

**Montello Resources Ltd.**

**Interim  
Consolidated  
Financial  
Statements  
(Unaudited– Prepared by Management)**

**January 31, 2006**

AMENDED

Head Office  
Suite 1206 – 836 5<sup>th</sup> Avenue S.W.  
Calgary, Alberta, T2P 0N5  
Phone: (403) 888-8822  
Web page [www.montello.com](http://www.montello.com)  
Email [ir@montello.com](mailto:ir@montello.com)

**Montello Resources Ltd.  
Suite 1206 – 836 5<sup>th</sup> Avenue SW  
Calgary, Alberta, T2P 0N5**

**NOTICE TO USERS**

March 31, 2006

The accompanying interim consolidated financial statements have not been reviewed by an auditor.

**“MONTELLO RESOURCES LTD.”**

# MONTELLO RESOURCES LTD.

## Consolidated Balance Sheet

Canadian Funds

	Jan 31, 2006 (unaudited)	Jul 31, 2005 (audited)
<b>ASSETS</b>		
Current		
Cash	\$ (96,627)	\$ 79,858
Reclamation deposit	50,372	40,372
Marketable securities (Note 5)	18,684	28,167
Advances to related party	-	2,703
Accounts receivable and prepaid expenses	82,562	47,677
	54,991	198,777
Exploration advance	80,453	39,817
Property and equipment net of depreciation (Note 7)	28,142	14,884
Resource properties (Note 8)	3,654,748	1,378,084
	\$ 3,818,334	\$ 1,631,562
<b>LIABILITIES</b>		
Current		
Accounts payable and accrued liabilities (Note 11(e))	\$ 283,565	\$ 243,960
	283,565	243,960
Advances from affiliated company (Note 6)	1,141,075	1,279,407
Convertible loan payable (Note 9)	944,444	-
	2,369,084	1,523,367
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (Notes 10 and 15)	17,371,859	15,575,284
Share subscriptions	-	122,850
Contributed surplus	788,366	425,361
Deficit	(16,710,975)	(16,015,300)
	1,449,250	108,195
	\$ 3,818,334	\$ 1,631,562

Approved by the directors

"Dwayne Tyrkalo", Director

"Patrick Power", Director

# **MONTELLO RESOURCES LTD.**

## **Interim Consolidated Statement of Operations and Deficit**

For the Periods Ended January 31, 2006 & January 31, 2005

(Unaudited, prepared by management)

Canadian Funds

	Three Months Ended..		Six Months Ended..	
	2006	2005	2006	2005
<b>Income</b>				
Oil and gas revenue	(109,314)	-	<b>(109,314)</b>	-
Capital gain on securities	(25,199)	-	<b>(25,199)</b>	-
	<b>(134,513)</b>	-	<b>(134,513)</b>	-
<b>General and administrative expense</b>				
Accounting and audit	\$ 19,600	\$ 3,050	\$ <b>25,600</b>	\$ 6,855
Amortization and depletion	26,852	-	<b>27,265</b>	-
Bank charges and interest	22,206	357	<b>22,705</b>	903
Consulting fees	121,267	18,000	<b>187,039</b>	33,000
Filing fees	10,826	10,767	<b>17,002</b>	12,192
Legal fees	731	15,786	<b>2,793</b>	16,770
Management fees	12,000	29,003	<b>48,000</b>	44,003
Office	2,911	5,260	<b>3,277</b>	5,308
Promotion	25,359	13,673	<b>29,104</b>	13,673
Property examination	-	(713)	-	15,275
Rent	6,004	7,777	<b>14,179</b>	15,277
Stock compensation	-	-	<b>363,005</b>	-
Transfer agent fees	3,979	3,127	<b>4,548</b>	4,406
Travel	35,991	7,371	<b>78,740</b>	7,371
Website hosting	48	3,100	<b>283</b>	3,625
	<b>287,774</b>	<b>116,558</b>	<b>823,540</b>	<b>178,658</b>
<b>Loss before undernoted items</b>	<b>153,261</b>	<b>116,558</b>	<b>689,027</b>	<b>178,658</b>
Interest income	(144)	(124)	<b>(241)</b>	(131)
Foreign exchange (gain) or loss	(1,485)	(335)	<b>6,889</b>	3,235
Recovery of resource property cost	-	(15,667)	-	(15,667)
<b>Loss for the period</b>	<b>151,632</b>	<b>100,432</b>	<b>695,675</b>	<b>166,095</b>
<b>Deficit, beginning of period</b>	<b>16,559,343</b>	<b>15,138,207</b>	<b>16,015,300</b>	<b>15,072,544</b>
<b>Deficit, end of period</b>	<b>\$ 16,710,975</b>	<b>\$ 15,238,639</b>	<b>\$ 16,710,975</b>	<b>\$ 15,238,639</b>
Loss (gain) per share basic and diluted	\$ 0.01	0.01	\$ <b>0.01</b>	\$ 0.01

# **MONTELLO RESOURCES LTD.**

## **Interim Consolidated Statement of Cash Flows**

For the Periods Ended January 31, 2006 & January 31, 2005  
(Unaudited, prepared by management)  
Canadian Funds

	Three Months Ended..		Six Months Ended..	
	2006	2005	2006	2005
<b>Operating activities</b>				
Gain (loss) for the period	\$ (151,632)	\$ (100,432)	\$ (695,675)	\$ (166,095)
Items not involving cash				
Depletion and depreciation	27,265	-	27,265	-
Stock compensation expense	-	-	363,005	-
Recovery of resource property costs	-	(15,667)	-	(15,667)
	(124,367)	(116,099)	(305,405)	(181,762)
Changes in non-cash working capital items	(4,975)	(292,518)	7,423	(284,824)
<b>Net cash used in operating activities</b>	<b>(129,342)</b>	<b>(408,617)</b>	<b>(297,982)</b>	<b>(466,586)</b>
<b>Financing activities</b>				
Issuance of shares for cash	437,155	630,500	946,575	630,500
Issuance of shares for property	850,000	-	850,000	-
Share subscriptions	(218,005)	-	(122,850)	-
Convertible loan payable	944,444	-	944,444	-
Advances from affiliated company	(138,659)	19,125	(138,332)	341,265
<b>Net cash provided by financing activities</b>	<b>1,874,935</b>	<b>649,625</b>	<b>2,479,837</b>	<b>971,765</b>
<b>Investing activities</b>				
Resource property expenditures	(987,349)	(178,174)	(727,664)	(377,813)
Resource property acquisitions	(850,000)	-	(1,574,000)	-
Exploration advance	(37,561)	-	(40,636)	-
Purchase property and equipment	(15,936)	(16,538)	(15,523)	(16,538)
Reclamation deposit	(10,000)	-	(10,000)	-
Marketable securities	9,483	-	9,483	-
<b>Net cash used in exploration activities</b>	<b>(1,891,363)</b>	<b>(194,712)</b>	<b>(2,358,340)</b>	<b>(394,351)</b>
<b>Net increase (decrease) in cash</b>	<b>(145,770)</b>	<b>46,296</b>	<b>(176,485)</b>	<b>110,828</b>
Cash, beginning of period	49,143	61,679	79,858	(2,853)
<b>Cash, end of period</b>	<b>\$ (96,627)</b>	<b>\$ 107,975</b>	<b>\$ (96,627)</b>	<b>\$ 107,975</b>

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

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January 31, 2006

(Unaudited, prepared by management)

Canadian Funds

### **1. Continuing Operations**

These interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles applicable to a going concern which assume that the Company will realize its assets and discharge its liabilities in the normal course of business. Realization values may be substantially different from the carrying values as shown in the financial statements should the Company be unable to continue as a going concern.

### **2. Nature of Operations**

The Company' business is in the oil and gas industry and is in the exploration and development stage.

The recoverability of amounts shown for resource properties and related deferred costs is dependent upon the discovery of economically recoverable reserves, the ability of the Company to obtain necessary financing to complete the development, and future profitable production from the properties or proceeds from disposition.

### **3. Significant Accounting Policies**

#### **(a) Basis of presentation**

These interim consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Moonshine Resources Ltd. and Montello Resources USA Ltd.

#### **(b) Oil and gas properties**

The Company follows the full cost method of accounting for its oil and gas properties, whereby all costs of exploring for and developing oil and gas reserves are capitalized to cost centres on a country-by-country basis. Such costs include land acquisition costs, geological costs, carrying charges on non-producing properties, costs of drilling both productive and non-productive wells, cost of production and gathering equipment and general and administrative charges related to acquisition, exploration and development activities. Proceeds from the disposal of oil and natural gas properties are applied against capitalized costs. Gains or losses are not recognized on disposals unless crediting the proceeds against capitalized costs would materially alter the rate of depletion.

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

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January 31, 2006

(Unaudited, prepared by management)

Canadian Funds

### 3. **Significant Accounting Policies** (continued)

#### (b) **Oil and gas properties** (continued)

The amounts shown for oil and gas properties represent costs to date and are not intended to reflect present or future values.

The capitalized costs together with estimated future capital costs associated with the development of proven reserves are depleted and amortized using the unit of production method based on proven oil and natural gas reserves, before royalties, determined by Company and independent engineers. For purpose of the depletion and amortization calculations, oil and natural gas reserves are converted to a common unit of measure based upon their relative energy content.

In applying the cost method, the Company performs a ceiling test which restricts capitalized costs less accumulated depletion and amortization from exceeding the estimated undiscounted value of future net revenues from proved oil and natural gas reserves less estimated future removal and site restoration costs, general and administrative expenses, financing costs and income taxes. In calculating the ceiling test, the year end prices of oil and natural gas are used and all costs are estimated to be constant.

The Company periodically reviews the cost associated with undeveloped properties to determine whether the costs will be recoverable. If the results of the review indicate an impairment has occurred, the cost of the property or the amount of the impairment is added to the full cost pool.

Estimated future removal and site restoration costs are provided for using the unit-of-production method. These costs are based on year end engineering estimates of the anticipated costs of the site restoration in accordance with current legislation and industry practices. The annual charge is recorded as additional depletion and amortization.

Where the Company's exploration development and production activities related to oil and gas are conducted jointly with others the accounts reflect only the Company's proportionate interest in such activities.

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

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January 31, 2006

(Unaudited, prepared by management)

Canadian Funds

### 3. **Significant Accounting Policies** (continued)

#### (c) **Values**

The amounts shown for oil and gas properties and deferred exploration costs represent costs to date, and do not necessarily represent present or future values, as they are entirely dependent upon the economic recovery of current and future reserves.

#### (d) **Cost of maintaining resource properties**

The Company does not accrue the estimated future costs of maintaining its resource properties in good standing.

#### (e) **Marketable securities**

Marketable securities are stated at lower of cost or market.

#### (f) **Investments**

The Company accounts for its investments using the cost method. Where in management's opinion there has been a loss in value that is other than a temporary decline, the carrying value is reduced to the estimated realizable value.

#### (g) **Property and equipment**

Property and equipment are reported at cost. Amortization is provided using the declining balance method at the rate of 20% per annum. Only one-half of the rate is used in the year of acquisition.

#### (h) **Share capital**

Common shares issued for non-monetary consideration are recorded at their fair market value based upon the trading price of the Company's shares on the TSX Venture Exchange on the date of the agreement to issue the shares or the date of share issuance, whichever is lower.

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

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January 31, 2006

(Unaudited, prepared by management)

Canadian Funds

### 3. **Significant Accounting Policies** (continued)

#### (h) **Share capital** (continued)

The proceeds from shares issued pursuant to flow-through share financing agreements are credited to share capital and the tax benefits related to the exploration expenditures incurred pursuant to these agreements are transferred to the purchaser of the flow-through shares. When the proceeds of flow-through financings are received, the Company becomes committed to incurring the underlying exploration expenditures on a “best efforts” basis; however, the Company does not recognize such future expenditures as liabilities for purposes of its financial reporting.

Costs incurred to issue shares are deferred until the shares are issued, at which time these costs are charged to share capital.

#### (i) **Stock-based compensation plan**

The Company accounts for options granted under its fixed stock option plan using the fair value based method of accounting for stock-based compensation. Accordingly, the fair value of the options at the date of the grant is accrued and charged to operations, with an offsetting credit to contributed surplus, on a straight-line basis over the vesting period. If and when the stock options are ultimately exercised, the applicable amounts of contributed surplus are transferred to share capital.

#### (j) **Environmental expenditures**

The operations of the Company may in the future be affected from time to time in varying degrees by changes in environmental regulations, including those for future removal and site restoration costs. Both the likelihood of new regulations and their overall effect upon the Company are not predictable.

#### (k) **Use of estimates**

The preparation of interim financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the year. Actual results could differ from these estimates.

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

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January 31, 2006

(Unaudited, prepared by management)

Canadian Funds

### **3. Significant Accounting Policies (continued)**

#### **(l) Loss per share**

The Company uses the treasury stock method to compute the dilutive effect of options, warrants and similar instruments. Under this method the dilutive effect on earnings per share is recognized on the use of the proceeds that could be obtained upon exercise of options, warrants and similar instruments. It assumes that the proceeds would be used to purchase common shares at the average market price during the year. For diluted loss per share, the dilutive effect has not been presented separately as it proved to be anti-dilutive.

Loss per share is calculated using the weighted-average number of shares outstanding during the year.

#### **(m) Income taxes**

Future income taxes are recorded using the asset and liability method. Using the asset and liability method, future 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. Future tax assets and liabilities are measured using the enacted or substantively enacted tax rates expected to apply when the asset is realized or the liability settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the year that substantive enactment occurs. To the extent that the Company does not consider it more likely than not a future tax asset will be recovered, it provides a valuation allowance against the excess.

#### **(n) Foreign currency translation**

Monetary items are translated at the exchange rate in effect at the balance sheet date; non-monetary items are translated at historical exchange rates. Income and expense items are translated at the average exchange rate for the period. Translation gains and losses are reflected in loss for the period.

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

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January 31, 2006

(Unaudited, prepared by management)

Canadian Funds

### 3. **Significant Accounting Policies** (continued)

#### (o) **Impairment of long-lived assets**

On August 1, 2004, the Company adopted the new CICA Handbook Section 3063 “Impairment of Long-Lived Assets” recommendations. These recommendations provide accounting guidance for the recognition, measurement and disclosure of impairment of long-lived assets, including property, plant and equipment and intangible assets with finite useful lives. They require the recognition of an impairment loss for a long-lived asset when events or changes in circumstances causes its carrying value to exceed the total undiscounted future cash flows expected from its use and eventual disposition. The impairment loss is calculated by deducting the fair value of the asset from its carrying value. This change in accounting policy has been applied prospectively. Adoption of CICA 3063 has no effect on these interim financial statements.

#### (p) **Asset retirement obligations**

On August 1, 2004, the Company has adopted the new CICA accounting standard on “Asset Retirement Obligations”. Under the new standard the Company is required to record a liability for the estimated future costs associated with legal obligations relating to the reclamation and closure of its oil and gas properties. This amount is initially recorded at its discounted present value with subsequent annual recognition of an accretion amount on the discounted liability. An equivalent amount is recorded as an increase to oil and gas properties and amortized over the useful life of the properties. As the Company does not currently have any legal obligations relating to the reclamation of its oil and gas properties, the adoption of this standard had no impact on the accounts of the Company.

### 4. **Acquisition**

On November 30, 2005, the Company acquired 100% of the outstanding common shares of Moonshine Resources Ltd. (“Moonshine”). The results of Moonshine’s operations have been included in the interim consolidated financial statements since November 30, 2005. Moonshine is an arm’s length private company engaged in oil and gas exploration and development in Alberta (Note 8(a)).

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

January 31, 2006  
(Unaudited, prepared by management)  
Canadian Funds

### 4. **Acquisition** (continued)

The aggregate purchase price for the 100% interest was \$850,000 consisting of 6,538,462 common shares issued at a deemed price of \$0.13 per share. The value of the common shares was determined by the closing market price of the common shares on the trading day prior to the transaction date.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at November 30, 2005:

Current assets	\$	167,365
Property and equipment, net		1,615
Petroleum and natural gas interests		334,979
Total assets acquired	\$	<u>503,959</u>
Current liabilities	\$	(361,217)
Long-term liabilities		(92,387)
Total liabilities assumed		<u>(453,604)</u>
Net assets acquired	\$	<u>50,355</u>

### 5. **Marketable Securities**

Marketable securities consist of shares in a public company related by a common director, which as at January 31, 2006 had a quoted market value of \$88,749 (July 31, 2005: \$197,162).

### 6. **Advances from Affiliated Company**

Advances from affiliated company, related by a common director and in which the Company holds a minority interest, are non-interest bearing and have no specified terms of repayment.

### 7. **Property and Equipment**

January 31			2006	2005
	Cost	Accumulated Amortization	Net Carrying Amount	Net Carrying Amount
Machinery and equipment	\$ 29,430	\$ 3,418	\$ 26,012	\$ -
Office equipment	2,631	500	2,131	-
	<u>\$ 32,061</u>	<u>\$ 3,918</u>	<u>\$ 28,143</u>	<u>\$ -</u>

# MONTELLO RESOURCES LTD.

## Notes to Consolidated Interim Financial Statements

January 31, 2006  
(Unaudited, prepared by management)  
Canadian Funds

### 8. Resource Properties

January 31	<u>2006</u>	<u>2005</u>
P& NG, Alberta	\$ 1,549,000	\$ -
Morgan and Scott, Tennessee	1,494,637	377,813
Tsui T'ina, Alberta	606,407	-
Fentress, Tennessee	<u>2,698</u>	<u>2,698</u>
	<u>\$ 3,654,748</u>	<u>\$ 380,511</u>

Acquisition costs and deferred exploration and development expenditures during the periods ended January 31, 2006 and 2005 were as follows:

January 31	<u>2006</u>	<u>2005</u>
Property acquisition costs		
Balance, beginning of period	\$ 356,431	\$ -
During the period		
Additions	1,574,000	172,833
Written off	<u>-</u>	<u>-</u>
Balance, end of period	<u>1,930,431</u>	<u>172,833</u>
Deferred exploration expenditures		
Balance, beginning of period	1,021,653	2,698
During the period		
Camp	-	-
Development costs	422,108	204,980
Drilling	305,556	-
Depletion	<u>(25,000)</u>	<u>-</u>
Balance, end of period	<u>1,724,317</u>	<u>207,678</u>
Total resource properties costs	<u>\$ 3,654,748</u>	<u>\$ 380,511</u>

#### (a) P & NG, Alberta

During the period ended January 31, 2006, the Company acquired certain oil and gas leases located in Alberta. The Company acquired these leases by acquiring Moonshine Resources Ltd. and all of its assets (Note 4). As well, the Company made a cash payment of \$724,000 to acquire the remainder of the leases in Townships 81 and 82-8-W6.

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

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January 31, 2006

(Unaudited, prepared by management)

Canadian Funds

### 8. **Resource Properties** (continued\)

#### (b) Morgan and Scott, Tennessee

During the year ended July 31, 2005, the Company paid \$351,046 toward the acquisition of various oil and gas leases covering lands and equipment located in Morgan and Scott Counties, Tennessee. As at January 31, 2006, the Company has incurred exploration and development expenditures of \$1,494,637 (2005: \$377,813) on the property.

During the period ended January 31, 2006, the Company granted an option, to a company related by a common director, whereby the optionee earned a 50% participating interest in one of the wells (the Tex Flora wells) by payment of \$260,027.

#### (b) Tsuu T'ina, Alberta

During the year ended July 31, 2005, the Company entered into a joint venture agreement whereby it acquired the right to earn a 2.5% working interest in certain oil and gas leases located near Calgary, Alberta by paying 5% of costs. The Company paid \$5,385 as its share of costs to secure the leases. As at January 31, 2006, the Company has incurred exploration expenditures of \$482,291 (2005: \$Nil) on the property.

The Company can also elect to participate in the drilling of certain other drill locations, earning a 2.5% working interest by paying 2.5% of costs.

#### (c) Fentress, Tennessee

During the year ended July 31, 2003, the Company acquired a five-year oil and gas lease covering lands located in Fentress County, Tennessee. To acquire the lease the Company paid US \$1,880 (CDN \$2,698).

The property is subject to a 12.5% production royalty.

# MONTELLO RESOURCES LTD.

## Notes to Consolidated Interim Financial Statements

January 31, 2006  
(Unaudited, prepared by management)  
Canadian Funds

### 9. Convertible Loan

During the period ended January 31, 2006, the Company entered into a convertible loan agreement in the principal amount of \$1,000,000. The loan, which has a maturity date of November 30, 2008, is payable as to \$27,778 per month, plus interest, commencing on December 31, 2005. The loan bears interest at the rate of 12% per annum, with interest in the first year calculated on the original amount of the loan, regardless of the principal balance outstanding. As at January 31, 2006 the principal remaining is \$944,444.

The loan is convertible, at any time prior to maturity, into shares of the Company at a conversion rate of \$0.18 per share.

The loan is secured by a pledge of the Company's interest in certain oil and gas assets located in Alberta and 60% of all production proceeds received by the Company from those assets (Note 8(a)).

### 10. Share Capital

January 31	2006	2005
Authorized:		
Unlimited common shares without par value		
Issued:		
99,838,343 Common shares (2005: 79,437,130 shares)	\$ 17,371,859	\$ 14,208,680

(a) Changes in issued common shares during the periods ended January 31, 2006 and 2005 were as follows:

January 31	2006		2005	
	Number of Shares	\$ Amount	Number of Shares	\$ Amount
Beginning of period	84,975,924	15,575,284	65,407,130	14,208,680
Issued for cash pursuant to private placements (Note 10(b))	3,868,449	473,426	-	-
Issued for cash on exercise of warrants (Note 10(b))	2,253,200	228,872	-	-
Issued for cash on exercise of options (Note 10(c))	2,202,308	244,277	-	-
Subsidiary acquired (Note 4)	6,538,462	850,000	-	-
End of period	99,838,343	17,371,859	65,407,130	14,208,680

# MONTELLO RESOURCES LTD.

## Notes to Consolidated Interim Financial Statements

January 31, 2006  
(Unaudited, prepared by management)  
Canadian Funds

### 10. Share Capital (continued)

(b) During the period ended January 31, 2006, the Company issued 3,868,449 units for cash proceeds of \$473,426 (net of cash finder's fees of \$29,472) pursuant to a private placement. Each unit consists of one common share and one non-transferable share purchase warrant. Each warrant entitles the holder to purchase an additional common share at an exercise price of \$0.20 per share, exercisable until September 15, 2007 as to 2,039,565 shares and until November 18, 2007 as to 1,828,884 shares.

The issuance includes 2,374,565 units, representing cash proceeds of \$308,693, issued on a flow-through basis as to the share portion only.

(c) During the period ended January 31, 2006, the Company issued 2,202,308 common shares for cash of \$244,277 on the exercise of stock options. The Company issued 2,235,200 common shares for cash of \$228,872 on the exercise of warrants.

(d) As at January 31, 2006, outstanding warrants are as follows:

Number of Warrants	Exercise Price	Expiry Date
3,449,666	\$0.15	February 8, 2006
10,414,467	\$0.10	December 16, 2006
3,650,461	\$0.20	May 6, 2007
820,000	\$0.20	June 8, 2007
2,039,565	\$0.20	September 15, 2007
1,828,884	\$0.20	November 18, 2007
22,203,043		

(e) As at January 31, 2006, outstanding stock options to directors, consultants, and employees are as follows:

Number of Shares	Exercise Price	Expiry Date
2,825,000	\$0.14	July 18, 2006
1,297,692	\$0.10	December 29, 2009
1,450,000	\$0.12	February 18, 2010
1,900,000	\$0.13	September 19, 2010
2,586,834	\$0.11	January 6, 2011
10,059,526		

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

January 31, 2006  
(Unaudited, prepared by management)  
Canadian Funds

### 10. **Share Capital** (continued)

The fair value of these options were determined on the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions.

	<u>2005</u>
Risk-free interest rate	3.25%
Expected life of options	5 years
Annualized volatility	116%
Dividend rate	-

### 11. **Related Party Transactions**

- (a) During the six month period ended January 31, 2006, the Company incurred management fees of \$48,000 (2005: \$44,003) with directors of the Company.
- (b) During the six month period ended January 31, 2006, the Company incurred \$7,300 for accounting fees (2005: \$7,105) with an officer of the Company.
- (c) During the six month period ended January 31, 2006, the Company incurred rent of \$15,000 (2004: \$15,000) with a company related by a director in common.
- (d) During the six month period ended January 31, 2006, the Company sold 237,000 shares (2005: nil shares) of Arctic Star Diamond Corp., a company related by a common director.
- (e) As at January 31, 2006, accounts payable and accrued liabilities include \$22,005 (2005: \$15,858) due to directors.

### 12. **Segmented Information**

The Company operates in one segment. As at January 31, 2006, the Company has resource properties totalling \$1,497,335 (2005: \$380,511) located in the United States. All other assets and operations are in Canada.

# **MONTELLO RESOURCES LTD.**

## **Notes to Consolidated Interim Financial Statements**

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January 31, 2006

(Unaudited, prepared by management)

Canadian Funds

### **13. Environmental Protection Practices**

The Company is subject to the laws and regulations relating to environmental matters in all jurisdictions in which it operates, including provisions relating to property reclamation, discharge of hazardous material and other matters. The Company may also be held liable should environmental problems be discovered that were caused by former owners and operators of its properties and properties in which it has previously had an interest. The Company is not aware of any existing environmental problems related to any of its current or former properties that may result in material liability to the Company.

### **14. Financial Instruments**

The Company's financial instruments consist of cash, reclamation deposit, marketable securities, accounts receivable, accounts payable and accrued liabilities, and advances. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments. As at 380,511, the fair value of receivables and payables approximate their carrying value due to the immediate short-term maturity of these instruments.

### **15. Subsequent Events**

Subsequent to January 31, 2006, the Company issued 720,000 common shares for cash of \$72,000 on the exercise of warrants.

**Montello Resources Ltd.**

**Management Discussion and Analysis**

**For the Six Months Ended January 31, 2006**

**Prepared as of March 31, 2006**

Suite 1206 – 836 5<sup>th</sup> Avenue SW  
Calgary, Alberta  
T2P 0N5

Phone: (403) 888-8822  
Web page [www.montello.com](http://www.montello.com)  
Email [ir@montello.com](mailto:ir@montello.com)

**Management Discussion And Analysis  
For The Six Months Ended January 31, 2006**

**DATE OF REPORT**            March 31, 2006

**OVERALL PERFORMANCE**

*General*

The following discussion and analysis, prepared as of March 31, 2006, should be read in conjunction with the unaudited interim consolidated financial statements for the six months ended January 31, 2006 and related notes attached thereto, which are prepared in accordance with Canadian generally accepted accounting principles. All amounts are stated in Canadian dollars unless otherwise indicated.

The reader should also refer to the annual audited Financial Statement for the years ended July 31, 2005 and 2004 and the Management Discussion and Analysis for those years

The Company is a junior natural resource company engaged in the acquisition, exploration and development of natural resource (oil and gas) properties. The Company is a reporting issuer in Alberta and British Columbia and trades on the TSX Venture Exchange under the symbol MEO. The Company has two subsidiaries, Moonshine Resources Limited ("Moonshine") and Montello Resources USA Ltd. ("Montello USA").

During the period the Company acquired all the shares of Moonshine. Moonshine is an arm's length privately held Alberta Oil and Gas Exploration-Production Company located in Calgary, Alberta. Moonshine currently produces approximately 17 BOE per day and has a large land base in the Peace River Arch of Northwestern Alberta. The Company acquired all of the issued and outstanding shares of Moonshine for CAD \$850,000 payable in common shares of the Company at a deemed price of CAD \$0.13 per share (6,538,462 common shares).

The Company also signed a letter of intent with Silver Peak Industries Ltd. ("Silver Peak"), an arm's length privately held Alberta Oil and Gas Exploration-Production Company, to acquire certain oil and gas assets in the Province of Alberta which are contiguous to the land package acquired from Moonshine. The assets of Silver Peak which are being acquired by the Company are currently producing approximately 21 BOE per day. The Company acquired these assets for cash of \$724,000.

During the period the Company issued 3,868,449 units for cash of \$473,426 (net of cash finder's fees of \$29,472) pursuant to a private placement. Each unit consists of one common share and one non-transferable share purchase warrant. Each warrant entitles the holder to purchase an additional common share at an exercise price of \$0.20 per share, exercisable until September 15, 2005 as to 2,039,565 shares and until November 18, 2007 as to 1,828,884 shares

During the period the Company also granted 1,900,000 stock options at an exercise price of \$0.13 per share, exercisable until September 19, 2010, and 2,586,834 shares at an exercise price of \$0.11 per share, exercisable until November 18, 2007.

### ***Oil and Gas Properties***

#### ***P & NG, Peace River Arch of Northwestern Alberta***

On September 16, 2005 the Company signed a letter of intent to acquire all the shares of Moonshine Resources Limited ("Moonshine"). Moonshine is a privately held Alberta Oil and Gas Exploration-Production Company located in Calgary, Alberta. The Company acquired all of the issued and outstanding shares of Moonshine for CAD \$850,000 payable in common shares of the Company at a deemed price of CAD \$0.13 per share (6,538,462 common shares). As well, the Company made a cash payment of \$724,000 to acquire the remainder of the leases in Townships 81 and 82-8-W6.

To finance these acquisitions the Company entered into a convertible loan agreement in the principal amount of \$1,000,000. The loan, which has a maturity date of November 30, 2008, is payable as to \$27,778 per month, plus interest, commencing on December 31, 2005. The loan bears interest at the rate of 12% per annum, with interest in the first year calculated on the original amount of the loan, regardless of the principal balance outstanding. As at January 31, 2006, the principal balance remaining is \$944,444.

The loan is convertible, at any time prior to maturity, into shares of the Company at a conversion rate of \$0.18 per share.

The loan is secured by a pledge of the Company's interest in certain oil and gas assets located in Alberta and 60% of all production proceeds received by the Company from those assets.

#### ***Morgan and Scott Counties Property, Tennessee***

The Company has paid approximately \$351,000 for the acquisition of various oil and gas leases covering lands and equipment located in Morgan and Scott Counties, Tennessee.

During the period the Company granted an option, to a company related by a common director, whereby the optionee earned a 50% participating interest in one of the wells (the Tsx Flora wells) by payment of \$260,027.

***Fentress County Property, Tennessee***

The Company also holds a 230 acre oil and gas lease located in Gentress county, Tennessee which it acquired in October 2002 for \$2,698.

***Arapahoe Joint Venture, Alberta***

In June 2005 the Company entered into a joint venture agreement with Arapahoe Energy Corporation pursuant to which the Company has a 5% participating interest (2.5% net) in land located on the Tsuu T'ina First Nation (Sarcee Indian) Reserve west of the city of Calgary, Alberta.

***Property Exploration and Development Plans and Work Programs Status***

The Company plans to continue exploration work on its currently held resource properties, subject to availability and timing of financing (including, where applicable, the ability to meet cash calls from the project operator) and data analysis from work programs.

For properties in which the Company is the operator, results of exploration programs, including technical disclosure, are prepared by or under the supervision of a qualified person.

For properties in which the Company is not the operator, results of exploration programs are provided to the Company by the project operator.

The Company is the project operator for both the Morgan and Scott property, and the Fentress property, both located in Tennessee. The Company is also the operator for the P & NG, Peace River Arch of Northwestern Alberta. The operator of the Arapahoe Joint Venture is C1 Energy Ltd.

As at January 31, 2006 the Company has incurred an aggregate of \$1,749,317 of exploration expenditures and acquisition costs of \$1,905,431 for a total of \$3,654,748 on oil and gas resource properties.

**RESULTS OF OPERATIONS*****Analysis of Financial Condition as at January 31, 2006 vs. January 31, 2005***

The Company recorded a net loss of \$695,675 (\$0.01 per share) for the six months ended January 31, 2006 as compared to a loss of \$166,095 (\$0.01 per share) for the six months ended January 31, 2005. The change is mainly due to stock option compensation for the employee stock options issued in the current quarter.

General and administrative expenses increased by \$644,882 from \$178,658 during the quarter ended January 31, 2005 to \$823,540 during the quarter ended January 31, 2006. The increase is due mainly to stock option compensation using Black Schoels stock volatility calculation of \$363,005. Also the Moonshine Resources acquisition created an increase in corporate activity. Management fees remained consistent, travel costs increased by \$71,369 and consulting fees increased by \$154,039. These increases were brought about primarily from the property acquisitions in Alberta and negotiations with Silver Peak Industries in August and September. Depletion increased by \$27,265 and interest expense increased by \$21,802.

All other general and administrative expenses on a year over year basis are similar and consistent with the Company's ongoing operations.

## SUMMARY OF QUARTERLY RESULTS

The following table presents certain selected financial information on a quarterly basis:

	2006	2005	2005	2005	2005	2004	2004	2004
	Jan 31	Oct 31	July 31	Apr 30	Jan 31	Oct 31	July 31	Apr 30
Total Revenue	134,657	97	844	124	124	7	27	15
Net loss	151,632	544,043	357,361	313,278	350,326	65,663	1,246,778	151,273
Loss (gain) per share basic and diluted	0.01	0.01	0.01	0.01	0.01	0.01	0.02	(0.01)

## LIQUIDITY

Since incorporation, the Company's capital resources have been limited. In addition to having to rely upon cash generated from operations, the Company has had to rely upon the sale of equity and debt securities for cash required for administration, acquisitions and exploration programs, among other things. While there are presently no known specific trends, events or uncertainties that are likely to result in the Company's liquidity decreasing in any material way over the next year, it is unlikely that significant cash will be generated from operations over this period. Since the Company is unlikely to have significant cash flow, the Company will have to continue to rely upon equity and debt financing during such period. There can be no assurance that financing, whether debt or equity, will always be available to the Company in the amount required at any particular time or for any particular period or, if available, that it can be obtained on terms satisfactory to the Company.

The Company is engaged in the acquisition, exploration and development of natural resource (oil/gas) properties. The Company has entered into agreements to acquire interests in the properties described above under the heading "Overall Performance - Oil and Gas Properties".

The main business risks facing the Company over the next several years relate to the availability of equity capital to finance the acquisition, exploration and development of existing and future exploration and development projects. The availability of equity capital to junior resource companies is affected by commodity prices, global economic conditions, and economic conditions and government policies in the countries of operation, among other things. These conditions are beyond the control of the management of the Company and have a direct effect on the Company's ability to raise equity capital.

The Company's working capital and liquidity fluctuate in proportion to its ongoing equity financing activities. The Company requires a certain amount of liquid capital in order to sustain its operations and in order to meet various obligations as specified under the Company's resource property acquisition agreements. Should the Company fail to obtain future equity financing due to reasons as described above, it will not be able to meet these obligations and may lose its interests in the properties covered by the agreements. Further, should the Company be unable to obtain sufficient equity financing for working capital, it may be unable to meet its ongoing operational commitments.

Exploration and development of natural resources involve substantial expenditures and a high degree of risk. Few properties which are explored are ultimately developed into producing properties. Accordingly, the Company has no material revenue, writes off its natural resource properties from time to time, and operates at a loss. Continued operations are dependent upon ongoing equity financing activities.

#### **OFF-BALANCE SHEET ARRANGEMENTS**

The Company does not have any off-balance sheet arrangements.

#### **RELATED PARTY TRANSACTIONS**

During the six month period ended January 31, 2006, the Company incurred management fees of \$48,000 (2005: \$44,003) with directors of the Company. During the six month period ended January 31, 2006, the Company incurred \$7,300 for accounting fees (2005: \$7,105) with an officer of the Company. During the six month period ended January 31, 2006, the Company incurred rent of \$15,000 (2004: \$15,000) with a company related by a director in common. During the six month period ended January 31, 2006, the Company sold 237,000 shares (2005: nil shares) of Arctic Star Diamond Corp., a company related by a common director. As at January 31, 2006, accounts payable and accrued liabilities include \$22,005 (2005: \$15,858).

**FINANCIAL INSTRUMENTS AND OTHER INSTRUMENTS**

It is management's opinion that the fair value of the Company's cash, reclamation deposit, marketable securities, accounts receivable, accounts payable and accrued liabilities, and advances approximate their carrying value due to the relatively short periods to the maturity of the instruments.

The maximum credit risks exposure for all financial assets is the carrying value of those assets.

None of the Company's financial instruments are denominated in U.S. dollars, and the Company does not use derivative instruments or foreign exchange contracts to hedge against gains or losses arising from foreign exchange fluctuations.

**OTHER MD&A REQUIREMENTS****Outstanding Share Data**

- a) The Company's authorized share capital is unlimited common shares without par value. The Company has only one kind and class of shares and there are no unusual rights or restrictions attached to that class.
- b) As at January 31, 2006, the Company had a total of 99,838,343 common shares issued and outstanding. As at January 31, 2005, the Company had a total of 79,437,130 common shares issued and outstanding.
- c) As at January 31, 2006, the Company had 22,203,043 share purchase warrants and 10,059,526 stock options outstanding. As at January 31, 2005, the Company had 16,179,666 share purchase warrants and 6,493,372 stock options outstanding.

**MANAGEMENT CHANGES**

In October 2005 the Company appointed Mr. Bill Cawker as its Vice President of Corporate Affairs. Mr. Cawker's primary focus is to assist in locating, financing and developing new and existing properties and drill prospects in both Alberta and Tennessee.

In February 2006 Mr. Dwayne Tyrkalo, the Company's VP of North American Operations and Moonshine's President, joined the Board of Directors and assumed the positions of President and Chief Operating Officer. Concurrently, Patrick Power stepped down as President, and remains Chairman of the Board and Chief Executive Officer. Also, Daniel Power resigned as a director. Mr. Shawn Runner of the Tsuu T'ina First Nation continues to serve as Consulting VP of Aboriginal Affairs.

At the same time the Company moved its head office to Calgary from Vancouver. The Company now has offices in Calgary, Alberta, Vancouver, BC, and O'Neida, Tennessee.

In March 2006 Ms. Jeannine Davies resigned from the Board.

### **SUBSEQUENT EVENTS**

Subsequent to January 31, 2006, the Company issued 720,000 common shares for cash of \$72,000 on the exercise of warrants.