

CHINA NORTH EAST PETROLEUM HOLDINGS LTD
Form 10-Q
May 15, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

- QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the quarterly period ended March 31, 2008
- TRANSITION REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the transition period from _____ to _____

Commission file number 000-49846

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

Nevada
(State of other jurisdiction of
incorporation or organization)

87-0638750
(IRS Employer identification No.)

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

(212) 307-3568
(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 No

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

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

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

Number of shares of common stock outstanding as of May 14, 2008: 19,224,080

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SPECIAL NOTE REGARDING FORWARD—LOOKING STATEMENTS

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

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

- Our expectation of continued growth in the demand for our oil;
- Our expectation that we will have adequate liquidity from cash flows from operations;
- A variety of market, operational, geologic, permitting, labor and weather related factors; and
- The other risks and uncertainties which are described below under “RISK FACTORS”, including, but not limited to, the following:
 - Unanticipated conditions may cause profitability to fluctuate.
 - 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-KSB, 10-QSB and 8-K, Proxy Statements on Schedule 14A, press releases, analyst and investor conference calls, and other communications released to the public. Although we believe that at the time made, the expectations reflected in all of these forward looking statements are and will be reasonable, any or all of the forward-looking statements in this quarterly report on Form 10-QSB, our reports on Forms 10-KSB and 8-K, our Proxy Statements on Schedule 14A and any other public statements that are made by us may prove to be incorrect. This may occur as a result of inaccurate assumptions or as a consequence of known or unknown risks and uncertainties. Many factors discussed in this Quarterly Report on Form 10-QSB, certain of which are beyond our control, will be important in determining our future performance. Consequently, actual results may differ materially from those that might be anticipated from forward-looking statements. In light of these and other uncertainties, you should not regard the inclusion of a forward-looking statement in this Quarterly Report on Form 10-QSB 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-KSB, 10-QSB 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

Item 1. Financial Statements

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

	March 31, 2008 (Unaudited)	December 31, 2007 (Audited)
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 12,734,345	\$ 74,638
Accounts receivable, net	5,981,125	4,852,633
Prepaid expenses and other current assets	682,928	398,046
Current portion of deferred financing costs, net	296,557	-
Value added tax recoverable	-	651,905
Total Current Assets	19,694,955	5,977,222
PROPERTY AND EQUIPMENT		
Oil and gas properties, net	42,616,236	40,345,008
Fixed assets, net	1,046,714	885,474
Oil and gas properties under construction	1,127,198	2,550,058
Total Property and Equipment	44,790,148	43,780,540
LAND USE RIGHTS, NET	44,045	45,076
LONG-TERM DEFERRED FINANCING COSTS, NET	864,959	-
TOTAL ASSETS	\$ 65,394,107	\$ 49,802,838
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 7,732,748	\$ 6,580,930
Current portion of secured debenture, net of discount	737,342	-
Other payables and accrued liabilities	1,561,934	1,020,980
Due to related parties	14,241	28,036
Note payable	284,811	273,444
Income tax and other taxes payable	5,001,942	2,687,449
Due to a stockholder	131,387	123,105
Total Current Liabilities	15,464,405	10,713,944
LONG-TERM LIABILITIES		
Accounts payable	8,665,641	15,467,661
Secured debenture, net of discount	6,636,074	-
Deferred tax payable	475,445	543,100
Due to a related party	1,579,572	3,118,085
Total Long-term Liabilities	17,356,732	19,128,846
TOTAL LIABILITIES	32,821,137	29,842,790

COMMITMENTS AND CONTINGENCIES	-	-
MINORITY INTERESTS	1,646,440	1,124,964
STOCKHOLDERS' EQUITY		
Common stock, \$0.001 par value, 150,000,000 shares authorized, 19,224,080 shares issued and outstanding	19,224	19,224
Additional paid-in capital	19,207,082	11,361,579
Deferred stock compensation	-	(27,125)
Retained earnings		
Unappropriated	8,482,166	5,200,907
Appropriated	916,263	916,263
Accumulated other comprehensive income	2,301,795	1,364,236
Total Stockholders' Equity	30,926,530	18,835,084
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 65,394,107	\$ 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 March 31,
2008 2007

NET SALES	\$ 10,823,974	\$ 1,879,947
COST OF SALES		
Production costs	712,305	336,790
Depreciation of oil and gas properties	1,874,692	389,227
Amortization of land use rights	2,842	2,624
Government oil surcharge	2,211,320	157,131
Total Cost of Sales	4,801,159	885,772
GROSS PROFIT	6,022,815	994,175
OPERATING EXPENSES		
Selling, general and administrative expenses	257,594	220,265
Professional fees	57,512	16,000
Consulting fees	81,630	27,125
Amortization of deferred financing costs	24,713	-
Amortization of discount on debenture	162,268	-
Depreciation of fixed assets	52,232	36,027
Total Operating Expenses	635,949	299,417
INCOME FROM OPERATIONS	5,386,866	694,758
OTHER INCOME (EXPENSE)		
Other expense	(2,311)	-
Interest expense	(119,697)	(10,591)
Imputed interest expenses	(26,896)	(131,846)
Interest income	4,042	248
Total Other Expense, net	(144,862)	(142,189)
NET INCOME BEFORE TAXES AND MINORITY INTERESTS	5,242,004	552,569
Income tax expense	(1,439,269)	(221,407)
Minority interests	(521,476)	(43,799)
NET INCOME	3,281,259	287,363
OTHER COMPREHENSIVE INCOME		
Foreign currency translation gain	937,559	87,251
COMPREHENSIVE INCOME	\$ 4,218,818	\$ 374,614

Net income per share			
- basic	\$	0.17	\$ 0.01
- diluted	\$	0.17	\$ 0.01
Weighted average number of shares outstanding during the period			
- basic		19,224,080	29,224,080
- diluted		20,537,854	29,224,080

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

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
For the three months ended March 31, 2008 and 2007 (Unaudited)

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 3,281,259	\$ 287,363
Adjusted to reconcile net income to cash provided by operating activities:		
Depreciation of oil and gas properties	1,874,692	389,227
Depreciation of fixed assets	52,232	36,027
Amortization of land use rights	2,842	2,624
Amortization of deferred financing costs	24,713	-
Amortization of discount on debenture	162,268	-
Warrants issued for services	29,755	-
Minority interests	521,476	43,799
Stocks issued for services	27,125	27,125
Imputed interest expenses	26,896	131,846
Changes in operating assets and liabilities (Increase) decrease in:		
Accounts receivable	(1,128,492)	358,931
Prepaid expenses and other current assets	(284,882)	(28,390)
Due from related parties	-	(49,836)
Value added tax recoverable	651,905	58,901
Deferred financing costs	(1,186,229)	-
Increase (decrease) in:		
Accounts payable	(5,650,202)	490,089
Other payables and accrued liabilities	540,954	2,296
Income tax and other taxes payable	2,314,493	462,572
Deferred tax payable	(67,655)	-
Net cash provided by operating activities	1,193,150	2,212,574
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of oil and gas properties	(748,820)	(2,742,832)
Purchase of fixed assets	(174,005)	(123,925)
Additions to oil and gas properties under construction	(211,709)	-
Net cash used in investing activities	(1,134,534)	(2,866,757)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from the issuance of secured debenture	15,000,000	-
Decrease in other loans payable	-	(25,612)
Increase in amount due to a stockholder	8,282	89,193
(Decrease) increase in amounts due to related parties	(1,552,308)	1,170,121
Net cash provided by financing activities	13,455,974	1,233,702

EFFECT OF EXCHANGE RATE ON CASH	(854,883)	(67,207)
NET INCREASE IN CASH AND CASH EQUIVALENTS	12,659,707	512,312
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	74,638	13,746
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 12,734,345	\$ 526,058
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Income tax expense	\$ 1,283,180	\$ 60,462
Interest expense	\$ 11,204	\$ 10,591

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 MARCH 31, 2008
(UNAUDITED)

NOTE 1 BASIS OF PRESENTATION

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

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

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 2 ORGANIZATION

China North East Petroleum Holdings Limited ("North East Petroleum") is a US listed company which 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.

On December 5, 2003, Song Yuan City Hong Xiang Petroleum Technical Services Co., Ltd. ("Hong Xiang Technical") was incorporated in the People's Republic of China ("PRC") which provided 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.

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

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

share 90% and 10% respectively of the equity and profit interests of Song Yuan Technical.

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

On January 26, 2007, Song Yuan Technical acquired 100% of the equity interest of Song Yuan City Yu Qiao Oil and Gas Development Limited Corporation (“Yu Qiao”) for 10,000,000 shares of the Company’s common stock having a fair value of \$3,100,000 based on the preceding 30-day average of the high bid and the low ask price for the Company’s common stock as quoted on the Over-the-Counter Bulletin Board as of the date of the closing of the transaction. Prior to this transaction, Yu Qiao was owned 70% by a related party of the Company and 30% by third parties held on behalf of the related party.

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AS OF MARCH 31, 2008
(UNAUDITED)

NOTE 2 ORGANIZATION (CONTINUED)

Yu Qiao was incorporated in Song Yuan City, Jilin Province, PRC on May 24, 2002 as a limited liability company. 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. Pursuant to a 20-year exclusive Cooperative Exploration Contract (the "Oil Lease") which was entered into on May 28, 2002 with PetroChina Group, a corporation organized and existing under the laws of PRC ("PetroChina"), the Company has the right to explore, develop and extract oil at Qian'an 112, Da 34 and Gu 31 area. Pursuant to the Oil Lease, 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. On May 28, 2002, the Company also executed an Agreement of leasing 20.7 square kilometers of Qian'an 112 area to Hong Xiang Oil Development and the Company is entitled to 2% of total sales revenue as consideration. This agreement was cancelled upon the dissolution of Hong Xiang Oil Development.

The acquisition of Yu Qiao was accounted for as a reorganization of entities under common control. Accordingly, the operations of Yu Qiao for the years ended December 31, 2007 and 2006 were included in the consolidated financial statements as if the transactions had occurred retroactively.

In March 2007, the Company approved the dissolution of its wholly owned subsidiaries, Hong Xiang Technical and Hong Xiang Oil Development.

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

NOTE 3 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.

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AS OF MARCH 31, 2008
(UNAUDITED)

NOTE 4 SECURED DEBENTURE

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

	March 31, 2008 (Unaudited)	December 31, 2007 (Audited)
\$15,000,000 8% Secured Debenture, net of unamortized discount of \$7,626,584 as of March 31, 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	\$ 7,373,416	\$ -
	7,373,416	-
Less: current maturities	(737,342)	-
Long-term portion	\$ 6,636,074	\$ -

On February 28, 2008, the Company entered into a Securities Purchase Agreement (the "Purchase Agreement") with Lotusbox Investments Limited (the "Investor"). Pursuant to which, 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, with all warrant exercise prices being subject to certain adjustments. The Class B Warrants are subject to certain call rights by the Company. The Company also granted the Investor an option up to 24% of the registered capital of Song Yuan Technical at fair market value which option shall vest immediately on the date following the occurrence of an event of default.

The Company accounts for warrants as liability instruments in accordance with paragraph 8 of EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock. The beneficial conversion feature associated with the secured debenture is measured at its intrinsic value after allocation between the warrant and the debenture and before transaction costs in accordance with EITF 00-27, Application of Issue 98-5 to Certain Convertible Instruments. Debt proceeds are first allocated to the warrant (as it is mark-to-market, fair-value liability instrument) and the remaining proceeds are allocated to the debt. The debenture will be accreted to liquidation value over two years, using the effective interest rate method.

The Company has recorded a cost of \$7,788,852 for the beneficial conversion feature granted to the Investor. The beneficial conversion feature is reflected as a discount on the debenture and is being amortized as additional interest expense over the term of the debenture.

Interest expense and discount amortized for the three months ended March 31, 2008 was \$108,493 and \$162,268 respectively.

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CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
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NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AS OF MARCH 31, 2008
(UNAUDITED)