

CHINA NORTH EAST PETROLEUM HOLDINGS LTD

Form 10-Q

November 19, 2010

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

FORM 10-Q

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

For the quarterly period ended September 30, 2010

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

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

Commission file number 001-34378

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

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

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

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

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

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

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

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

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

Number of shares of common stock outstanding as of November 17, 2010: 29,604,860

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## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

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

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

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

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. However, your attention is directed to any further disclosures made on related subjects in our subsequent annual and periodic reports filed with the SEC on Forms 10-K, 10-Q and 8-K and Proxy Statements on Schedule 14A.

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

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PART I FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS

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

	As of	
	September 30, 2010 (Unaudited)	December 31, 2009 (Audited)
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$50,520,855	\$28,693,132
Accounts receivable, net	23,375,295	16,231,369
Prepaid expenses and other current assets	823,087	678,349
<b>Total Current Assets</b>	<b>74,719,237</b>	<b>45,602,850</b>
<b>PROPERTY AND EQUIPMENT</b>		
Oil properties, net	42,494,697	45,777,428
Fixed assets, net	15,097,941	16,466,117
Oil properties under construction	93,535	69,395
<b>Total Property and Equipment</b>	<b>57,686,173</b>	<b>62,312,940</b>
<b>LAND USE RIGHTS, NET</b>	<b>610,242</b>	<b>630,387</b>
<b>GOODWILL</b>	<b>1,645,589</b>	<b>1,645,589</b>
<b>DEFERRED TAX ASSETS</b>	<b>7,892,582</b>	<b>7,538,868</b>
<b>DEPOSITS PAID FOR ACQUISITION OF LAND USE RIGHTS</b>	<b>810,678</b>	<b>-</b>
<b>TOTAL ASSETS</b>	<b>\$143,364,501</b>	<b>\$117,730,634</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$7,863,131	\$13,373,640
Current portion of secured debenture	-	5,625,000
Other payables and accrued expenses	844,770	1,165,494
Due to a related party	14,930	14,626
Due to a related company	28,367	144,796
Income tax and other taxes payable	5,026,931	4,930,202
Due to a stockholder	2,703,736	89,269
<b>Total Current Liabilities</b>	<b>16,481,865</b>	<b>25,343,027</b>
<b>LONG-TERM LIABILITIES</b>		
Secured debenture	-	4,875,000
Warrants	14,007,665	39,528,261

Total Long-term Liabilities	14,007,665	44,403,261
<b>TOTAL LIABILITIES</b>	<b>30,489,530</b>	<b>69,746,288</b>
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>EQUITY</b>		
NEP Stockholders' Equity		
Common stock (\$0.001 par value, 150,000,000 shares authorized, 29,504,860 shares issued and outstanding as of September 30, 2010; 27,935,818 shares issued and outstanding as of December 31, 2009)		
	29,505	27,936
Additional paid-in capital	47,882,439	42,582,142
Retained earnings (deficits)		
Unappropriated	45,592,252	(7,995,947 )
Appropriated	2,524,055	2,524,055
Accumulated other comprehensive income	4,575,595	3,181,452
Total NEP Stockholders' Equity	100,603,846	40,319,638
Noncontrolling interests	12,271,125	7,664,708
<b>TOTAL EQUITY</b>	<b>112,874,971</b>	<b>47,984,346</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 143,364,501</b>	<b>\$ 117,730,634</b>

The accompanying footnotes are an integral part of the consolidated financial statements

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES ("NEP")  
Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)  
(Unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2010	2009 (Restated)	2010	2009 (Restated)
<b>REVENUE</b>				
Sales of crude oil	\$ 9,853,426	\$ 14,403,921	\$ 41,890,415	\$ 34,654,549
Drilling revenue	10,132,841	-	34,731,330	-
Total Revenue	19,986,267	14,403,921	76,621,745	34,654,549
<b>COST OF REVENUE</b>				
Production costs	932,168	1,103,163	3,024,158	2,769,762
Drilling costs	3,059,478	-	12,420,196	-
Depreciation, depletion and amortization of oil properties	1,294,078	2,369,888	5,037,116	7,684,931
Depreciation of drilling equipment	481,385	-	1,436,443	-
Amortization of land use rights	7,937	2,982	23,684	8,943
Government oil surcharge	1,495,917	1,655,000	6,498,555	2,273,167
Total Cost of Revenue	7,270,963	5,131,033	28,440,152	12,736,803
<b>GROSS PROFIT</b>	12,715,304	9,272,888	48,181,593	21,917,746
<b>OPERATING EXPENSES</b>				
Selling, general and administrative expenses	1,801,405	855,138	3,944,810	2,252,285
Professional fees	160,000	105,225	352,734	278,140
Consulting fees	224,750	89,265	449,500	159,260
Depreciation of fixed assets	94,404	69,947	285,826	209,748
Impairment of oil properties	-	1,456	-	13,833,812
Total Operating Expenses	2,280,559	1,121,031	5,032,870	16,733,245
<b>INCOME FROM OPERATIONS</b>	10,434,745	8,151,857	43,148,723	5,184,501
<b>OTHER INCOME (EXPENSE)</b>				
Other income	1,319	7,134	10,839	7,134
Other expense	-	(20,780 )	(74,882 )	(22,581 )
Interest expense	(2,246 )	(236,931 )	(26,980 )	(777,595 )
Amortization of deferred financing costs	-	-	-	(144,507 )
Amortization of discount on debenture	-	-	-	(670,492 )
Imputed interest expense	-	(70,210 )	-	(120,127 )
Interest income	30,996	25,141	77,616	44,905
Change in fair value of warrants	81,430	2,272,159	25,520,596	(9,805,886 )
Loss on extinguishment of debt	-	-	-	(8,260,630 )
Total Other Income (expense), net	111,499	1,976,513	25,507,189	(19,749,779 )



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NET INCOME (LOSS) BEFORE				
INCOME TAXES	10,546,244	10,128,370	68,655,912	(14,565,278 )
Income tax expense	(2,851,199 )	(1,955,789 )	(11,626,300 )	(1,955,789 )
NET INCOME (LOSS)	7,695,045	8,172,581	57,029,612	(16,521,067 )
Less: net loss ( income) attributable to noncontrolling interests	(837,903 )	(704,386 )	(3,439,993 )	(866,915 )
NET INCOME (LOSS) ATTRIBUTABLE TO NEP COMMON STOCKHOLDERS				
	6,857,142	7,468,195	53,589,619	(17,387,982 )
OTHER COMPREHENSIVE INCOME (LOSS)				
Total other comprehensive income	1,984,970	19,608	2,699,752	88,980
Less: foreign currency translation (gain) loss attributable to noncontrolling interests	692,332	(1,961 )	(269,975 )	(8,898 )
Foreign currency translation gain attributable to NEP common stockholders	2,677,302	17,647	2,429,777	80,082
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO NEP COMMON STOCKHOLDERS				
	\$ 9,534,443	\$ 7,485,842	\$ 56,019,395	\$ (17,307,900 )
Net income (loss) per share				
- basic	\$ 0.23	\$ 0.34	\$ 1.84	\$ (0.81 )
- diluted	\$ 0.22	\$ 0.31	\$ 1.72	\$ (0.81 )
Weighted average number of shares outstanding during the period				
- basic	29,829,089	21,780,364	29,191,932	21,143,560
- diluted	31,334,453	24,025,976	31,188,901	21,143,560

The accompanying footnotes are an integral part of the consolidated financial statements

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

	For the nine months ended September 30,	
	2010	2009 (Restated)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ 57,029,612	\$ (16,521,067 )
Adjusted to reconcile net income (loss) to cash provided by operating activities:		
Depreciation, depletion and amortization of oil properties	5,037,116	7,684,931
Depreciation of drilling equipment	1,436,443	
Depreciation of fixed assets	285,826	209,748
Amortization of land use rights	23,684	8,943
Amortization of deferred financing costs	-	144,507
Amortization of discount on debenture	-	670,492
Amortization of stock option compensation	642,908	794,951
Loss on extinguishment of debt	-	8,260,630
Change in fair value of warrants	(25,520,596 )	9,805,886
Impairment of oil properties	-	13,833,812
Warrants issued for services	17,827	175,855
Stock issued for consulting services	-	88,000
Stock-based compensation for employee service	1,346,667	607,500
Imputed interest expenses	-	120,127
Gain on disposal of fixed assets	(13,586 )	(7,134 )
Changes in operating assets and liabilities		
(Increase) decrease in:		
Accounts receivable	(7,143,926 )	(2,279,360 )
Prepaid expenses and other current assets	(144,738 )	(3,206,650 )
Value added tax recoverable	-	311,240
Deferred tax assets	(353,714 )	(4,027,787 )
Increase (decrease) in:		
Accounts payable	(5,510,509 )	(7,404,068 )
Other payables and accrued expenses	(320,724 )	163,052
Income tax and other taxes payable	96,729	1,242,325
Net cash provided by operating activities	26,909,019	10,675,933
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of oil properties	(754,291 )	(3,053,668 )
Purchase of fixed assets	(43,236 )	(185,369 )
Additions to oil properties under construction	(161,372 )	-
Proceeds on disposal of fixed assets	11,709	28,656
Deposits paid for acquisition of land use right	(810,678 )	
Cash outflow from acquisition of a subsidiary	-	(7,837,926 )
Net cash used in investing activities	(1,757,868 )	(11,048,307 )

CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance and sale in a public offering of common stock and warrants, net	-	17,276,003
Repayment of secured debenture	(8,696,260 )	(2,500,000 )
Proceeds from exercise of stock warrants and options	1,670,932	1,200
Increase in amount due to a stockholder	2,614,467	5,601,438
Increase (decrease) in due to a related party	304	(51,637 )
Decrease in due to a related company	(116,429 )	-
Net cash (used in) provided by financing activities	(4,526,986 )	20,327,004
EFFECT OF EXCHANGE RATE ON CASH		
	1,203,558	(35,495 )
NET INCREASE IN CASH AND CASH EQUIVALENTS		
	21,827,723	19,919,135
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		
	28,693,132	13,239,213
CASH AND CASH EQUIVALENTS AT END OF PERIOD		
	\$ 50,520,855	\$ 33,158,348
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Income tax expense	\$ 11,418,016	\$ 5,975,876
Interest expense	\$ 234,740	\$ 540,664

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

- (1) On January 10, 2010, 867,438 shares of common stock at \$2.35 per share was issued to settle the secured debenture regarding the warrant issued.
- (2) On March 29, 2010, 400,000 shares of common stocks valued at \$3,232,000 were issued to the key management of Tiancheng; of which the Company recognized \$1,346,667 as staff compensation expenses included in selling, general and administrative expenses for the nine months ended September 30, 2010.
- (3) In April 2010, a total of 29,865 shares of common stocks were issued in connection with cashless exercise of investor warrants.

The accompanying footnotes are an integral part of the consolidated financial statements

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

**NOTE 1 RESTATEMENT OF PREVIOUSLY REPORTED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

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

**STATEMENT OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS) INFORMATION**

	Three months ended September 30, 2009			Nine months ended September 30, 2009	
	As previously reported	Adjustments	As restated	As previously reported	Adjusted
Cost of sales:					
Depletion, depreciation and amortization of oil properties	\$ 2,824,981	\$ (455,093)	\$ 2,369,888	\$ 8,283,230	\$ (8,283,230)
Operating Expenses:					
Selling, general and administrative expenses	749,204	105,934	855,138	1,932,541	1,932,541
Professional fees	98,261	6,964	105,225	323,309	323,309
Consulting fees	142,332	(53,067)	89,265	298,627	298,627
Impairment of oil properties	-	1,456	1,456	-	13,418
Other Income (Expense):					
Amortization of deferred financing costs	(74,139)	74,139	-	(222,418)	(222,418)
Amortization of discount on debenture	(513,415)	513,415	-	(1,515,473)	(1,515,473)
Change in fair value of warrants	-	2,272,159	2,272,159	-	(9,000)
Loss on extinguishment of debt	-	-	-	-	(8,000)

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Net income (loss)	4,688,695	3,483,886	8,172,581	10,675,244	(27,383,823)
Income tax expense	(2,186,156)	230,367	(1,955,789)	(5,273,823)	3,186,156
Non-controlling interests	(635,986)	(68,400)	(704,386)	(1,533,605)	1,533,605
Net income (loss) attributable to NEP common stockholders	4,052,709	3,415,486	&		