
Chief Financial Officer
(Principal Financial and
Accounting
Officer)

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