CHINA NORTH EAST PETROLEUM HOLDINGS LTD
Form 10-Q/A
August 31, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q /A
(Amendment No. 1)

x QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the quarterly period ended September 30, 2008

o 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	87-0638750
(State of other jurisdiction of incorporation or organization)	(IRS Employer identification No.)

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

(212) 307-3568
(Issuer's telephone number)

Check whether the issuer (1) 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 x No o

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. (Check one):

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting	x

company

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

Number of shares of common stock outstanding as of November 12, 2008: 20,784,080

EXPLANATORY NOTE

This Amendment on Form 10-Q/A (the “Amended Filing”) amends the quarterly report on Form 10-Q for the quarter ended September 30, 2008, originally filed on November 14, 2008 (the “Original Filing”), of China North East Petroleum Holdings Limited. (the “Company”). The purpose of this amendment is to revise certain non-cash items in Part I, Item Financial Statements: (i) reclassify warrants issued in conjunction with a secured debenture issued on February 28, 2008, in accordance with FASB’s Emerging Issues Task force 00-19 as liability instruments rather than equity instruments; (ii) the change in fair value of those warrants from the date of issuance through the end of the reporting period; (iii) effective interest expense arising from amortization of the discount to the carrying value of the secured debenture issued on February 28, 2008; (iv) the recording of warrants issued to investment consultants in connection with the secured debenture issued on February 28, 2008 as deferred financing costs instead of consulting fees; (v) the amount of amortization of deferred financing costs associated with the issuance of the secured debenture issued on February 28, 2008; and (vi) amount payable to a consultant included in accrued liabilities.

As a result of the revisions in Part I, Item 1 of this Amended Filing, Part I, Item 2, Management’s Discussion and Analysis of Financial condition and Results of Operation, is revised to incorporate all the revisions made to Part I, Item 1 as stated in the previous paragraph. Furthermore, due to the revisions described above, management has concluded that the Company did not maintain effective controls over financial reporting, and accordingly Part I, Item 4T is revised to state such conclusion and to state the remedial actions which the Company has taken and will take to attain effective control over its financial reporting.

In accordance with Rule 12b-15 under the Exchange Act, each item of the Original Filing that is amended by this Amended Filing is also restated in its entirety, and this Amended Filing is accompanied by currently dated certifications on Exhibits 31.1 and 32.1 by the Company’s Chief Executive Officer and Principal Financial Officer. Except as described above, this Amended Filing does not amend, update, or change any items, financial statements, or other disclosures in the Original Filing. Information not affected by the changes described above is unchanged and reflects the disclosures made at the time of the Original Filing. Accordingly, this Amended Filing should be read in conjunction with the Original Filing and our other SEC filings subsequent to the filing of the Original Filing, including any amendments to those filings. Capitalized terms not defined in the Amended Filing are as defined by the Original Filing.

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SPECIAL NOTE REGARDING FORWARD—LOOKING STATEMENTS

On one or more occasions, we may make forward-looking statements in this amended and restated Quarterly Report on Form 10-Q/A 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,” “projects,” “targets,” “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.
- 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 amended and restated quarterly report on Form 10-Q/A, 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 amended and restated Quarterly Report on Form 10-Q/A, 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 amended and restated Quarterly Report on Form 10-Q/A 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 “CNEH” 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
Condensed Consolidated Balance Sheets

	September 30, 2008 (Unaudited) (Restated)	December 31, 2007 (Audited)
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 7,762,017	$ 74,638
Accounts receivable, net	10,595,234	4,852,633
Prepaid expenses and other current assets	2,261,853	398,046
Value added tax recoverable	-	651,905
Total Current Assets	20,619,104	5,977,222
PROPERTY AND EQUIPMENT		
Oil and gas properties, net	56,007,998	40,345,008
Fixed assets, net	1,462,703	885,474
Oil and gas properties under construction	784,851	2,550,058
Total Property and Equipment	58,255,552	43,780,540
LAND USE RIGHTS, NET	39,168	45,076
DEFERRED FINANCING COSTS, NET	1,693,467	-
DEFERRED TAX ASSETS	209,102	-
TOTAL ASSETS	$ 80,816,393	$ 49,802,838
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 10,806,009	$ 6,580,930
Current portion of secured debenture	2,625,000	-
Other payables and accrued liabilities	947,069	1,020,980
Due to related parties	14,588	28,036
Note payable	-	273,444
Income tax and other taxes payable	7,605,514	2,687,449
Due to a stockholder	783,258	123,105
Total Current Liabilities	22,781,438	10,713,944
LONG-TERM LIABILITIES		
Accounts payable	7,783,956	15,467,661
Secured debenture, net of discount	3,767,527	-
Deferred tax liabilities	-	543,100

Due to a related party	486,714	3,118,085
Warrants	10,148,772	-
Total Long-term Liabilities	22,186,969	19,128,846
TOTAL LIABILITIES	44,968,407	29,842,790
COMMITMENTS AND CONTINGENCIES	-	-
MINORITY INTERESTS	3,014,421	1,124,964
STOCKHOLDERS' EQUITY		
Common stock ($0.001 par value, 150,000,000 shares authorized, 20,784,080 shares issued and outstanding as of September 30, 2008; 19,224,080 shares issued and outstanding as of December 31, 2007)	20,784	19,224
Additional paid-in capital	12,557,531	11,361,579
Deferred stock compensation	-	(27,125)
Retained earnings		
Unappropriated	15,954,119	5,200,907
Appropriated	916,263	916,263
Accumulated other comprehensive income	3,384,868	1,364,236
Total Stockholders' Equity	32,833,565	18,835,084
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 80,816,393	$ 49,802,838

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) Three months ended September 30		(Unaudited) Nine months ended September 30	
	2008 (Restated)	2007	2008 (Restated)	2007
NET SALES	$ 19,060,007	$ 5,826,506	$ 44,051,519	$ 11,804,007
COST OF SALES				
Production costs	895,155	704,568	2,390,432	1,669,166
Depreciation, depletion and amortization of oil properties	3,774,327	1,361,732	8,155,321	2,601,561
Amortization of land use rights	2,975	2,695	8,743	7,972
Government oil surcharge	4,480,955	848,315	9,865,655	1,500,902
Total Cost of Sales	9,153,412	2,917,310	20,420,151	5,779,601
GROSS PROFIT	9,906,595	2,909,196	23,631,368	6,024,406
OPERATING EXPENSES				
Selling, general and administrative expenses	1,527,175	194,697	2,080,836	694,103
Professional fees	69,590	26,245	202,573	46,245
Consulting fees	(116,092)	27,125	286,715	81,375
Depreciation of fixed assets	50,445	42,609	160,930	117,593
Total Operating Expenses	1,531,118	290,676	2,731,054	939,316
	-			
INCOME FROM OPERATIONS	8,375,477	2,618,520	20,900,314	5,085,090
OTHER INCOME (EXPENSE)				
Other income	809	-	66,651	-
Other expense	(2,000)	(3,878)	(107,601)	(3,878)
Interest expense	(296,761)	(28,186)	(721,805)	(51,290)
Amortization of deferred financing costs	(218,943)	-	(519,594)	-
Amortization of discount on debenture	(1,015,864)	-	(2,410,848)	-
Imputed interest expense	(16,794)	(6,404)	(49,535)	(139,079)
Interest income	4,238	615	34,204	1,105
Recovery of deposit from a supplier previously written off	-	2,515	-	358,609
Gain on disposal of fixed assets	-	460	-	15,217
Change in fair value of warrants	18,191,606	-	1,146,381	-
Total Other Income (Expense), net	16,646,291	(34,878)	(2,562,147)	180,684
NET INCOME BEFORE TAXES AND MINORITY INTERESTS	25,021,768	2,583,642	18,338,167	5,265,774
Income tax expense	(2,390,961)	(885,188)	(5,695,498)	(1,825,513)
Minority interests	(726,566)	(198,959)	(1,889,457)	(399,836)

NET INCOME	21,904,241	1,499,495	10,753,212	3,040,425
OTHER COMPREHENSIVE INCOME				
Foreign currency translation gain	152,651	235,873	2,020,632	450,633
COMPREHENSIVE INCOME	$ 22,056,892	$ 1,735,368	$ 12,773,844	$ 3,491,058
Net income per share				
- basic	$ 1.10	$ 0.08	$ 0.55	$ 0.12
- diluted	$ 1.06	$ 0.08	$ 0.55	$ 0.12
Weighted average number of shares outstanding during the period				
- basic	19,987,123	19,224,080	19,480,284	25,780,857
- diluted	20,676,711	19,224,080	19,624,216	25,780,857

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

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CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
For the nine months ended September 30, 2008 and 2007 (Unaudited)

	2008 (Restated)	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$10,753,212	$3,040,425
Adjusted to reconcile net income to cash provided by operating activities:		
Depreciation, depletion and amortization of oil properties	8,155,321	2,601,561
Depreciation of fixed assets	160,930	117,593
Amortization of land use rights	8,743	7,972
Amortization of deferred financing costs	519,594	-
Amortization of discount on debenture	2,410,848	-
Amortization of stock option compensation	263,584	-
Change in fair value of warrants	(1,146,381)	-
Warrants issued for services	62,393	-
Minority interests	1,889,457	399,836
Stocks issued for services	27,125	81,375
Stock-based compensation for service	810,000	-
Imputed interest expenses	49,535	139,079
Gain on disposal of fixed assets	-	(15,217)
Changes in operating assets and liabilities		
(Increase) decrease in:		
Accounts receivable	(5,742,601)	(2,026,688)
Prepaid expenses and other current assets	(1,863,807)	(262,501)
Due from related parties	-	38,692
Value added tax recoverable	651,905	(1,200,623)
Deferred tax assets	(209,102)	-
Increase (decrease) in:		
Accounts payable	(3,458,626)	3,781,456
Other payables and accrued liabilities	(73,911)	(2,824)
Income tax and other taxes payable	4,918,065	2,123,234
Deferred tax liabilities	(543,100)	363,774
Net cash provided by operating activities	17,643,184	9,187,144
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to oil and gas properties	(18,300,636)	(8,992,444)
Purchase of fixed assets	(668,233)	(321,211)
Additions to oil and gas properties under construction	(649,786)	(714,885)
Proceeds on disposal of fixed assets	-	23,451
Net cash used in investing activities	(19,618,655)	(10,005,089)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from the issuances of notes payable	-	798,128
Repayment of note payable	-	(133,021)
Payment of deferred financing costs	(1,186,229)	-
Proceeds from issuance of secured debenture	15,000,000	-

Repayment of secured debenture	(750,000)	-
Decrease in other loans payable	-	(25,612)
Proceeds from exercise of stock warrants	12,000	-
Increase in due to a stockholder	660,153	146,813
(Decrease) increase in due to related parties	(2,644,819)	1,280,048
Net cash provided by financing activities	11,091,105	2,066,356
EFFECT OF EXCHANGE RATE ON CASH	(1,428,255)	(950,576)
NET INCREASE IN CASH AND CASH EQUIVALENTS	7,687,379	297,835
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	74,638	13,746
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$7,762,017	$311,581
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Income tax expense	$4,932,518	$208,315
Interest expense	$721,805	$51,290

SUPPLEMENTAL DISCLOSURE OF NON-CASH OPERATING ACTIVITIES:

During 2008, the Company issued warrants in connection with the secured debenture to the investor and to investment consultants valued at $10,268,321 and $1,026,832, respectively

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, 2008
(UNAUDITED)

NOTE 1 RESTATEMENT OF PREVIOUSLY REPORTED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

On February 23, 2010, China North East Petroleum Holdings Limited (the "Company) determined that the Company's financial statements as of September 30, 2008 and for the three and nine month periods then ended should no longer be relied upon and should be restated as a result of certain non-cash errors contained therein regarding the accounting for: (i) warrants issued in conjunction with a secured debenture on February 28, 2008, which warrants should have been classified according to Emerging Issues Task Force ("EITF") 00-19 as liability instruments rather than equity instruments; (ii) the change in the fair value of those warrants from the date of issuance through the end of the reporting period; (iii) effective interest expense arising from amortization of the discount to the carrying value of the secured debenture; (iv) the recording of warrants issued to investment consultants in connection with the issuance of the secured debenture as deferred financing costs instead of consulting fees; (v) the amount of amortization of deferred financing costs associated with the issuance of that secured debenture; (vi) amounts payable to a consultant included in accrued liabilities; and (vii) compensation issued to employees in the form of stock.

As a result, the accompanying unaudited condensed consolidated financial statements as of September 30, 2008 and for the three and nine months then ended have been restated from the amounts previously reported. The information in the data table below represents only those income statement, balance sheet, cash flow and comprehensive income statement line items affected by the restatement.

STATEMENT OF OPERATIONS AND COMPREHENSIVE INCOME INFORMATION

	Three months ended September 30, 2008			Nine months ended September 30, 2008		
	As previously reported	Adjustments	As restated	As previously reported	Adjustments	As restated
Operating Expenses:						
Selling, general & administrative expenses	$ 793,479	$ 733,696	$ 1,527,175	$ 1,339,404	$ 741,432	$ 2,080,836
Professional fees	42,850	26,740	69,590	140,180	62,393	202,573
Consulting fees	91,926	(208,018)	(116,092)	319,764	(33,049)	286,715
Other Income (Expense):						
Amortization of deferred financing costs	(74,140)	(144,803)	(218,943)	(172,992)	(346,602)	(519,594)
Amortization of discount on debenture	(486,803)	(529,061)	(1,015,864)	(1,135,874)	(1,274,974)	(2,410,848)
	-	18,191,606	18,191,606	-	1,146,381	1,146,381

Change in fair value of warrants						
Net income	4,938,917	16,965,324	21,904,241	11,999,183	(1,245,971)	10,753,212
Comprehensive income	5,091,568	16,965,324	22,056,892	14,019,815	(1,245,971)	12,773,844
Net income per share -- Basic	0.25	0.85	1.10	0.62	(0.07)	0.55
Net income per share -- Diluted	0.24	0.82	1.06	0.61	(0.06)	0.55

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CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL
STATEMENTS AS OF SEPTEMBER 30, 2008
(UNAUDITED)

NOTE 1 RESTATEMENT OF PREVIOUSLY REPORTED CONDENSED FINANCIAL STATEMENTS (CONTINUED)

BALANCE SHEET INFORMATION

	As of September 30, 2008		
	As previously reported	Adjustments	As restated
Assets:			
Deferred financing costs, net	$ 1,013,237	$ 680,230	$ 1,693,467
Total Assets	80,136,163	680,230	80,816,393
Current Liabilities:			
Current portion of secured debenture	1,399,451	1,225,549	2,625,000
Other payables and accrued liabilities	825,947	121,122	947,069
Total current liabilities	21,434,767	1,346,671	22,781,438
Long-term Liabilities:			
Secured debenture, net of discount	6,197,571	(2,430,044)	3,767,527
Warrants	-	10,148,772	10,148,772
Total long-term liabilities	14,468,241	7,718,728	22,186,969
Stockholders' Equity:			
Additional paid-in capital	21,147,979	(8,590,448)	12,557,531
Deferred stock compensation	(1,451,250)	1,451,250	-
Retained earnings, unappropriated	17,200,090	(1,245,971)	15,954,119
Total stockholders’ equity	41,218,734	(8,385,169)	32,833,565
Total liabilities and stockholders’ equity	80,136,163	680,230	80,816,393

STATEMENT OF CASH FLOWS INFORMATION

	Nine months ended September 30, 2008		
	As previously reported	Adjustments	As restated
Net income	$ 11,999,183	$ (1,245,971)	$ 10,753,212
Adjustments to reconcile net income to cash provided by operating activities:			

Amortization of deferred financing costs	172,992	346,602	519,594
Amortization of discount on debenture	1,135,874	1,274,974	2,410,848
Amortization of stock option compensation	163,402	100,182	263,584
Change in fair value of warrants	-	(1,146,381)	(1,146,381)
Warrants issued for services	154,171	(91,778)	62,393
Stock-based compensation for service	168,750	641,250	810,000
Other payables and accrued liabilities	(195,033)	121,122	(73,911)

NOTE 2 BASIS OF PRESENTATION

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

In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments consisting only of normal recurring accruals considered necessary to present fairly the Company's financial position at September 30, 2008, the results of operations for the three and nine months ended September 30, 2008 and 2007 and cash flows for the nine months ended September 30, 2008 and 2007. The results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2008.

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL
STATEMENTS AS OF SEPTEMBER 30, 2008
(UNAUDITED)

NOTE 2 BASIS OF PRESENTATION (CONTINUED)

These financial statements should be read in conjunction with the Company's annual report on Form 10-K as filed with the Securities and Exchange Commission.

NOTE 3 ORGANIZATION

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

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

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

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

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

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 each contributed $1 million and $121,000, respectively, to the registered capital of Song Yuan North East Petroleum Technical Service Co., Ltd. (“Song Yuan Technical”) for a 90% and 10% share 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 extraction and production of crude oil in Jilin Province, PRC and operates 3 oilfields with a total exploration area of 39.2 square kilometers.

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.

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

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CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL
STATEMENTS AS OF SEPTEMBER 30, 2008
(UNAUDITED)

NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation

The accompanying unaudited condensed consolidated financial statements 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 (collectively, “the Company”). The minority 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.

Use of estimates

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

Foreign currency translation and other comprehensive income

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

For the subsidiaries whose functional currencies are other than the US dollar, all assets and liabilities accounts were translated at the exchange rate on the balance sheet date; stockholder's equity is translated at the historical rates and items in the statement of operations items and cash flow statements are translated at the average rate for the year. Translation adjustments resulting from this process are included in accumulated other comprehensive income in the statement of stockholders’ equity. The resulting translation gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred.

Accumulated other comprehensive income in the consolidated statement of stockholders’ equity amounted to $3,384,868 and $1,364,236 as of September 30, 2008 and December 31, 2007, respectively. The balance sheet amounts with the exception of equity at September 30, 2008 were translated at 6.8551 RMB to $1.00 USD. The average translation rates applied to statement of operations and cash flow statement amounts for the nine months ended September 30, 2008 was 6.99886 RMB to $1.00 USD.

Cash and concentration of risk

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

The Company's cash equivalents are exposed to concentration of credit risk. The Company maintains balances at financial institutions which, from time to time, may exceed Federal Deposit Insurance Corporation insured limits for the banks located in the United States. Balances at financial institutions or state owned banks within the PRC are not covered by insurance. As of September 30, 2008 and December 31, 2007, the Company had deposits in excess of federally insured limits totaling $906,270 and $0, respectively. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant risks on its cash in bank accounts.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Substantially all of the Company's operations are carried out in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in that country, and by the general state of that country's economy. The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in the United States. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

Revenue Recognition

The Company records revenues from the sales of oil when delivery to the customer (PetroChina) has occurred and title has transferred. This occurs when oil has been delivered to a PetroChina depot.

Pursuant to the Company's twenty year term oil leases entered into on May 2002 (for Qian 112, Daan 34 and Gudian 31 oilfields) and May 2003 (for Hetingbao 301 oilfield) with PetroChina, the Company is entitled to 80% of the Company's oil production for the first ten years and 60% of the Company's oil production for the second ten years. The Company receives payment for the net physical volume of oil delivered (either 80% or 60% by volume, depending upon the lease terms that are current at that point in time).

Major customers

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

Accounts receivables and allowance for doubtful accounts

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

Long-lived assets

Long-lived assets to be held and used in the Company's operations are reviewed for impairment whenever events or changes in circumstances indicate that the related carrying amount may not be recoverable. When the carrying amounts of long-lived assets exceed the fair value, which is generally based upon discounted future cash flows the Company records an impairment. No impairment was recorded during the quarters and nine months ended September 30, 2008 and 2007.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Financial instruments

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

Fair value of financial instruments

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

· Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

· Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the assets or liability, either directly or indirectly, for substantially the full term of the financial instruments.

· Level 3 inputs to the valuation methodology are unobservable and significant to the fair value.

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

Assets and liabilities measured at fair value on a recurring basis as of September 30, 2008 are summarized as follows (unaudited):

	Fair value measurement using inputs		
	Level 1	Level 2	Level 3
Liabilities:			
Derivative instruments – Warrants	$ -	$ -	$ 10,148,772
Total	$ -	$ -	$ 10,148,772

The Company determines the fair value of the warrants using a Black-Scholes option model using inputs that are derived from observable and unobservable data and are therefore considered Level 3 in the fair value hierarchy. See Note 9 for further information.

The carrying values of cash and cash equivalents, trade receivables, current trade payables, and short-term bank loans and debts approximate their fair values due to the short maturities of these instruments. The Company believes that the carrying value of non-current trade payables and the secured debenture at September 30, 2008 approximates fair value, after considering the various attributes of the debt and the Company's current credit standing (see Note 5, "Secured Debenture," for additional information regarding the carrying value of the secured debenture).

Deferred financing costs

The Company accounts for all third party costs incurred in associated with a material financing event as deferred financing costs. Deferred financing costs are capitalized and expensed over the term of the financing using the effective interest method. Deferred financing costs include the costs associated with the Company's issuance of the $15,000,000 secured debenture dated February 28, 2008 (see Note 5). The Company recorded amortization expense of $218,943 and $519,594 related to these costs during the three and nine months ended September 30, 2008.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Stock-Based Compensation

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

Property and equipment, net

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

Investments in unproved properties, including capitalized interest costs, are not depleted pending determination of the existence of proved reserves. Unproved reserves are assessed periodically to ascertain whether impairment has occurred. Unproved properties whose costs are individually significant are assessed individually by considering the primary lease terms of the properties, the holding periods of the properties, and geographic and geologic data obtained relating to the properties. Where it is not practicable to assess individually the amount of impairment of properties for which costs are not individually significant, such properties are grouped for purposes of assessing impairment. The amount of impairment assessed is added to the costs to be amortized. As of September 30, 2008, the Company did not have any investment in unproved oil properties.

Pursuant to full cost accounting rules, the Company must perform a ceiling test each quarter on its proved oil assets within each separate cost center. The ceiling test provides that capitalized costs less related accumulated depletion and deferred income taxes for each cost center may not exceed the sum of (1) the present value of future net revenue from estimated production of proved oil reserves using current prices, excluding the future cash outflows associated with settling asset retirement obligations that have been accrued on the balance sheet, at a discount factor of 10%; plus (2) the cost of properties not being amortized, if any; plus (3) the lower of cost or estimated fair value of unproved properties included in the costs being amortized, if any; less (4) income tax effects related to the differences in the book and tax basis of oil properties. Should the net capitalized costs for a cost center exceed the sum of the components noted above, an impairment charge would be recognized to the extent of the excess capitalized costs. There were no provisions for impairment of proved oil properties in 2008 or 2007, although the Company’s ceiling test in its cost center could be adversely affected by declines in the price of oil.

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

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

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Asset Retirement Obligations

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

Earnings per share

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

Income taxes

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

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

Deferred tax is accounted for using the balance sheet liability method in respect of temporary differences arising from differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax basis used in the computation of assessable tax profit. In principle, deferred tax liabilities are recognized for all taxable temporary differences, and deferred tax assets are recognized to the extent that it is probably that taxable profit will be available against which deductible temporary differences can be utilized. Deferred tax is calculated at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled. Deferred tax is charged or credited in the income statement, except when it related to items credited or charged directly to equity, in which case the deferred tax is also dealt with in equity. Deferred tax assets and liabilities are offset when they relate to income taxes levied by the same taxation authority and the Company intends to settle its current tax assets and liabilities on a net basis. As of September 30, 2008, the Company’s deferred tax assets amounted to $209,102.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Value Added Tax

Sales revenue represents the invoiced value of oil, net of a value-added tax (“VAT”). All of the Company’s oil that is sold in the PRC is subject to a Chinese value-added tax at a rate of 17% of the gross sales price. This VAT may be offset by VAT paid by the Company on investment and operating costs associated with oil production. The Company records its net VAT Payable or VAT Recoverable balance in the financial statements. As of September 30, 2008 the Company had a net VAT Payable liability balance of $69,795, compared with a net VAT Recoverable asset balance of $651,905 as of December 31, 2007.

Recently issued accounting pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115”. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. Most of the provisions of SFAS No. 159 apply only to entities that elect the fair value option. However, the amendment to SFAS No. 115 “Accounting for Certain Investments in Debt and Equity Securities” applies to all entities with available-for-sale and trading securities. SFAS No. 159 is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provision of SFAS No. 157, “Fair Value Measurements”. The adoption of this statement did not have a material effect on the Company's financial statements.

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51”. This statement improves the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards that require; the ownership interests in subsidiaries held by parties other than the parent and the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income, changes in a parent’s ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently, when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary be initially measured at fair value, entities provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 affects those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Early adoption is prohibited. The adoption of this statement will result in the reclassification of “Minority interests” to equity as “Noncontrolling interests” and separate disclosures in the statements of operations.

In December 2007, the FASB issued SFAS No. 141(R), “Business Combinations – a replacement of FASB Statement No. 141,” which significantly changes the principles and requirements of how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This statement is effective prospectively, except for certain retrospective adjustments to deferred tax balances, for fiscal years beginning after December 15, 2008. This statement will be effective for the Company beginning in fiscal 2010. The adoption of SFAS No. 141(R) will only impact future acquisitions.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133". This statement amends and expands the disclosure requirements of SFAS No. 133 to require qualitative disclosure about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. The statement will be effective for the Company beginning in fiscal 2009. We are currently evaluating the disclosure implications of this statement.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

In May 2008, the FASB released SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles.” SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that presented in conformity with generally accepted accounting principles in the United States of America. The Company does not believe SFAS No. 162 will have a significant impact on its consolidated financial statements.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation. These reclassifications have no effect on net income or cash flows.

NOTE 5 SECURED DEBENTURE

The following is a summary of secured debenture at September 30, 2008 and December 31, 2007:

		September 30, 2008 (Restated and unaudited)		December 31, 2007 (Audited)
8% Secured Debenture, net of unamortized discount of $7,857,473 as of September 30, 2008 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 27, 2012	$	6,392,527	$	-
				-
Less: current maturities		(2,625,000)		-
Long-term portion	$	3,767,527	$	-

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

The Company accounts for these warrants as liability instruments in accordance with paragraph 8 of EITF 00-19, “Accounting for Derivative Financial Instruments Indexed to, and potentially settled in, a Company’s Own Stock.” Upon issuance, the warrants were recorded at fair value of $10,268,321, which was recognized as a discount to the carrying value of the debenture. The initial carrying value of the debenture, net of unamortized discount, was $4,731,679. The debenture will be accreted to liquidation value over four years, using the effective interest rate method.

Interest expense and discount amortized for the three months ended September 30, 2008 was $296,578 and $1,015,864 respectively, and for the nine months ended September 30, 2008 was $704,249 and $2,410,848 respectively. As of September 30, 2008, the carrying value of the debenture, net of discount, was $6,392,527.

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NOTE 6 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 Sep 30, 2008 (Restated)	Nine months ended Sep 30, 2007
Numerator:		
Net income used in computing basis net income per share	$ 10,753	$ 3,040
Net income used in computing diluted net income per share	$ 10,753	$ 3,040
Denominator:		
Shares used in computation of basic net income per share (weighted average common stock outstanding)	19,480	25,781
Dilutive potential common stock:		
Options and warrants	144	-
Shares used in computation of diluted net income per share	19,624	25,781
Basic net income per share	$ 0.55	$ 0.12
Diluted net income per share	$ 0.55	$ 0.12

For the nine months ended September 30, 2008, options and warrants to purchase 2,720,000 shares of common stock with exercise prices greater than the average fair market value of the Company's stock of $3.23 were not included in the calculation because the effect is anti-dilutive.

	Three months ended Sep 30, 2008 (Restated)	Three months ended Sep 30, 2007
Numerator:		
Net income used in computing basis net income per share	$ 21,904	$ 1,499
Net income used in computing diluted net income per share	$ 21,904	$ 1,499
Denominator:		
Shares used in computation of basic net income per share (weighted average common stock outstanding)	19,987	19,224
Dilutive potential common stock:		
Options and warrants	690	-
Shares used in computation of diluted net income per share	20,677	19,224
Basic net income per share	$ 1.10	$ 0.08
Diluted net income per share	$ 1.06	$ 0.08

For the three months ended September 30, 2008, options and warrants to purchase 410,000 shares of common stock with exercise prices greater than the average fair market value of the Company's stock of $3.89 were not included in the calculation because the effect is anti-dilutive.

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NOTE 7 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, June 30, 2015, November 14, 2008 and September 14, 2009 at annual rental of $182, $14,004, $10,941 and $37,200 respectively.

As of September 30, 2008, the Company had outstanding commitments with respect to the above operating leases, which are due as follows:

2008	$	14,670
2009		40,536
2010		14,186
2011		14,186
Thereafter		51,152
	$	134,730

(B) Capital commitments

As of September 30, 2008, the Company had capital commitments of $3,888,000 with a contractor for the completion of drilling of 17 oil wells under construction.

NOTE 8 STOCK-BASED COMPENSATION

Stock Options

In May 2008, the Company granted to three directors 60,000 stock options qualified under the Company's 2006 Stock Option/Stock Issuance Plan (the "2006 Plan") to purchase Common Stock. In July 2008, 350,000 stock options were granted to two directors who are also Company officers under the 2006 Plan. As of September 30, 2008, stock options granted under the Company's 2006 Plan to purchase 410,000 shares of its Common Stock (the "Options") at an exercise price from $4.05 to $4.50 per share were outstanding. 100,000 stock options were director options that shall vest 25% upon grant and 25% every three months thereafter, and these stock options shall expire ten years after the grant date if unexercised at that time. 310,000 stock options were issued as bonuses to officers with vesting of 50% of those options upon the grant date and the remaining 50% 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 of Common Stock

5 years	292% to 308%	0%	3.25% to 3.42%	$4.05 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 3.25% to 3.42% was used. The risk-free interest rate was based on U.S. Treasury yields with a remaining term that corresponded to the expected term of the option calculated on the 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.

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NOTE 8 STOCK-BASED COMPENSATION (CONTINUED)

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.

The 410,000 stock options issued during the nine months ended September 30, 2008 had a total fair value of approximately $1,816,267. The Company recognized $263,584 of staff compensation expenses included in selling, general and administrative expenses for the nine months ended September 30, 2008.

As of September 30, 2008, the total compensation cost related to stock options not yet recognized was $1,552,683 and this will be recognized over the next two years.

The following is a summary of the stock options activity:

	Number of Options Outstanding	Weighted-Average Exercise Price
Balance, December 31, 2007	-	-
Granted	410,000	$ 4.43
Forfeited	-	-
Exercised	-	-
Balance, September 30, 2008	410,000	$ 4.43
Exercisable, September 30, 2008	195,000	$ 4.43

The following is a summary of the status of options outstanding at September 30, 2008:

	Outstanding Options			Exercisable Options	
Exercise Price	Number	Average Remaining Contractual Life	Average Exercise Price	Number	Weighted Average Exercise Price
$4.05	60,000	9.67 year	$4.05	30,000	$4.05
$4.50	310,000	9.79 year	$4.50	155,000	$4.50
$4.50	40,000	9.79 year	$4.50	10,000	$4.50

Stock Grants

On July 18, 2008, the Company issued 360,000 shares of common stock to two executive officers and three engineers as bonuses for a period of two years. The stock was valued at the closing price on the date of grant of $4.50 per share, yielding an aggregate value of $1,620,000. The Company recognized expense of $810,000 during the nine months ended September 30, 2008.

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NOTE 9 STOCKHOLDERS' EQUITY

(A) Issuance of warrants

On February 28, 2008, the Company issued three tranches of warrants in conjunction with the issuance of a secured debenture as discussed in Note 8. In addition, the Company issued an additional three tranches of warrants to investment consultants in conjunction with the issuance of the secured debenture. The Company analyzes all financial instruments with features of both liabilities and equity under SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity," SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

The Company treats these warrants as liabilities under EITF 00-19 and accordingly records the warrants at fair value with changes in fair values recorded in the statement of income until such time as the warrants are exercised or expire. The fair values were $11,295,153 at issuance and $10,148,772 at September 30, 2008. For the three and nine months ended September 30, 2008, the Company recorded gains of $18,191,606 and $1,146,381, respectively, in changes in the fair value of the warrants in earnings.

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

	September 30, 2008	February 28, 2008
Market price and estimated fair value of common stock:	$2.49	$2.14
Exercise price:	$0.01 - $3.45	$0.01 - $3.45
Remaining contractual life (years):	4.42	5
Dividend yield:	–	–
Expected volatility:	314%	316%
Risk-free interest rate:	2.98%	2.73%

Also on February 28, 2008, the Company issued warrants to purchase 100,000 shares of Common Stock to a professional service provider in conjunction with a two year service agreement. The Company treats these warrants as equity instruments and is accordingly recognizing the grant date fair value of the warrants as professional fee expense ratably over the two year term. For the three and nine months ended September 30, 2008, the Company recognized $26,740 and $62,393, respectively, of expense associated with these warrants.

(B) Stock issuances

On August 26, 2008, Class A Warrants to purchase 1,200,000 shares of the Company's common stock at an exercise price of $0.01 per share were exercised.

NOTE 10 RELATED PARTY TRANSACTIONS

a) As of September 30, 2008, the Company owed a stockholder of $783,258 which is repayable on demand. Imputed interest is computed at 5% per annum on the amount due.

b) As of September 30, 2008, the Company owed a related party of $14,588 which is repayable on demand. Imputed interest is computed at 5% per annum on the amount due.

c) As of September 30, 2008, the Company owed a related party of $486,714 which is repayable in December 2009. Imputed interest is computed at 5% per annum on the amount due.

d) Total imputed interest expenses recorded as additional paid-in capital amounted to $49,535 for the nine months ended September 30, 2008.

e) The Company paid a stockholder $10,287 for leased office spaces for the nine months ended September 30, 2008.

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

We are engaged in the exploration and production of crude oil in Northern China. We have an arrangement with the Jilin Refinery of PetroChina Group to sell our crude oil production for use in the China marketplace. We currently operate 214 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	190	1,963,319
Da34	2,298	7	168,335
Gu31	1,779	7	62,533
He301	2,471	14	274,637
Total	11,663	218	2,468,824

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”), among PetroChina Group, Yu Qiao and the Company, entered into 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.

LongDe is a party to a 20-year contract with PetroChina Group entered into in May 2003, pursuant to which LongDe has the right to explore, develop and produce oil at the Hetingbao 301 oilfield in the PRC. Pursuant to such 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 contracts that Yu Qiao has entered into with PetroChina. These oilfields include the Daan 34 oilfield and Gudian 31 oilfield in Jilin Province.

Song Yuan Technical Joint Venture

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

Acquisition of LongDe

In order to comply with certain PRC laws relating to foreign entities’ ownership of oil and gas companies in the PRC, prior to March 17, 2008, Song Yuan Technical directly owned a 70% equity interest in LongDe, while Sun Peng and Ai Chang Shan, respectively, owned 10% and 20% of the equity interests in Long De in trust for Song Yuan Technical. On March 17, 2008, Song Yuan Technical 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.

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

Yuan Technical and Wang Hongjun. Pursuant to the trust agreement, Wang Hongjun holds 10% of the total outstanding equity interest in Long De in trust for the benefit of Song Yuan Technical.

Acquisition of Yu Qiao

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

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

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

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

Oil and Gas Properties and Activities

As of September 30, 2008, the Company had a total of 218 producing wells, including 190 producing wells at the Qian'an 112 oilfield, 14 producing wells at the Hetingbao 301 oilfield, 7 producing wells at the Daan 34 oilfield and 7 producing wells at the Gudian 31 oilfield.

All of the Company's crude oil production is sold to the Jilin Refinery of 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 an international commodity and trading company that collects and publishes pricing data on a wide range of petroleum and non-petroleum commodity types. The price paid to the Company is FOB at the local Jilin Province PetroChina oil storage depot.

PetroChina pays the Company 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 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. For example, as of September 30, 2008, the Company's Accounts Receivable balance totaled $10,595,234, which is all due to the Company from PetroChina, and includes amounts related to the following items:

September Oil Sales, net of oil surcharge:	$6,114,279
Quarterly total oil surcharge:	$4,480,955

Operating Performance

Our operating performance is influenced by several factors, the most significant of which are the price we receive for our oil and the quantities of oil that we are able to produce. The world price for oil has overall influence on the prices that we receive for our oil production. The prices received for different grades of oil are based upon the world price of oil, which is then adjusted based upon the particular grade. Typically light 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 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
- Extension of credit from our suppliers, including particularly our suppliers of well drilling and completion services.

For the three months ended September 30, 2008 (the "Current Quarter"), the sale price we received for our crude oil production averaged $111.90 per barrel, compared with $72.90 per barrel for the three months ended September 30, 2007 (the "Comparable Quarter"). For the nine months ended September 30, 2008 (the "Current Period"), the sale price we received for our crude oil production average $103.60 per barrel, compared with $65.80 per barrel for the nine months ended September 30, 2007 (the “Comparable Period”).

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 Statement of Financial Accounting Standards No. 19 (“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 each of the three and nine months ended September 30, 2008 and September 30, 2007.

	Three months ended September 30		Nine months ended September 30	
	2008	2007	2008	2007
Oil Output (Bbl)	172,730	86,222	422,788	174,280
Avg. Sale Price ($/bbl)	$ 111.90	$ 72.90	$ 103.60	$ 65.80
Operating Revenue	$ 19,060,007	$ 5,826,506	$ 44,051,519	$ 11,804,007
Cost of Sales				
Production Costs	895,155	704,568	2,390,432	1,669,166
Depreciation	3,774,327	1,361,732	8,155,321	2,601,561
Amortization	2,975	2,695	8,743	7,972
Oil Surcharge	4,480,955	848,315	9,865,655	1,500,902
Total Cost of Sales	9,153,412	2,917,310	20,420,151	5,779,601
Gross Profit	$ 9,906,595	$ 2,909,196	$ 23,631,368	$ 6,024,406

RESULTS OF OPERATIONS

Three Months Ended September 30, 2008 Compared To Three Months Ended September 30, 2007

Revenues. Revenues for the Current Quarter were $19,060,007 compared to $5,826,506 for the Comparable Quarter, an increase of $13,233,501, or 227%. This increase was due to an increase in both crude oil production and the average price we received for our crude oil. Our output of crude oil for the Current Quarter was 172,730 barrels compared to 86,222 barrels for the Comparable Quarter. The increase in production was mainly because of (i) refracturing and other technical improvements made on the existing wells; (ii) implementation of a water injection network which efficiently prevented the decrease of production of existing wells and helped to maintain certain production levels of such wells; and (iii) 30 new wells brought into production during the third quarter of 2008.

Cost of sales. Cost of sales increased by 214% from $2,917,310 for the three months ended September 30, 2007 to $9,153,412 for the three months ended September 30, 2008. The increase in cost of sales resulted primarily from increases in direct production costs, depreciation of oil and gas properties, and the payment of the government oil surcharge. For the three months ended September 30, 2008, the Company paid an oil surcharge of $4,480,955 to the PRC government as compared to $848,315 paid for the same quarter in 2007. 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. In addition, depreciation of oil and gas properties increased from $1,361,732 for the three months period ended September 30, 2007 to $3,774,327 for the three months period ended September 30, 2008, an increase of 177%. The increase in the depreciation of oil and gas properties was mainly attributable to the higher volumes of oil produced and the addition of 30 new wells to the depreciable production equipment base during the third quarter of 2008.

Operating Expenses. Operating expenses totaled $1,531,118 for the Current Quarter, compared to $290,676 for the Comparable Quarter, an increase of 427%. This increase is primarily a result of an increase of $1,332,478 in selling, general and administrative costs. This increase includes $810,000 of non-cash charges associated with common stock and option grants made to officers, directors and senior staff of the company.

Other Income (Expense). Other expense decreased from $(34,878) for the three months ended September 30, 2007 to other income of $16,646,291 for the three months ended September 30, 2008. This decrease is primarily the result of increases in the change in fair value of warrants which warrants of $18,191,606 offset by additional amortization of debt discount and deferred financing costs of $1,234,807.

Net Income. Net income increased by 1,361% from $1,499,495 for the three months ended September 30, 2007 to $21,904,241 for the three months ended September 30, 2008, primarily as a result of a 227% increase in sales and a significant non-cash gain in the change of fair value of warrants as described above.

Nine Months Ended September 30, 2008 Compared To Nine Months Ended September 30, 2007

Revenues. Revenues for the nine months ended September 30, 2008 were $44,051,519 compared to $11,804,007 for the nine months ended September 30, 2007, an increase of $32,247,512, or 273%. This increase was due to an increase in crude oil production and crude oil price. Our output of crude oil for the nine months ended September 30, 2008 was 422,788 barrels compared to 174,280 barrels for the same nine months in 2007. The increase in production was mainly because of (i) refracturing and other technical improvements made on the existing wells; (ii) implementation of a water injection network which efficiently prevented the decrease of production of existing wells and helped to maintain certain production levels of such wells; and (iii) 61 new wells brought into production during the first three quarters of 2008.

Cost of sales. Cost of sales increased by 253% from $5,779,601 for the nine months ended September 30, 2007 to $20,420,151 for the nine months ended September 30, 2008. The increase in cost of sales resulted primarily from the increase in production volumes and the payment of oil surcharge. For the nine months ended September 30, 2008, the Company paid an oil surcharge of $9,865,655 to the PRC government as compared to $1,500,902 paid for the same nine months in 2007. 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. In addition, depreciation of oil and gas properties increased from $2,601,561 for the nine months period ended September 30, 2007 to $8,155,321 for the nine months period ended September 30, 2008, an increase of 214%. The increase in the depreciation of oil and gas properties was mainly attributable to the increased volume of crude oil produced and the addition of depreciable assets associated with the 61 new wells brought into production during the first nine months of 2008.

Operating Expenses. Operating expenses increased by 191% from $939,316 for the nine months ended September 30, 2007 to $2,731,054 for the nine months ended September 30, 2008. This increase is primarily a result of an increase of $1,386,733 in selling, general and administrative costs, largely due to stock-based compensation expense in 2008 of $810,000, and $205,340 in consulting fees.

Other Income (Expense). Other income decreased from $180,684 for the nine months ended September 30, 2007 to a total expense of $2,562,147 for the nine months ended September 30, 2008. This decrease in other income is primarily the result of increases in (i) amortization of discount on debenture and (ii) interest expense. The amount of amortization of discount on debenture recorded in the Current Period was $2,410,848, compared to $0 in the Comparable Period.

Net Income. Net income increased by 254% from $3,040,425 for the nine months ended September 30, 2007 to $10,753,212 for the nine months ended September 30, 2008, primarily as a result of a 273% increase in sales as described above and the non-cash gain in the change of fair value of warrants offset by the increase in depreciation, depletion and amortization of oil properties, the special oil surcharge, and income tax expense.

LIQUIDITY AND CAPITAL RESOURCES

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, 2008, the Company had cash and cash equivalents of $7,762,017, total current assets of $20,619,104 and current liabilities of $22,781,438. For the nine months ended September 30, 2008, our primary sources of liquidity were $17,643,184 provided by operating activities and approximately $11,091,105 in cash provided by financing activities.

Net cash provided by operating activities was $17,643,184 for the Current Period compared to net cash provided by operating activities of $9,187,144 for the Comparable Period. The increase in net cash provided by operating activities is primarily related to the increase in net income. Additionally, an increase in the amount of income tax and other taxes payable of $2,794,831 provided substantial operating cash flow for the Company. These factors were somewhat offset by increases in accounts receivable of $5,742,601, increased prepaid expenses related to the drilling of new wells in the amount of $1,863,807, and a reduction in accounts payable in the amount of $3,458,626.

The reduction in accounts payable relates primarily to costs related to the drilling of wells accrued in 2007. The Company seeks to strategically manage the level of trade credit that it has outstanding with key well drilling and completion suppliers, and at times elects to pay down the current and long-term accounts payable balances with these suppliers in advance of stated due dates in order to strengthen the Company's negotiating leverage with these suppliers for current and/or future drilling projects. The increase in accounts receivable is due to the increase in sales of crude oil to PetroChina during the quarter.

Net cash used in investing activities was $19,618,655 for the nine months ended September 30, 2008 compared to $10,005,089 for the same period in 2007. This increase is primarily due to the increase in additions to oil and gas properties of $9,308,192 during the nine months ended September 30, 2008 associated with the cost of drilling and bringing new wells into production.

Net cash provided by financing activities was $11,091,105 for the nine months ended September 30, 2008, primarily as a result of the financing by Lotusbox Investments Limited, which was completed in the first quarter of 2008.

The Company has paid for the development of its producing oil wells and oil wells under construction with cash from operations as well as by funds raised as a result of the financing by Lotusbox Investments Limited. To fully implement the Company's business plan and growth strategy the Company may require additional resources. The Company is continually evaluating opportunities to expand production and grow the Company's operations, including via acquisition of additional leased oil fields or expansion into related businesses such as the provision of oil field services. The Company's 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.

Capital Commitments

As of September 30, 2008, the Company had capital commitments of $3,888,000 with a contractor for the completion of drilling of 17 oil wells under construction.

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 we have currently drilled only 218 wells out of the 675 wells that we believe can be drilled in our four oilfields (as of September 30, 2008), we anticipate that we will continue to increase production in these areas. We are also actively seeking additional oil fields that we can lease and operate.

Operating Expense Trends
Drilling, workover and maintenance activity in northeastern Chinese oil fields continues at a historically high level. Service rates charged by oil field service companies have increased, as they have in other parts of the world. These increased cost levels have affected our production costs, and further increases are possible. However, we believe we face relatively low operating costs compared to other oil producing regions around the globe. We also are 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 $25.90 per barrel, as compared to $9.80 per barrel in the Comparable Quarter.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Not required.

ITEM 4T. CONTROLS AND PROCEDURES

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

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

Limitations on the Effectiveness of Disclosure Controls and Procedures.

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

Deficiencies Relating to Internal Controls over Financial Reporting

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

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

- the Company lacked adequate internal controls over the calculation methodologies used in calculation of depreciation, depletion and amortization, and of the ceiling test value, on its oil properties.

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

- provide periodic training for employees on accounting and financial reporting practices, particularly with respect to oil industry measurements and disclosures;

- retain an outside consulting firm with expertise in financial accounting and oil industry accounting and disclosure matters, to assist the management team with its preparation of quarterly and annual financial reports;

- institute and cultivate a culture of excellence with respect to accounting and financial reporting practices to ensure that the foregoing contributing factors do not recur.

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

Consequently, we have revised our financial reports for the periods from March 31, 2008 to September 30, 2009, including this amended quarterly financial report. This restatement, as well as specific information regarding its impact, is discussed in Note 1, “Restatement” to the Consolidated Financial Statements. Restatement of previously issued financial statements to reflect the correction of a misstatement is an indicator of the existence of a material weakness in internal control over financial reporting as defined in the Public Company Accounting Oversight Board’s Auditing Standard No. 2, “An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.” We have identified deficiencies in our internal controls that did not prevent the misstatement of certain non-cash accounting items. These deficiencies, which we believe constituted a material weakness in our internal control over financial reporting, included inadequate training and understanding of the SEC and accounting rules for booking certain non-cash accounting items, including items specific to oil industry reporting. In light of the determination that previously issued financial statements should be restated, our management concluded that a material weakness in internal control over financial reporting existed as of September 30, 2008 and disclosed this matter to the audit committee, and our independent registered public accounting firm.

Remedial Actions

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

We have implemented the following actions to mitigate weaknesses identified:

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we have retained an outside consulting firm with expertise in financial accounting and oil industry accounting and disclosure matters, to assist the management team with its review and restatement of the financial reports for the periods in question.

We intend to implement the following actions in 2010:

- implement formal and informal training programs, particularly with respect to the accounting for non-cash items;

- during 2010 and thereafter, consult with our outside consulting firm on a interim basis on the preparation of financial reports.

Evaluation of Disclosure Control and Procedures

Our Chief Executive Officer and our Chief Financial Officer, with the participation of other members of our senior management, reviewed and evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. In making this evaluation, the Chief Executive Officer and the Chief Financial Officer considered the issues discussed above, together with the remedial steps we have taken. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, because of the material weakness discussed above, as of September 30, 2008, our disclosure controls and procedures were not effective in recording, processing, summarizing and reporting information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934 (the “Exchange Act”).

Management's Report on Internal Control over Financial Reporting

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

Because of this material weakness, management has concluded that, as of September 30, 2008, we did not maintain effective internal control over financial reporting, based on the criteria established in Internal Control-Integrated Framework issued by the COSO.

Management's assessment of the effectiveness of our internal control over financial reporting as of September 30, 2008 has not been audited by Baker Tilly Hong Kong Limited (successor to Jimmy Cheung & Co.), an independent registered public accounting firm, as stated in their report which is included herein.

Changes in Internal Control Over Financial Reporting

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

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

We intend to implement the following additional actions in 2010:

- implement formal and informal training programs, particularly with respect to the accounting for non-cash items;

- continue our retention of an outside consulting firm to assist us with a review of financial report preparation.

Except as discussed above, there has not been any change in our internal control over financial reporting that occurred during our quarter ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On August 17, 2007, the Company filed a complaint in the Third Judicial District Court in and for Salt Lake County, State of Utah, naming Topworth Assets Limited ("Topworth") as the principal defendant. The Company asserted conversion, unjust enrichment, breach of warranty, fraud, and for declaratory relief causes of action. The actions arise out of the issuance of 3,715,000 shares of the Company's stock to Topworth in or about early 2004. The Company was able to recover from Topworth 2,715,000 of these shares shortly after their issuance, and now contends it is entitled to recover the remaining 1,000,000 shares because Topworth received all the stock by fraud. The Company sought and obtained an injunction preventing Topworth's transfer of this disputed stock.

In response to the Company's complaint and the issuance of the injunction against it, Topworth filed an answer to the complaint and a counterclaim against the Company, Wei Guo Ping, and Wang Hong Jun on December 11, 2007. Topworth asserts various legal theories that contend it performed consulting services to the Company; was entitled to all of the disputed stock as compensation for services; and was improperly required to return some of the disputed stock to the Company. The Company filed a motion to dismiss Topworth's Counterclaim. The Company's motion to dismiss Topworth's Counterclaim was denied, but the court required Topworth to file another amended Answer and Counterclaim to clarify its claims against the Company. To date, Topworth has yet to file the required amendments to its Answer and Counterclaim.

Overall, the principal parties seek recovery of the ownership or value of all the shares of stock the Company contends were fraudulently issued to Topworth. All of the disputed shares are currently deemed to be issued and outstanding. The Company intends to vigorously pursue its claims for recovery against Topworth and to defend against the counterclaim of Topworth.

We know of no other material, active or pending legal proceedings against our Company, and, other than as disclosed above, we are not involved as a plaintiff in any other material proceeding or pending litigation. There are no proceedings in which any of our directors, officers or affiliates, or any registered or beneficial shareholder, is an adverse party or has a material interest adverse to our interest.

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 31, 2008.

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 of Exhibit
31.1	Certifications 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	Certifications 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 Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	China North East Petroleum Holdings Limited	
August 31, 2010	By:	/s/ Jingfu Li Jingfu Li Acting Chief Executive Officer (Principal Executive Officer and Principal Financial Officer)