

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2007 AND 2006

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES

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Jimmy C.H. Cheung & Co
Certified Public Accountants
(A member of Kreston International)

Registered with the Public Company
Accounting Oversight Board

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors of:
China North East Petroleum Holdings Limited

We have audited the accompanying consolidated balance sheets of China North East Petroleum Holdings Limited and subsidiaries as of December 31, 2007 and 2006 and the related consolidated statements of operations and comprehensive income, stockholders' equity and cash flows for the years ended December 31, 2007 and 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits of the financial statements provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of China North East Petroleum Holdings Limited and subsidiaries as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years ended December 31, 2007 and 2006, in conformity with accounting principles generally accepted in the United States of America.

JIMMY C.H. CHEUNG & CO
Certified Public Accountants

Hong Kong

Date: March 3, 2008



CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2007 AND 2006

	<u>ASSETS</u>	
	2007	2006
CURRENT ASSETS		
Cash and cash equivalents	\$ 74,638	\$ 13,746
Accounts receivable, net	4,852,633	750,684
Prepaid expenses and other current assets	398,046	925,358
Due from a related party	-	64,031
Value added tax recoverable	651,905	447,603
Total Current Assets	5,977,222	2,201,422
PROPERTY AND EQUIPMENT		
Oil and gas properties, net	40,345,008	22,858,367
Fixed assets, net	885,474	754,052
Oil and gas properties under construction	2,550,058	8,955,976
Total Property and Equipment	43,780,540	32,568,395
LAND USE RIGHTS, NET		
	45,076	52,669
TOTAL ASSETS	\$ 49,802,838	\$ 34,822,486
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
CURRENT LIABILITIES		
Accounts payable	\$ 6,580,930	\$ 21,236,864
Other payables and accrued liabilities	1,020,980	1,393,269
Due to related parties	28,036	55,835
Notes payable	273,444	128,062
Other loans payable	-	25,612
Income tax and other taxes payable	2,687,449	104,912
Due to a stockholder	123,105	1,656,935
Total Current Liabilities	10,713,944	24,601,489
LONG-TERM LIABILITIES		
Accounts payable	15,467,661	-
Deferred tax payable	543,100	202,752
Due to a related party	3,118,085	4,255,441
Note payable	-	256,125
Total Long-term Liabilities	19,128,846	4,714,318
TOTAL LIABILITIES	29,842,790	29,315,807
COMMITMENTS AND CONTINGENCIES		
	-	-
MINORITY INTERESTS		
	1,124,964	402,594
STOCKHOLDERS' EQUITY		
Common stock (\$0.001 par value, 150,000,000 shares authorized, 19,224,080 shares issued and outstanding as of December 31, 2007; 29,224,080 shares issued and outstanding as of December 31, 2006)	19,224	29,224
Additional paid-in capital	11,361,579	3,953,601
Deferred stock compensation	(27,125)	(135,625)
Retained earnings		
Unappropriated	5,200,907	696,955
Appropriated	916,263	287,634
Accumulated other comprehensive income	1,364,236	272,296
Total Stockholders' Equity	18,835,084	5,104,085
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 49,802,838	\$ 34,822,486

The accompanying notes are an integral part of these financial statements

**CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND
COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006**

	2007	2006
NET SALES	\$ 19,482,069	\$ 5,321,905
COST OF SALES		
Production costs	2,872,990	1,091,190
Depreciation of oil and gas properties	3,562,265	1,067,335
Amortization of intangible assets	10,711	4,368
Government oil surcharge	2,857,376	560,584
Recovery of deposit from a supplier previously written off	(361,366)	-
Total Cost of Sales	8,941,976	2,723,477
GROSS PROFIT	10,540,093	2,598,428
OPERATING EXPENSES		
Selling, general and administrative expenses	880,161	884,778
Professional fees	186,214	164,577
Consulting fees	108,500	81,375
Depreciation of fixed assets	187,766	103,448
Gain on disposal of fixed assets	(68,131)	-
Total Operating Expenses	1,294,510	1,234,178
INCOME FROM OPERATIONS	9,245,583	1,364,250
OTHER INCOME (EXPENSE)		
Other expense	(13,144)	(33,930)
Other income	-	78,888
Interest expense	(81,434)	(55,775)
Interest expense on overdue payables	-	(61,814)
Imputed interest expense	(200,165)	(349,393)
Interest income	1,760	883
Total Other Expense, net	(292,983)	(421,141)
NET INCOME BEFORE TAXES AND MINORITY INTERESTS	8,952,600	943,109
Income tax (expense) benefits	(3,097,649)	16,852
Minority interests	(722,370)	(7,566)
NET INCOME	5,132,581	952,395
OTHER COMPREHENSIVE INCOME		
Foreign currency translation gain	1,091,940	325,859
COMPREHENSIVE INCOME	\$ 6,224,521	\$ 1,278,254
Net income per share-basic and diluted	\$ 0.21	\$ 0.03
Weighted average number of shares outstanding during the year- basic and diluted	24,128,190	29,003,806

The accompanying notes are an integral part of these financial statement

CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

	Common stock		Additional paid-in capital	Deferred stock compensation	Unappropriated retained earnings (Accumulated deficit)	Appropriated retained earnings	Accumulated other comprehensive income (loss)	Total
	Number of shares	Amount						
Balance at December 31, 2005 (business combination under common control)	28,274,080	\$ 28,274	\$ 3,300,658	\$ -	\$ (110,390)	\$ 142,584	\$ (53,563)	\$ 3,307,563
Issuance of common stock for services	250,000	250	87,250	-	-	-	-	87,500
Issuance of common stock for services	700,000	700	216,300	(135,625)	-	-	-	81,375
Net income for the year	-	-	-	-	952,395	-	-	952,395
Foreign currency translation gain	-	-	-	-	-	-	325,859	325,859
Comprehensive income	-	-	-	-	-	-	-	1,278,254
Imputed interest expenses on advances from a stockholder and related parties	-	-	349,393	-	-	-	-	349,393
Transfer from retained earnings to statutory and staff welfare reserves	-	-	-	-	(145,050)	145,050	-	-
Balance at December 31, 2006	29,224,080	29,224	3,953,601	(135,625)	696,955	287,634	272,296	5,104,085
Amortization of deferred stock compensation related to common stocks issued for services	-	-	-	108,500	-	-	-	108,500
Contribution from a stockholder by waive of repayment of advance from the stockholder	-	-	1,746,128	-	-	-	-	1,746,128
Contribution from a related party by waive of repayment of advance from the related party	-	-	5,451,685	-	-	-	-	5,451,685
Contribution from a related party by cancellation of common stock previously issued to the related party	(10,000,000)	(10,000)	10,000	-	-	-	-	-
Net income for the year	-	-	-	-	5,132,581	-	-	5,132,581
Foreign currency translation gain	-	-	-	-	-	-	1,091,940	1,091,940
Comprehensive income	-	-	-	-	-	-	-	6,224,521
Imputed interest expenses on advances from a stockholder and related parties	-	-	200,165	-	-	-	-	200,165
Transfer from retained earnings to statutory and staff welfare reserves	-	-	-	-	(628,629)	628,629	-	-
Balance at December 31, 2007	19,224,080	\$ 19,224	\$ 11,361,579	\$ (27,125)	\$ 5,200,907	\$ 916,263	\$ 1,364,236	\$ 18,835,084

The accompanying notes are an integral part of these financial statements

**CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006**

	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 5,132,581	\$ 952,395
Adjusted to reconcile net income to cash provided by operating activities:		
Depreciation of oil and gas properties	3,562,265	1,067,335
Depreciation of fixed assets	187,766	103,448
Amortization of intangible assets	10,711	4,368
Minority interests	722,370	7,566
Stocks issued for services	108,500	109,148
Imputed interest expense	200,165	349,393
Gain on disposal of fixed assets	(68,131)	-
Changes in operating assets and liabilities		
(Increase) decrease in:		
Accounts receivable	(4,101,949)	(285,527)
Prepaid expenses and other current assets	527,312	231,213
Due from related parties	64,031	484,983
Value added tax recoverable	(204,302)	(378,375)
Increase (decrease) in:		
Accounts payable	811,727	13,876,620
Other payables and accrued liabilities	(372,289)	333,218
Income tax and other tax payable	2,582,537	(530,284)
Deferred tax payable	340,348	(33,967)
Net cash provided by operating activities	9,503,642	16,291,534
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of oil and gas properties	(9,699,958)	(9,814,502)
Purchase of fixed assets	(352,219)	(410,846)
Additions to oil and gas properties under construction	(2,448,587)	(8,955,976)
Proceeds from the disposal of fixed assets	166,728	-
Net cash used in investing activities	(12,334,036)	(19,181,324)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from the issuance of notes payable	-	12,440
Repayment of note payable	(110,743)	-
Decrease in other loans payable	(25,612)	(17,759)
Increase in amount due to a stockholder	212,298	550,572
Increase in amounts due to related parties	4,286,530	2,079,717
Net cash provided by financing activities	4,362,473	2,624,970
EFFECT OF EXCHANGE RATE ON CASH	(1,471,187)	(354,741)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		
EQUIVALENTS	60,892	(619,561)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	13,746	633,307
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 74,638	\$ 13,746
 <u>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</u>		
Cash paid during the year for:		
Income tax expenses	\$ 1,681,005	\$ 552,794
Interest expenses	\$ 81,434	\$ 117,589

The accompanying notes are an integral part of these financial statements

**CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2007 AND 2006**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION

(A) 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 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.

Yu Qiao was incorporated in Song Yuan City, Jinlin 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.

**CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2007 AND 2006**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION (CONTINUED)

(B) Principles of consolidation

The accompanying consolidated financial statements for 2007 include the 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.

The accompanying consolidated financial statements for 2006 include the financial statements of North East Petroleum and its wholly owned subsidiaries, Hong Xiang Petroleum Group, Hong Xiang Petroleum Technical and Hong Xiang Oil Development Co., Ltd. and 90% equity interest owned subsidiaries, Song Yuan Technical, LongDe and Yu Qiao. 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.

(C) Use of estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount 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. Actual results could differ from those estimates. The most significant assumptions are for estimated reserves of oil and gas. Oil and gas reserve estimates are developed from information provided by the Company to Ralph E. Davis Associates, Inc. of Houston, Texas for the years ended December 31, 2007 and 2006, respectively. In 2007, management's estimate of its proved reserves was revised upward from 2,242,194 to about 2,468,824 barrels of oil. The estimates were made using performance methods that utilize extrapolations of various historical data including, but not limited to oil, gas and water production. For the undeveloped reserves, estimates were made using analogy to wells within each respective field and reservoir. While reserves are not reflected on the Company's Consolidated Balance Sheets, the revision in estimate has affected the depreciation expense associated with its oil and gas properties which is calculated on the basis of proved reserves. The change was accounted for as a revision in an estimate, and the effect was to decrease the net income by approximately \$1,766,000.

(D) Cash and cash equivalents

For purpose of the statements of cash flows, cash and cash equivalents include cash on hand and demand deposits with a bank with a maturity of less than three months.

(E) Accounts receivable

The Company extends unsecured credit to its customers in the ordinary course of business but mitigates the associated risks by performing credit checks and actively pursuing past due accounts. An allowance for doubtful accounts is established and recorded based on managements' assessment of the credit history with the customer and current relationships with them.

As of December 31, 2007 and 2006, the Company considers all its accounts receivable to be collectible and no provision for doubtful accounts has been made in the financial statements.

(F) Oil and gas properties

The Company follows the full cost method of accounting for oil and gas properties. Accordingly, all costs associated with the acquisition of development rights, and the development of oil reserves, including direct related overhead costs, are capitalized.

Depreciation, depletion and amortization of capitalized costs, excluding unproved properties, are based on the unit-of-production methods based on proved reserves. Investments in unproved properties and major development projects are not amortized until proved reserves associated with the projects can be determined or until impairment occurs. If the results of an assessment indicate that the properties are impaired, the amount of the impairment is added to the capitalized costs to be amortized.

**CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2007 AND 2006**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION (CONTINUED)

(F) Oil and gas properties (Continued)

In addition, the capitalized costs are subject to a "ceiling test", which basically limits such costs to the aggregate of the "estimated present value", discounted at a 10-percent interest rate of future net revenues from proved reserves, based on current economic and operating conditions, plus the lower of cost or fair market value of unproved properties.

Sales of portion of development rights and other proved and unproved properties are accounted for as adjustments to capitalized costs with no gain or loss recognized, unless such adjustments would significantly alter the relationship between capitalized costs and proved reserves of oil and gas, in which case the gain or loss is recognized as income.

Abandonment of oil and gas properties other than the development rights are accounted for as adjustments of capitalized costs with no loss recognized.

(G) Fixed assets

Fixed assets are stated at cost, less accumulated depreciation. Expenditures for additions, major renewals and betterments are capitalized and expenditures for maintenance and repairs are charged to expense as incurred.

Depreciation is provided on a straight-line basis, less estimated residual values over the assets' estimated useful lives. The estimated useful lives are as follows:

Buildings	20 Years
Furniture, fixtures and equipment	5 Years
Motor vehicles	5 Years

Land use rights are stated at cost, less accumulated amortization and are amortized over the term of the relevant rights of 6 years from the date of acquisition.

(H) Long-lived assets

The Company accounts for long-lived assets under the Statements of Financial Accounting Standards ("SFAS") Nos. 142 and 144 "Accounting for Goodwill and Other Intangible Assets" and "Accounting for Impairment or Disposal of Long-Lived Assets" ("SFAS No. 142 and 144"). In accordance with SFAS No. 142 and 144, long-lived assets held and used by the Company are reviewed for impairment annually in the fourth quarter or more frequently if events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. For purposes of evaluating the recoverability of long-lived assets, when undiscounted future cash flows will not be sufficient to recover an asset's carrying amount, the asset is written down to its fair value. The long-lived assets of the Company, which are subject to evaluation, consist primarily of oil and gas properties. For the years ended December 31, 2007 and 2006, the Company has not recognized any allowances for impairment.

(I) Fair value of financial instruments

SFAS No. 107, "Disclosure About Fair Value of Financial Instruments," requires certain disclosures regarding the fair value of financial instruments. Fair value of financial instruments is made at a specific point in time, based on relevant information about financial markets and specific financial instruments. As these estimates are subjective in nature, involving uncertainties and matters of significant judgment, they cannot be determined with precision. Changes in assumptions can significantly affect estimated fair values.

The carrying value of cash and cash equivalents, accounts receivable (trade and others), accounts payable (trade and related party), accrued liabilities, notes payable and other loans payable approximate their fair values because of the short-term nature of these instruments. The management of the Company is of the opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments.

**CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2007 AND 2006**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION (CONTINUED)

(I) Fair value of financial instruments (Continued)

The Company's major operation is in the PRC, which may give rise to significant foreign currency risks from fluctuations and the degree of volatility of foreign exchange rates between the United States dollars ("US\$") and the Chinese Renminbi ("RMB"). On July 21, 2005, the PRC allowed the RMB to fluctuate ending its decade-old valuation peg to the US\$. The new RMB rate reflects an approximately 2% increase in value against the US\$. Historically, the PRC government has benchmarked the RMB exchange ratio against the US\$, thereby mitigating the associated foreign currency exchange rate fluctuation risk. The Company does not believe that its foreign currency exchange rate fluctuation risk is significant, especially if the PRC government continues to benchmark the RMB against the US\$.

(J) Revenue recognition

The Company recognizes revenue upon the delivery of its share of crude oil extracted to its sole customer, PetroChina at which time title is passed; there are no uncertainties regarding customer acceptance; persuasive evidence of an arrangement exists; the sales price is fixed and determinable; and collectability is deemed probable.

Pursuant to the Oil Lease entered into on May 28, 2002 with PetroChina Group, the Company is entitled to 80% of the Company's oil production for the first ten years to 2012 and 60% of the Company's oil production for the remaining ten years to 2022.

(K) Income taxes

The Company accounts for income taxes under the SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"). Under SFAS 109, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Under SFAS 109, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that included the enactment date.

(L) Foreign currency translation

Except for North East Petroleum and Hong Xiang Petroleum Group, which maintain their accounting records in their functional currency in US\$, all other subsidiaries of the Company maintain their accounting records in their functional currency in RMB.

Foreign currency transactions during the year are translated to their functional currencies at the approximate rates of exchange on the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the approximate rates of exchange at that date. No-monetary assets and liabilities are translated at the rates of exchange prevailing at the time the asset or liability was acquired. Exchange gains or losses are recorded in the statement of operations.

The financial statements of the subsidiaries whose functional currencies are RMB are translated into US\$ using the closing rate method. The balance sheet items are translated into US\$ using the exchange rates at the respective balance sheet dates. The capital and various reserves are translated at historical exchange rates prevailing at the time of the transactions while income and expenses items are translated at the average exchange rate for the year. All exchange differences are recorded as a component of accumulated other comprehensive income within equity. Translation gain for the years ended December 31, 2007 and 2006 was \$1,091,940 and \$325,859 respectively.

(M) Comprehensive income

The foreign currency translation gain or loss resulting from the translation of the financial statements expressed in RMB to US\$ is reported as other comprehensive income in the statements of operations and stockholders' equity. Other comprehensive income for the years ended December 31, 2007 and 2006 was \$1,091,940 and \$325,859 respectively.

**CHINA NORTH EAST PETROLEUM HOLDINGS LIMITED
AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2007 AND 2006**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION (CONTINUED)

(N) Earnings per share

Basic earnings per share are computed by dividing income available to common stockholders by the weighted average number of common stocks outstanding during the year. Diluted income per share is computed similar to basic income per share except that the denominator is increased to include the number of additional common stocks that would have been outstanding if the potential common stocks had been issued and if the additional common stocks were diluted. There were no potentially dilutive securities for 2007 and 2006.

(O) Segments

The Company operates in only one segment. Thereafter segment disclosure is not presented.

(P) Environmental costs

The PRC has adopted extensive environmental laws and regulations that affect the operations of the oil and gas industry. The outcome of environmental liabilities under proposed or future environmental legislation cannot be reasonably estimated at present, and could be material. Under existing legislation, however, the management believes that there are no probable liabilities that will have a material adverse effect on the financial position of the Company. Hence no reserves have been set up for environmental costs.

(Q) Asset retirement obligations

The Company adopts the provisions of SFAS No. 143, Accounting for Asset Retirement Obligations. This Statement generally applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or the normal operation of a long-lived asset. SFAS No. 143 requires the Company to recognize the fair value of asset retirement obligations in the financial statements by capitalizing that cost as a part of the cost of the related asset. With regard to the Company, asset retirement obligations primarily relate to the abandonment of oil producing facilities. The Company did not incur and does not anticipate to incur any material dismantlement, restoration and abandonment costs given the nature of its producing activities and the current PRC regulations surrounding such activities.

(R) Recent accounting pronouncements

In September 2006, the FASB issued SFAS No.157, Fair Value Measurements ("SFAS 157"), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under accounting principles generally accepted in the United States. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. 157-2 of which the effective date delays the effective date of SFAS 157 for certain non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008. The Company is currently evaluating the impact of the adoption of SFAS No. 157 on its consolidated financial statements, but believes that it will not have a material impact on the Company's financial position.

In February 2007, the FASB issued SFAS No. 159 ("SFAS 159") The Fair Value Option for Financial Assets and Financial Liabilities, providing companies with an option to report selected financial assets and liabilities at fair value. This Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. SFAS 159 helps to mitigate this type of accounting-induced volatility by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with detailed rules for hedge accounting. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. This Standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the

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1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION (CONTINUED)

(R) Recent accounting pronouncements (Continued)

Company's choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the Company has chosen to use fair value on the face of the balance sheet. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 159 did not have a material impact on the Company's financial statements.

In June 2007, the Emerging Issues Task Force (Task Force) of the FASB reached a consensus on Issue No. 07-3 ("EITF 07-3"), Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities. Under EITF 07-3, nonrefundable advance payments for goods or services that will be used or rendered for research and development activities should be deferred and capitalized. Such payments should be recognized as an expense as the goods are delivered or the related services are performed, not when the advance payment is made. If a company does not expect the goods to be delivered or services to be rendered, the capitalized advance payment should be charged to expense. EITF 07-3 is effective for new contracts entered into in fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Earlier application is not permitted. The Company is currently evaluating the impact of the adoption of EITF 07-3 on its consolidated financial statements, but believes that it will not have a material impact on the Company's financial position.

In its December 2007 meeting, the FASB ratified the consensus reached by the Emerging Issues Task Force (EITF or Task Force) in Issue No. 07-1 ("EITF 07-1"), Accounting for Collaborative Arrangements. The scope of EITF 07-1 is limited to collaborative arrangements where no separate legal entity exists and in which the parties are active participants and are exposed to significant risks and rewards that depend on the success of the activity. The Task Force concluded that revenue transactions with third parties and associated costs incurred should be reported in the appropriate line item in each company's financial statements pursuant to the guidance in EITF 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent. The Task Force also concluded that the equity method of accounting under Accounting Principles Board Opinion 18, The Equity Method of Accounting for Investments in Common Stock, should not be applied to arrangements that are not conducted through a separate legal entity. The Task Force also concluded that the income statement classification of payments made between the parties in an arrangement should be based on a consideration of the following factors: the nature and terms of the arrangement; the nature of the entities' operations; and whether the partners' payments are within the scope of existing GAAP. To the extent such costs are not within the scope of other authoritative accounting literature, the income statement characterization for the payments should be based on an analogy to authoritative accounting literature or a reasonable, rational, and consistently applied accounting policy election. The provisions of EITF 07-1 are effective for fiscal years beginning on or after December 15, 2008, and companies will be required to apply the provisions through retrospective application to all collaborative arrangements existing at adoption as a change in accounting principle. If it impracticable to apply the consensus to a specific arrangement, disclosure is required regarding the reason why retrospective application is not practicable and the effect of reclassification on the current period. The Company is currently evaluating the impact of the adoption of EITF 07-1 on its consolidated financial statements, but believes that it will not have a material impact on the Company's financial position.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations" ("SFAS 141(R)"), which replaces SFAS No. 141. SFAS No. 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. The Statement also establishes disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS 141(R) will have an impact on accounting for business combinations once adopted, but the effect is dependent upon acquisitions at that time.

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1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION (CONTINUED)

(R) Recent accounting pronouncements (Continued)

In December 2007, the Financial Accounting Standards Board (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 is not expected to have a material effect on the Company's financial statements.

2. BUSINESS COMBINATIONS BETWEEN ENTITIES UNDER COMMON CONTROL

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 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 and 30% by third parties held on behalf of the related party. As of January 26, 2007, Yu Qiao has become a 90% owned subsidiary of the Company.

This transaction 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 at the beginning of the first period presented, each account stated at its historical cost. In this regard, the prior year's financial statements and financial information have been amended to combine the previously separate entities to furnish comparative information. The results of this change in presentation were to increase the total assets, total liabilities and additional paid-in capital as of December 31, 2006 by \$18,453,923, \$15,638,857 and \$1,949,583 respectively, and to increase the net income for the year ended December 31, 2006 by \$26,782. (Note 19)

3. ACCOUNTS RECEIVABLE, NET

Accounts receivable at December 31, 2007 and 2006 consisted of the following:

	2007	2006
Accounts receivable from PetroChina	\$ 4,852,633	\$ 750,684
Less: allowance for doubtful accounts	-	-
Accounts receivable, net	\$ 4,852,633	\$ 750,684

As of December 31, 2007 and 2006, the Company considered all accounts receivable collectable and has not recorded a provision for doubtful accounts.

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4. PREPAID EXPENSES AND OTHER CURRENT ASSETS

Prepaid expenses and other current assets at December 31, 2007 and 2006 consist of the following:

	<u>2007</u>	<u>2006</u>
Prepaid expenses	\$ 150,973	\$ 223,551
Deposits paid to suppliers	183,562	627,171
Other receivables	<u>63,511</u>	<u>74,636</u>
	<u>\$ 398,046</u>	<u>\$ 925,358</u>

5. OIL AND GAS PROPERTIES

The following is a summary of oil and gas properties at December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Oil and gas properties, proven reserves	\$ 47,594,281	\$ 26,172,718
Intangible mining right	13,445	13,445
Less: accumulated depreciation	<u>(7,262,718)</u>	<u>(3,327,796)</u>
Oil and gas properties, net	<u>\$ 40,345,008</u>	<u>\$ 22,858,367</u>

Depreciation expense for the years ended December 31, 2007 and 2006 was \$3,562,265 and \$1,067,335 respectively.

6. FIXED ASSETS

The following is a summary of fixed assets at December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Buildings	\$ 308,067	\$ 249,512
Furniture, fixtures and equipment	197,171	158,959
Motor vehicles	<u>798,613</u>	<u>588,838</u>
	1,303,851	997,309
Less: accumulated depreciation	<u>(418,377)</u>	<u>(243,257)</u>
Fixed assets, net	<u>\$ 885,474</u>	<u>\$ 754,052</u>

Depreciation expense for the years ended December 31, 2007 and 2006 was \$187,766 and \$103,448 respectively.

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7. LAND USE RIGHTS

The following is a summary of land use rights at December 31:

	<u>2007</u>	<u>2006</u>
Land use rights	\$ 66,927	\$ 62,688
Less: accumulated amortization	<u>(21,851)</u>	<u>(10,019)</u>
Land use rights, net	\$ <u>45,076</u>	\$ <u>52,669</u>

The land use rights are amortized over six years of the term of the leases. The amortization expense for the years ended December 31, 2007 and 2006 was \$10,711 and \$4,368 respectively.

8. ACCOUNTS PAYABLE

During the year, the Company negotiated new payment terms with its primary drilling company that enabled the Company to pay the drilling expenses for each well over 24 months commencing from the completion of the well. Accordingly, \$15,467,661 was re-classified as long-term liabilities as of December 31, 2007.

9. OTHER PAYABLES AND ACCRUED LIABILITIES

Other payables and accrued liabilities at December 31, 2007 and 2006 consist of the following:

	<u>2007</u>	<u>2006</u>
Other payables	\$ 662,941	\$ 892,004
Accrued professional fees	154,869	152,204
Other accrued liabilities	<u>203,170</u>	<u>349,061</u>
	\$ <u>1,020,980</u>	\$ <u>1,393,269</u>

10. NOTES PAYABLE

Notes payable at December 31, 2007 and 2006 consist of the following:

	<u>2007</u>	<u>2006</u>
Note payable to a bank, interest rate of 10.60% per annum, guaranteed by a subsidiary, due June 2007	\$ -	\$ 128,062
Note payable to a bank, interest rate of 11.16% per annum, secured by a property owned by a stockholder, due July 2008	<u>273,444</u>	<u>256,125</u>
	273,444	384,187
Less: current maturities	<u>273,444</u>	<u>128,062</u>
Long-term portion	\$ -	\$ <u>256,125</u>

Interest expense paid for the years ended December 31, 2007 and 2006 was \$81,434 and \$43,541 respectively.

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11. OTHER LOANS PAYABLE

As of December 31, 2006, the Company has two outstanding short-term loans in the amount of \$12,806 and \$12,806, which were borrowed from third parties in October 2005 without fixed repayment terms. Interest is charged at 36% per annum.

Interest expense paid for the years ended December 31, 2007 and 2006 was \$0 and \$11,883 respectively.

12. COMMITMENTS AND CONTINGENCIES

(A) Employee benefits

The full time employees of LongDe and Yu Qiao are entitled to employee benefits including medical care, welfare subsidies, unemployment insurance and pension benefits through a Chinese government mandated multi-employer defined contribution plan. The Company is required to accrue for those benefits based on certain percentages of the employees' salaries and make contributions to the plans out of the amounts accrued for medical and pension benefits. The total provision and contributions made for such employee benefits for the years ended December 31, 2007 and 2006 was \$92,835 and \$54,175 respectively. The Chinese government is responsible for the medical benefits and the pension liability to be paid to these employees.

(B) Commitments

The Company leases office spaces from a stockholder, land and office spaces from third parties under six operating leases which expire on September 20, 2023, June 30, 2015, April 10, 2010, November 14, 2008, June 1, 2008 and June 1, 2008 at annual rental of \$171, \$13,125, \$8,340, \$10,254, \$3,281 and \$1,340 respectively.

As at December 31, 2007, the Company has outstanding commitments with respect to the above operating leases, which are due as follows:

2008	\$	32,961
2009		21,636
2010		15,381
2011		13,296
Thereafter		<u>47,947</u>
	\$	<u>131,221</u>

(C) Capital commitments

According to the amended Articles of Association of Song Yuan Technical, the Company has to fulfill registered capital contribution of \$1 million. As of December 31, 2007, the Company has fulfilled \$490,000 of the registered capital requirement and has outstanding capital contributions of \$510,000.

As of December 31, 2007, the Company had capital commitments of \$1,780,000 with a contractor for the completion of drilling of 19 oil wells under construction.

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13. STOCKHOLDERS' EQUITY

(A) Stock issuances

On January 26, 2007, Song Yuan Technical entered into an agreement with a related party and third parties who are the stockholders of Yu Qiao to acquire 100% of the equity interest of Yu Qiao. In consideration for the acquisition, the Company will issue to the related party an aggregate of 10,000,000 shares of the Company's common stock ("the Acquisition Shares") having a fair value of \$3,100,000.

On June 29, 2007, the Company and the related party entered into an agreement pursuant to which the related party unconditionally and irrevocably contributed the Acquisition Shares to the Company. The contribution of the Acquisition Shares was recorded as additional paid-in capital by the Company.

(B) Appropriated retained earnings

The Company's PRC subsidiaries are required to make appropriations to reserve funds, comprising the statutory surplus reserve, statutory public welfare fund and discretionary surplus reserve, based on the after-tax net income determined in accordance with the laws and regulations of the PRC. Prior to January 1, 2006 the appropriation to the statutory surplus reserve should be at least 10% of the after tax net income determined in accordance with the laws and regulations of the PRC until the reserve is equal to 50% of the entities' registered capital. Appropriations to the statutory public welfare fund are at 5% to 10% of the after tax net income determined by the Board of Directors. Effective January 1, 2006, the Company is only required to contribute to one statutory reserve fund at 10 percent of net income after tax per annum, such contributions not to exceed 50 percent of the respective companies' registered capital.

The statutory reserve funds are restricted for use to set off against prior period losses, expansion of production and operation or for the increase in the registered capital of the Company. The statutory public welfare fund is restricted for use in capital expenditures for the collective welfare of employees. These reserves are not transferable to the Company in the form of cash dividends, loans or advances. These reserves are therefore not available for distribution except in liquidation.

During 2007 and 2006, the Company appropriated \$628,629 and \$145,050 respectively to the reserves funds based on its net income in accordance with the laws and regulations of the PRC.

14. RELATED PARTY TRANSACTIONS

a) Pursuant to an agreement entered into by a stockholder, a related party and the Company on June 29, 2007, the stockholder and the related party unconditionally and irrevocably contributed all of the advances owed by the Company as of March 31, 2007 amounting to \$1,746,128 and \$5,451,685 respectively to the Company. These contributions were recorded as additional paid-in capital by the Company.

b) On January 26, 2007, Song Yuan Technical entered into an agreement with a related party and certain third parties who are stockholders of Yu Qiao to acquire 100% of the equity interest of Yu Qiao. In consideration for the acquisition, the Company will issue to the related party an aggregate of 10,000,000 shares of the Company's common stock ("the Acquisition Shares") having a fair value of \$3,100,000.

On June 29, 2007, the Company and the related party entered into an agreement pursuant to which the related party unconditionally and irrevocably contributed the Acquisition Shares to the Company. The contribution of the Acquisition Shares was recorded as additional paid-in capital by the Company.

c) In 2007 and 2006, the Company owed a related party \$3,118,085 and \$4,255,441 respectively for advances made without fixed repayment terms. Imputed interest expense is computed at 7% and 6% per annum on the amount due respectively.

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14. RELATED PARTY TRANSACTIONS (CONTINUED)

- d) In 2007 and 2006, the Company owed a related party \$13,672 and \$12,806 respectively which is repayable on demand. Imputed interest expense is computed at 7% and 6% per annum on the amount due respectively.
- e) In 2007, the Company owed a related party \$14,364 which is repayable on demand. Imputed interest expense is computed at 7% per annum on the amount due.
- f) In 2006, a related party owed the Company \$64,031 which is interest free and repayable on demand.
- g) In 2006, the Company owed a related party \$43,029 which is repayable on demand. Interest is charged at 24% per annum. Interest expense paid for the year ended December 31, 2006 was \$351.
- h) In 2007 and 2006, the Company owed a stockholder \$123,105 and \$1,656,935 respectively which is repayable on demand. Imputed interest expense is computed at 7% and 6% per annum on the amount due respectively.
- i) Total imputed interest expenses recorded as additional paid-in capital amounted to \$200,165 and \$349,393 for the years ended December 31, 2007 and 2006 respectively.
- j) The Company paid a stockholder \$12,603 and \$12,027 for leased office spaces for the years ended December 31, 2007 and 2006 respectively.
- k) On April 3, 2006, the Company issued 700,000 shares of common stock to a related party for consulting services. The stock was valued at the closing price on the date of grant of \$0.31 per share, yielding an aggregate value of \$217,000.

15. INCOME TAX

It is management's intention to reinvest all the income attributable to the Company earned by its operations outside of the US. Accordingly, no US corporate income taxes are provided for in these financial statements.

The Company is subject to income taxes on an entity basis on income arising in or derived from the tax jurisdiction in which each entity is domiciled.

North East Petroleum was incorporated in the United States and has incurred net operating loss as for income tax purposes for 2007 and 2006.

North East Petroleum has net operating loss carry forwards for income taxes amounting to approximately \$1,942,000 as at December 31, 2007 which may be available to reduce future years' taxable income. These carry forwards, will expire, if not utilized, commencing in 2024. Management believes that the realization of the benefits from these losses appears uncertain due to the Company's operating history income and continuing losses. Accordingly, a full deferred tax asset valuation allowance has been provided and no deferred tax asset benefit has been recorded. The valuation allowances at December 31, 2007 and December 31, 2006 were \$660,286 and \$553,815 respectively. The net change in the valuation allowance was an increase of \$106,471.

Hong Xiang Petroleum Group was incorporated in the British Virgin Islands (the "BVI") and income earned is not subject to income tax.

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15. INCOME TAX (CONTINUED)

Song Yuan Technical, Yu Qiao and LongDe were incorporated in the PRC and are subject to PRC income tax which is computed according to the relevant laws and regulations in the PRC. The applicable tax rate has been 33% and no tax benefit is expected from the tax credits in the future. The income tax expense (benefits) for 2007 and 2006 are summarized as follows:

	Year ended December 31,	
	2007	2006
Current	2,784,009	24,127
Deferred	313,640	(40,979)
	\$ 3,097,649	\$ (16,852)

Deferred income tax liabilities for 2007 and 2006 reflect the effect of temporary differences between amounts of assets, liabilities, and equity for financial reporting purposes and the bases of such assets, liabilities, and equity as measured by tax laws.

Deferred income tax liabilities mainly result from temporary differences for revenues earned but not yet taxable under the PRC tax regulations. All the deferred tax liabilities are classified as long-term liabilities as the Company will not be demanded for payment within the next twelve months.

16. CONCENTRATIONS AND RISKS

During 2007 and 2006, 100% of the Company's assets were located in the PRC and 100% of the Company's revenues were derived from one customer located in the PRC. The Oil Lease requires the Company to sell crude oil to PetroChina only.

17. RECLASSIFICATIONS

Certain reclassifications have been made in the consolidated financial statements for the year ended December 31, 2006 to conform to the current year's presentation.

18. SUBSEQUENT EVENTS

(A) Private placement

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 a 8.00% 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.

As of March 25, 2008, the Company has received net proceeds of \$13,815,500 from the sale Debentures. The Company intends to use the net proceeds to fund drilling operations, to increase production and for general working capital purposes.

At the closing of the transaction, the Company entered into:

- A 8.00% Secured Debenture due 2012;
- A registration rights agreement covering the shares of common stock issuable upon exercise of the Class A, Class B and Class C Warrants;

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18. SUBSEQUENT EVENTS (CONTINUED)

(A) Private placement (Continued)

- A share pledge agreement whereby the Company granted to the Investor a pledge on 66% of the Company's equity interest in Song Yuan Technical as collateral to secure the Debenture;
- A security agreement whereby the Company granted to the Investor a security interest in certain properties of the Company as collateral to secure the Debenture; and
- An option agreement whereby the Company grants the Investor an option to purchase up to 24% of the registered capital of Song Yuan Technical at fair market value, which option will vest immediately on the date following the occurrence of an event of default which results in the acceleration of the Debenture.

In addition, Hongjun Wang, President and Chief Executive Officer of the Company, executed a pledge agreement whereby Mr. Wang, personally pledged 6,732,000 shares of common stock in the Company as collateral to secure the Debenture.

Hong Jie Ltd. acted as the financial consultant for this transaction and is entitled to receive a cash fee equal to 6.5% of the aggregate principal amount of the Debenture and warrants to purchase up to (i) 120,000 shares of common stock in the Company on the same terms as the Class A Warrants, (ii) 150,000 shares of common stock in the Company on the same terms as the Class B Warrants and (iii) 210,000 shares of common stock in the company on the same terms as the Class C Warrants.

The Debenture will mature on February 27, 2012. The Company is required to make payments on the principal amount of the Debenture as follows:

<u>Repayment Date</u>	<u>Repayment of Principal Amount</u>
6 months from the issue date	\$ 750,000
12 months from the issue date	\$ 750,000
18 months from the issue date	\$ 1,875,000
24 months from the issue date	\$ 1,875,000
30 months from the issue date	\$ 3,375,000
36 months from the issue date	\$ 3,375,000
42 months from the issue date	\$ 1,500,000
48 months from the issue date	\$ 1,500,000

The Company has the option to redeem the Debenture at any time after the second anniversary of the issue date of the Debenture by prepaying 100% of the then outstanding principal amount of the Debenture, all accrued but unpaid interest and all other amounts due in respect of the Debenture. If any portion of the payment pursuant to such redemption is not be paid by the Company, interest will accrue thereon at an interest rate equal to the lesser of 18% per annum and the maximum rate permitted by applicable law until such amount is paid in full.

Interest on the then outstanding principal amount of the Debenture will accrue at the rate of 8% per annum, payable quarterly on January 1, April 1, July 1 and October 1, beginning on the first such date after the issue date.

The Debenture requires the Company to pay interest at the rate equal to the lesser of 18% per annum or the maximum rate permitted under applicable law if certain events of default occur, including but not limited to, the event where the Company has not obtained a listing of its common stock on the Nasdaq Stock Market or the American stock Exchange by one year anniversary of the issue date of the Debenture and use its best efforts to maintain such listing continuously thereafter as long as the Debenture is outstanding.

The Debenture limits the Company's ability to incur debt and enter into transactions with affiliates, among other things.

Upon an event of default, the Investor will have the right to require that the Company pay any portion or all principal and accrued interest on the Debenture with 10 days' prior written notice to the Company.

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18. SUBSEQUENT EVENTS (CONTINUED)

(B) Fulfillment of capital commitments

On March 4, 2008, the Company has fulfilled the remaining balance of \$510,000 capital contribution to Song Yuan Technical.

(C) Increase of registered capital of a subsidiary of the Company

On March 13, 2008, the registered capital of Song Yuan Technical was increased from \$1,121,000 to \$6,000,000. The capital contribution is payable on or before March 13, 2011.

19. PRESENTATION OF FINANCIAL STATEMENTS

The Company has amended the audited consolidated financial statements for the year ended December 31, 2006 to reflect the retroactive effects on the acquisition of Yu Qiao as a reorganization of entities under common control.

20. SUPPLEMENTAL OIL AND GAS DISCLOSURES (UNAUDITED)

The accompanying table presents information concerning the Company's crude oil producing activities as required by SFAS No. 69, Disclosures about Oil and Gas Producing Activities.

A. Capitalized costs relating to oil and gas producing activities are as follows:

	<u>2007</u>	<u>2006</u>
Proved crude oil properties	\$ 47,594,281	\$ 26,172,718
Intangible mining right	13,445	13,445
Accumulated depreciation, depletion and amortization	<u>(7,262,718)</u>	<u>(3,327,796)</u>
Net capitalized costs	\$ <u>40,345,008</u>	\$ <u>22,858,367</u>

B. Cost incurred in oil and gas property acquisitions, exploration and development activities are as follows:

	<u>2007</u>	<u>2006</u>
Property acquisition costs (net of costs of properties sold)		
Proved reserves	\$ <u>12,518,210</u>	\$ <u>9,151,521</u>
Property development costs	\$ <u>35,076,071</u>	\$ <u>17,021,197</u>

C. The results of operations for oil and gas producing activities are as follows:

	<u>2007</u>	<u>2006</u>
Net sales	\$ 19,482,069	\$ 5,321,905
Production costs	(2,872,990)	(1,091,190)
Depreciation, depletion and amortization	(3,760,742)	(1,175,151)
Government oil surcharge	(2,857,376)	(560,584)
General and administrative expenses	(880,161)	(884,778)
Income tax (expense) benefits	<u>(3,097,649)</u>	<u>16,852</u>
Results of operations from oil and gas producing (excluding corporate overhead and financing costs)	\$ <u>6,013,151</u>	\$ <u>1,627,054</u>

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20. SUPPLEMENTAL OIL AND GAS DISCLOSURES (UNAUDITED) (CONTINUED)

D. Estimated quantities of proved oil and gas reserves

The following schedule estimates proved crude oil reserves attributable to the Company. Proved reserves are estimated quantities of oil which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. Proved developed reserves are those which are expected to be recovered through existing wells with existing equipment and operating methods. Reserves are stated in barrels of oil (Bbls). Geological and engineering estimates of proved oil and natural gas reserves at one point in time are highly interpretive, inherently imprecise and subject to ongoing revisions that may be substantial in amount. Although every reasonable effort is made to ensure that the reserve estimates reported represent the most accurate assessments possible, these estimates are by their nature generally less precise than other estimates presented in connection with financial statement disclosures.

	Bbls
Proved oil reserves	
Balance at January 1, 2006	2,419,021
Discoveries and extensions	-
Revisions of previous estimates	(89,631)
Production	(87,196)
Balance at December 31, 2006	2,242,194
Discoveries and extensions	-
Revisions of previous estimates	494,146
Production	(267,516)
Balance at December 31, 2007	2,468,824
Proved developed producing reserves at December 31, 2007	1,369,401
Proved developed producing reserves at December 31, 2006	898,516

The following schedule presents the standardized measure of estimated discounted future net cash flows from the Company's proved developed reserves for the years ended December 31, 2007 and 2006. Estimated future cash flows were based on independent reserves evaluation from Ralph E. Davis Associates, Inc. and R.A. Lenser and Associates, Inc. for the years ended December 31, 2007 and 2006, respectively. Because the standardized measure of future net cash flows was prepared using the prevailing economic conditions existing at December 31, 2007 and 2006, it should be emphasized that such conditions continually change. Accordingly, such information should not serve as a basis in making any judgment on the potential value of the Company's recoverable reserves or in estimating future results of operations.

Estimated future net cash flows represent an estimate of future net revenues from the production of proved reserves using current sales prices, along with estimates of the operating costs, production taxes and future development and abandonment costs (less salvage value) necessary to produce such reserves. The average prices per barrel used at December 31, 2007 for four oilfields were \$95.95 and at December 31, 2006 for Qian'an 112, Gu 31, Da 34 and He 301 were \$72.58, \$64.45, \$70.65 and \$69.70 respectively. No deduction has been made for depreciation, depletion or any indirect costs such as general corporate overhead or interest expense.

Operating costs and production taxes are estimated based on current costs with respect to producing gas properties. Future development costs are based on the best estimate of such costs assuming current economic and operating conditions.

Income tax expense is computed based on applying the appropriate statutory tax rate to the excess of future cash inflows less future production and development costs over the current tax basis of the properties involved, less applicable carry forwards, for both regular and alternative minimum tax.

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AS OF DECEMBER 31, 2007 AND 2006**

20. SUPPLEMENTAL OIL AND GAS DISCLOSURES (UNAUDITED) (CONTINUED)

D. Estimated quantities of proved oil and gas reserves (Continued)

The future net revenue information assumes no escalation of costs or prices, except for gas sales made under terms of contracts which include fixed and determinable escalation. Future costs and prices could significantly vary from current amounts and, accordingly, revisions in the future could be significant.

Standardized measures of discounted future net cash flows relating to proved oil and gas reserves at December 31, 2007 and 2006 is as follows:

	<u>2007</u>	<u>2006</u>
Future cash inflows	\$ 235,187,861	\$ 160,225,370
Future production costs and taxes	(68,891,575)	(40,574,908)
Future development costs	(28,713,919)	(8,587,200)
Future income tax expense	<u>(33,801,457)</u>	<u>(25,131,207)</u>
Future net cash flows	103,780,910	85,932,055
Discount at 10% for timing of cash flows	<u>(64,469,078)</u>	<u>(49,592,849)</u>
Standardized measure of discounted future net cash related to proved reserves	\$ <u>39,311,832</u>	\$ <u>36,339,206</u>

Of the Company's total proved reserves as of December 31, 2007 and 2006, 55% and 40% respectively were classified as proved developed producing. All of the Company's reserves are located in the PRC.

The following table sets forth the changes in the standardized measure of discounted future net cash flows from proved reserves for December 31, 2007 and 2006.

	<u>2007</u>	<u>2006</u>
Balance, beginning of year	\$ 36,339,206	\$ 24,425,715
Purchase of minerals in place	12,148,545	18,770,478
Sales and transfers of oil and gas produced, net of production costs	(13,522,379)	(4,217,906)
Changes in prices and production costs	23,455,903	39,720,407
Revision of quantity estimates	36,712,367	(4,746,885)
Changes in estimated future development and acquisition costs	(32,275,264)	(15,282,478)
Net changes in income taxes	(8,670,317)	(5,949,064)
Accretion of discount	<u>(14,876,229)</u>	<u>(16,381,061)</u>
Standardized measure, end of year	\$ <u>39,311,832</u>	\$ <u>36,339,206</u>