

MONTELLO RESOURCES LTD.

Consolidated Financial Statements
Years Ended July 31, 2009 and 2008
(Expressed in Canadian dollars)

AUDITORS' REPORT

To the Shareholders of
Montello Resources Ltd.

We have audited the consolidated balance sheet of Montello Resources Ltd. as at July 31, 2009 and the consolidated statements of operations, comprehensive loss, deficit, and cash flows for the year then ended. 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 audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance 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.


In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at July 31, 2009 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements as at July 31, 2008 and for the year then ended were audited by other auditors who expressed an opinion without reservation on those statements in their audit report dated November 28, 2008.



Saturna Group Chartered Accountants LLP
Vancouver, Canada

June 22, 2010



MONTELLO RESOURCES LTD.

Consolidated balance sheets
As at July 31, 2009 and 2008
(Expressed in Canadian dollars)

	2009	(Restated – Note 16) 2008
	\$	\$
Assets		
Current Assets		
Cash and cash equivalents	297,962	590,660
Accounts receivable	–	527,221
GST receivable	37,553	–
Prepaid expenses	5,101	65,098
	340,616	1,182,979
Restricted cash	30,343	30,659
Property and equipment (Note 3)	–	8,642
Oil and gas properties (Note 4)	6,432,631	9,818,539
	6,803,590	11,040,819
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable and accrued liabilities	903,111	1,315,246
Due to related parties (Note 10)	29,042	–
	932,153	1,315,246
Asset retirement obligations (Note 5)	47,596	346,905
	979,749	1,662,151
Shareholders' Equity		
Share capital (Note 6)	30,712,240	30,493,662
Contributed surplus (Note 7)	4,974,844	4,925,101
Deficit	(29,863,243)	(26,040,095)
	5,823,841	9,378,668
	6,803,590	11,040,819

Nature of operations and continuance of business (Note 1)

Approved on behalf of the Board:

/s/ "Peter Brown"
Peter Brown, Director

/s/ "Dennis Petke"
Dennis Petke, Director

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

MONTELLO RESOURCES LTD.

Consolidated statements of operations, comprehensive loss, and deficit
Years ended July 31, 2009 and 2008
(Expressed in Canadian dollars)

	2009	(Restated – Note 16) 2008
	\$	\$
Revenue		
Oil and gas sales	197,515	552,613
Royalty expense	(23,871)	(55,939)
	173,644	496,674
Operating expenses		
Bad debts	473,768	–
Depletion, depreciation and accretion	165,767	83,531
Foreign exchange loss (gain)	13,327	(107,341)
General and administrative	764,405	645,965
Production costs	254,127	244,576
Stock-based compensation	–	3,936,231
Write-down of oil and gas properties	2,330,661	–
	4,002,055	4,802,962
Loss before other income (expense)	(3,828,411)	(4,306,288)
Other income (expense)		
Interest income	–	23,360
Gain on sale of marketable securities	–	8,070
Write-down of property and equipment	(7,009)	–
	(7,009)	31,430
Loss before income taxes	(3,835,420)	(4,274,858)
Future income tax recovery	12,272	–
Net loss and comprehensive loss for the year	(3,823,148)	(4,274,858)
Deficit, beginning of year	(26,040,095)	(21,765,237)
Deficit, end of year	(29,863,243)	(26,040,095)
Loss per share, basic and diluted	(0.02)	(0.02)
Weighted average shares outstanding	194,488,381	179,105,715

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

MONTELLO RESOURCES LTD.

Consolidated statements of cash flows
Years ended July 31, 2009 and 2008
(Expressed in Canadian dollars)

	2009 \$	(Restated – see Note 16) 2008 \$
Operating activities		
Net loss for the year	(3,823,148)	(4,274,858)
Items not affecting cash:		
Depletion, depreciation and accretion	165,767	83,531
Future income tax recovery	(12,272)	–
Gain on sale of marketable securities	–	(8,070)
Stock-based compensation	–	3,936,231
Write-down of oil and gas properties	2,330,661	–
Write-down of property and equipment	7,009	–
Changes in non-cash operating working capital:		
Accounts receivable	527,221	(230,827)
GST receivable	(37,553)	–
Prepaid expenses	59,997	(17,244)
Accounts payable and accrued liabilities	(412,135)	(1,085,168)
Due to related parties	29,042	(20,320)
	(1,165,411)	(1,616,725)
Investing activities		
Additions to oil and gas properties	(297,498)	(5,708,046)
Restricted cash	316	(30,659)
Proceeds from sale of marketable securities	–	26,587
Proceeds from sale of oil and gas properties	889,302	–
	592,120	(5,712,118)
Financing activities		
Issuance of shares, net of issuance costs	280,593	4,658,235
	280,593	4,658,235
Decrease in cash and cash equivalents	(292,698)	(2,670,608)
Cash and cash equivalents, beginning of year	590,660	3,261,268
Cash and cash equivalents, end of year	297,962	590,660
Cash and cash equivalents consists of:		
Cash	258,062	590,660
Term deposits	39,900	–
	297,962	590,660
Non-cash investing and financing activities:		
Shares issued for purchase of oil and gas property	–	3,499,000
Supplemental disclosures:		
Interest paid	–	–
Income tax paid	–	–

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

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

(Expressed in Canadian dollars)

1. NATURE OF OPERATIONS AND CONTINUANCE OF BUSINESS

Montello Resources Ltd. (the "Company") is engaged in the acquisition, exploration and development of oil and natural gas properties in western Canada and Tennessee, USA.

These 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 carrying values as shown in these consolidated financial statements should the Company be unable to continue as a going concern. As at July 31, 2010, the Company has incurred cumulative losses of \$29,863,243 and has a working capital deficiency of \$591,537. The Company's ability to meet its obligations and maintain its operations is contingent upon attaining profitable operations, successful completion of additional financing arrangements and the continuing support of its creditors. Management is also aware that significant material uncertainties exist, related to current economic conditions that could cast significant doubt upon the Company's ability to continue to finance its operations. These factors represent a liquidity risk and create doubt as to the ability of the Company to continue as a going concern. The financial statements do not reflect adjustments which may be required should the Company be unable to raise additional funds to continue operations.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements of the Company are prepared in accordance with Canadian generally accepted accounting principles. The financial statements include the accounts of the Company and its wholly owned subsidiary, Montello Resources USA Ltd. All inter-company transactions and balances have been eliminated upon consolidation.

Newly Adopted Accounting Policies

Effective August 1, 2008, the Company adopted the new CICA Handbook Sections: 1535, "Capital Disclosures", 3862, "Financial Instruments – Disclosures", 3863 "Financial Instruments – Presentation", 3031, "Inventories", and 1400, "General Standards of Financial Statement Presentation" (revised).

(i) Capital Disclosures

Section 1535 establishes standards for disclosing information about a company's capital and how it is managed. The company's disclosure should include information about its objectives, policies and processes for managing capital, quantitative data about what the company regards as capital, whether the company has complied with any capital requirements and if it has not complied, the consequences of such non-compliance.

(ii) Financial Instruments

Section 3862, "Financial Instruments – Disclosures", requires companies to provide disclosures in their financial statements that enable users to evaluate (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and how the company manages those risks. The principles in this section complement the principles for recognizing, measuring and presenting financial assets and financial liabilities in Section 3855, "Financial Instruments – Recognition and Measurement", Section 3863, "Financial Instruments – Presentation", and Section 3865, "Hedges".

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Newly Adopted Accounting Policies (continued)

Section 3863, "Financial Instruments – Presentation", enhances financial statement users' understanding of the significance of financial instruments to a company's financial position, performance and cash flows. This section establishes standards for presentation of financial instruments and non-financial derivatives. It deals with the classification of financial instruments, from the perspective of the issuer, between liabilities and equity, the classification of related interest, dividends, losses and gains, and circumstances in which financial assets and financial liabilities are offset.

The adoption of these standards did not have any impact on the classifications and valuation of the Company's financial instruments.

(iii) Inventories

Section 3031, "Inventories", introduces significant changes to the measurement and disclosure of inventories, including the requirement to measure inventories at the lower of cost and net realizable value, the use of the specific cost method for specific purposes, and the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories. Inventory policies, carrying amounts, amounts recognized as an expense, write-downs and the reversal of write-downs are required to be disclosed. The adoption of this standard did not have any impact on the Company's financial statements.

(iv) General Standards of Financial Statement Presentation

Section 1400, "General Standards of Financial Statement Presentation", provides revised guidance on management's responsibility to assess and disclose the Company's ability to continue as a going concern. The adoption of this standard did not have any impact on the Company's financial statements.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, 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. Significant areas requiring the use of management estimates include the depletion and impairment of oil and natural gas properties, estimated useful life and recoverability of long-lived assets, asset retirement obligations, stock-based compensation, and future income asset valuation allowances. Financial results as determined by actual events could differ from those estimates due to the inherent uncertainty involved with making such estimates.

Cash and Cash Equivalents

The Company considers all highly liquid instruments with a maturity of three months or less at the time of issuance to be cash equivalents.

Foreign Currency Translation

Monetary assets and liabilities of integrated operations and other monetary assets and liabilities denominated in foreign currencies are translated to Canadian dollars at exchange rates in effect at the balance sheet date. Non-monetary assets and liabilities are translated at transaction date rates. Revenue and expenses are translated at average rates for the period. Foreign exchange gains and losses are included in the results of operations.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Oil and Gas Properties

The Company follows the full cost method of accounting for its oil and gas operations whereby all costs related to the acquisition, exploration, and development of oil and gas interests are capitalized in cost centers on a country-by-country basis. Such costs include land and lease acquisition costs, annual carrying charges of non-producing properties, geological and geophysical costs, costs of drilling and equipping productive and non-productive wells, and direct exploration salaries and related benefits.

Costs capitalized, together with the costs of production equipment, are depleted and amortized on the unit-of-production method based on the estimated gross proved reserves as determined by independent petroleum engineers. Petroleum products and reserves are converted to a common unit of measure, using six thousand cubic feet of natural gas to one barrel of oil.

Costs of acquiring and evaluating unproved properties are initially excluded from depletion calculations. Unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proved reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations.

In applying the full cost method, the Company performs a ceiling test on properties which restricts the capitalized costs less accumulated depletion from exceeding an amount equal to the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost and market value of unproved properties, as determined by independent engineers, based on sales prices achievable under existing contracts and posted average reference prices in effect between the end of the year and the finalization of the year end audit and current costs, and after deducting estimated future general and administrative expenses, production related expenses, financing costs, future site restoration costs and income taxes.

Property and Equipment

Property and equipment consists of office equipment and is stated at cost. The Company amortizes the cost over the estimated useful life on a declining balance basis at 20% per annum.

Long-lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Joint Interests

Substantially all of the Company's exploration activities are conducted jointly with others and, accordingly, the financial statements reflect only the Company's proportionate interest in such activities.

Asset Retirement Obligations

The Company follows CICA Handbook Section 3110, "Asset Retirement Obligations", which established standards for asset retirement obligations and the associated retirement costs related to site reclamation and abandonment. The fair value of the liability for an asset retirement obligation is recorded when it is incurred and the corresponding increase to the asset is depreciated over the life of the asset. The liability is increased over time to reflect an accretion element considered in the initial measurement at fair value.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Revenue Recognition

Revenue associated with the sale of oil and gas is recognized when title passes to the customer, the amount is determinable, and collection is reasonably assured.

Stock-based Compensation

The Company recognizes stock-based compensation expense in accordance with CICA Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments". When stock or stock options are issued to employees, compensation expense is recognized based on the fair value of the stock or stock options issued on the date of grant, over the vesting period of the stock or stock options. Stock-based payments to non-employees are measured at the fair value of the consideration received, or the fair value of the equity instruments issued, or liabilities incurred, whichever is more reliably measurable. The fair value of stock-based payments to non-employees is periodically re-measured until counterparty performance is complete, and any change therein is recognized over the period and in the same manner as if the Company had paid cash instead of paying with or using equity instruments. The cost of stock-based payments to non-employees that are fully vested and non-forfeitable at the grant date is measured and recognized at that date. On the exercise of stock options, share capital is credited for consideration received and for fair value amounts previously credited to contributed surplus.

Income Taxes

The Company follows the asset and liability method of accounting for income taxes. Future income taxes assets and liabilities are recognized for the estimated future tax consequences attributable to the difference between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases ("temporary differences") and loss carry forwards. When necessary, a valuation allowance is recorded to reduce income tax assets to an amount where realization is more likely than not. Future income tax assets and liabilities are measured using enacted or substantively enacted tax laws and rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in rates is recognized in the period that included the date of enactment or substantive enactment.

Flow-through Shares

The Company follows the guidance of Emerging Issues Committee Abstract No. 146, "Flow-through Shares", which is effective for all flow-through share transactions. Canadian tax legislation permits a company to issue securities referred to as flow-through shares whereby the Company assigns the tax deductions arising from the related resource expenditures to the shareholders. When resource expenditures are renounced to the investors and the Company has reasonable assurance that the expenditures will be completed, a future income tax liability is recognized and share capital is reduced. If the Company has sufficient unused tax losses carried forward or other future income tax assets to offset all or part of this future income tax liability and no future income tax assets have been previously recognized for these items, a portion of such unrecognized losses is recorded as income up to the amount of the future income tax liability that was previously recognized on the renounced expenditures.

Loss per Share

Basic loss per share is computed using the weighted average number of common shares outstanding during the period. The treasury stock method is used for the calculation of diluted loss per share. Stock options, share purchase warrants, and other equity instruments are dilutive when the average market price of the common shares during the period exceeds the exercise price of the options, warrants and other equity instruments. As the Company has recorded a loss in each of the periods presented, basic and diluted loss per share are the same since the exercise of warrants or options would reduce the loss per share. As at July 31, 2009, the Company had 7,900,000 (2008 – 34,437,883) dilutive potential shares outstanding.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Financial Instruments

The Company classifies all financial instruments as either held-for-trading, available-for-sale, held-to-maturity, loans and receivables or other financial liabilities. Financial instruments are required to be measured at fair value on initial recognition. Measurement in subsequent periods depends on the financial instruments classification. Held-for-trading instruments are measured at fair value with unrealized gains and losses recognized in results of operations. Available-for-sale instruments are measured at fair value with unrealized gains and losses recognized in other comprehensive income. Instruments held-to-maturity, loans and receivables and other financial liabilities are measured at amortized cost.

The Company has classified its cash and cash equivalents as held-for-trading. Receivables are classified as loans and receivables. Accounts payable, accrued liabilities and amounts due to related parties are classified as other financial liabilities.

Future Changes in Accounting Standards

In June 2009, the Accounting Standards Board (“AcSB”) further amended CICA Handbook Section 3862, “Financial Instruments – Disclosures” to include additional disclosures about fair value measurements of financial instruments and to enhance risk disclosure. The additional fair value measurement disclosures include classification of financial instrument fair values in a fair value hierarchy comprising three levels reflecting the significance of the inputs used in making the measurements, described as follows:

Level 1: Valuation based on quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2: Valuations based on directly or indirectly observable inputs in active markets for similar assets or liabilities, other than Level 1 prices, such as quoted interest or currency exchange rates; and

Level 3: Valuations based on significant inputs that are not derived from observable market data, such as discounted cash flow methodologies based on internal cash flow forecasts.

These amendments are required to be adopted for fiscal years ending after September 30, 2009, but early adoption is permitted. The adoption of this section is not expected to have a material effect on the Company’s consolidated financial statements.

In January 2009, the AcSB issued CICA Handbook Sections 1582, “Business Combinations”, 1601, “Consolidated Financial Statements” and 1602, “Non-controlling Interests” which replace CICA Handbook Sections 1581, “Business Combinations” and 1600, “Consolidated Financial Statements”. Section 1582 establishes standards for the accounting for business combinations that is equivalent to the business combination accounting standard under IFRS. Section 1582 is applicable for the Company’s business combinations with acquisition dates on or after August 1, 2011. Early adoption of this section is permitted. Section 1601 together with Section 1602 establishes standards for the preparation of consolidated financial statements. Section 1601 is applicable for the Company’s interim and annual consolidated financial statements for its fiscal year beginning August 1, 2011. Early adoption of this section is permitted and all three sections must be adopted concurrently. The adoption of these sections is not expected to have a material effect on the Company’s consolidated financial statements.

In February 2008, the AcSB issued CICA Handbook Section 3064, “Goodwill and Intangible Assets”, which replaces Section 3062, “Goodwill and Intangible Assets”, and Section 3450, “Research and Development Costs”. Section 3064 establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets. This new standard is effective for the Company’s interim and annual financial statements for its fiscal year commencing on August 1, 2009. The Company is currently assessing the impact of the new standard and has not yet determined its effect on the Company’s consolidated financial statements.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Future Changes in Accounting Standards (continued)

In February 2008, the AcSB confirmed that public companies will be required to prepare interim and annual financial statements under International Financial Reporting Standards ("IFRS") for fiscal years beginning on or after January 1, 2011. The transition date of August 1, 2011 will require the restatement for comparative purposes of amounts reported by the Company for the year ended July 31, 2011. Management is currently assessing the impact of adopting IFRS and it has not yet determined its effect on the Company's financial statements.

Comprehensive Loss

Section 1530 establishes standards for the reporting and display of comprehensive income. The Company does not have any items representing comprehensive income or loss.

Reclassifications

Certain comparative figures have been reclassified to conform to the current year's presentation.

3. PROPERTY AND EQUIPMENT

	Cost \$	Accumulated depreciation \$	Write-down \$	2009 Net carrying value \$	2008 Net carrying value \$
Office equipment	18,253	11,244	7,009	–	8,642

4. OIL AND GAS PROPERTIES

	Cost \$	Accumulated depletion \$	Write-down \$	2009 Net carrying value \$	2008 Net carrying value \$
Canada	7,000,435	2,379,551	2,330,661	2,290,223	5,188,848
United States	4,142,408	–	–	4,142,408	4,629,691
	11,142,843	2,379,551	2,330,661	6,432,631	9,818,539

During the year ended July 31, 2008, the Company purchased the Sarcee Oil and Gas Property ("Sarcee Property") from Vanguard Exploration Corp. for \$3,499,000 which was settled through the issuance of 11,663,333 shares of the Company. On July 22, 2009, all assets and liabilities related to the Sarcee Property were transferred to Canadian Phoenix Resources Corp. for which a Quit Claim was signed on September 10, 2009.

During the year ended July 31, 2009, the Company sold 100% of its interest in its Mulligan Oil and Gas Properties in northern Alberta for net proceeds of \$221,000.

During the year ended July 31, 2009, the Company sold a portion of its interest in the John Bowen Oil and Gas Property in Tennessee, United States to a partner for gross proceeds of US\$446,000.

During the year ended July 31, 2009, the Company and its partners sold the surface rights to their John Bowen Property, resulting in net proceeds of US\$98,648 after costs incurred on the sale.

At July 31, 2009, the depletion calculation excluded undeveloped land and unproved properties of \$4,645,504 (2008 - \$4,755,550) from the cost centres.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

(Expressed in Canadian dollars)

4. OIL AND GAS PROPERTIES (continued)

As at July 31, 2009, the Company applied the ceiling test to its oil and gas properties as at July 31, 2009, and recorded a write down of \$2,330,661 (2008 - \$nil). The following independent petroleum engineering benchmark prices were used:

	OIL WTI US\$/STB	GAS GRP \$/MMBTU
2010	70	5.60
2011	75	6.70
2012	80	7.20
2013	90	7.60
2014	95	8.00
Percentage change thereafter	+/-2%	+/-2%

5. ASSET RETIREMENT OBLIGATIONS

The total future asset retirement obligations were estimated by management based on the Company's net ownership interest in all wells and facilities. This includes all estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods. As at July 31, 2009, the Company has estimated the net present value of its total asset retirement obligations to be \$47,596 (2008 - \$346,905) based on total estimated cash flows to settle the obligations of \$178,018. These obligations are expected to be settled during the period from 2010 to 2020. The estimated cash flows have been discounted using an average credit-adjusted risk free rate of return of 12.5% and an inflation rate of 2%.

The following table reconciles the asset retirement obligations:

	2009 \$	2008 \$
Balance, beginning of year	346,905	219,729
Liabilities incurred	—	43,825
Liabilities disposed through capital dispositions	(266,664)	—
Changes in prior year estimates	(69,016)	—
Accretion	36,971	83,351
Balance, end of year	47,596	346,905

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

(Expressed in Canadian dollars)

6. SHARE CAPITAL

Common Shares

Authorized: Unlimited number of common shares without par value

Issued and outstanding:

	Number of shares	\$
Balance, July 31, 2007	142,363,552	21,130,478
Issued pursuant to private placement, net of fair value of warrants	8,202,166	1,049,877
Issued pursuant to private placement – flow-through	480,000	62,400
Issued pursuant to the exercise of warrants	12,928,780	1,625,206
Issued pursuant to the exercise of stock options	13,999,855	1,617,717
Issued for oil and gas properties	11,663,333	3,499,000
Transfer from contributed surplus upon exercise of warrants	–	538,301
Transfer from contributed surplus upon exercise of stock options	–	1,139,262
Share issuance costs	–	(168,579)
Balance, July 31, 2008	189,637,686	30,493,662
Issued pursuant to private placements – non flow-through	8,823,088	253,677
Issued pursuant to private placements – flow-through	864,632	40,143
Share issuance costs	–	(13,227)
Fair value of warrants issued pursuant to private placements	–	(49,743)
Reduction from renunciation of flow-through tax benefit	–	(12,272)
Balance, July 31, 2009	199,325,406	30,712,240

Share transactions for the year ended July 31, 2009:

In October 2008 the Company completed a private placement by issuing 93,000 non flow-through units at \$0.51 per unit for gross proceeds of \$47,430 and 85,772 flow-through units at \$0.57 per unit for gross proceeds of \$48,890. Share issuance costs of \$11,808 were incurred pursuant to the private placement.

Each non flow-through unit consisted of 10 non flow-through common shares of the Company and 10 non flow-through warrants. Each warrant is exercisable into one additional non flow-through common share at \$0.10 per share expiring on May 29, 2009.

Each flow-through unit consisted of 4 non flow-through common shares, 6 flow-through shares of the Company and 10 non flow-through warrants. Each warrant is exercisable into one additional non flow-through share at \$0.10 per share expiring on May 29, 2009.

The fair value of the warrants of \$5,372 was recorded as contributed surplus and determined using the Black-Scholes option-pricing model with the following assumptions:

Expected dividend yield	0%
Expected volatility	97%
Risk-free interest rate	2.60%
Expected life	0.67 years

In February, 2009, the Company completed a private placement by issuing 7,550,000 non flow-through units at \$0.025 per unit for gross proceeds of \$188,750 and 350,000 flow-through units at \$0.025 per unit for gross proceeds of \$8,750. Share issuance costs of \$1,419 were incurred pursuant to the private placement.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2009 and 2008

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6. SHARE CAPITAL (continued)

Each non flow-through unit consisted of one non flow-through common share of the Company and one non flow-through warrant. Each warrant is exercisable into one additional non flow-through common share at \$0.05 per share expiring on February 25, 2010.

Each flow-through unit consisted of one flow-through common share of the Company and one non flow-through warrant. Each warrant is exercisable into one additional non flow-through common share at \$0.05 per share expiring on February 25, 2010.

The fair value of the warrants of \$44,371 was recorded as contributed surplus and determined using the Black-Scholes option-pricing model with the following assumptions:

Expected dividend yield	0%
Expected volatility	135%
Risk-free interest rate	1.27%
Expected life	1 year

Share transactions for the year ended July 31, 2008:

The Company completed a private placement of 8,202,166 units at \$0.18 per unit for gross proceeds of \$1,476,390. Each unit consisted of one common share and one share purchase warrant exercisable at \$0.30 per share expiring on October 18, 2008. The warrants had a fair value of \$426,513 which was recorded as contributed surplus. The Company also issued 820,217 warrants with a fair value of \$42,651 with the same terms to brokers which were recorded as share issuance costs.

The Company issued 480,000 flow-through shares at \$0.13 per share for gross proceeds of \$62,400.

The Company issued 12,928,780 common shares for warrants exercised at various prices ranging from \$0.11 to \$0.20 per share for total proceeds of \$1,625,206. The fair value assigned to these warrants exercised of \$538,301 was transferred to share capital from contributed surplus.

The Company issued 13,999,855 common shares for stock options exercised at various prices ranging from \$0.10 to \$0.11 for total cash proceeds of \$1,617,717. The fair value assigned to these options exercised of \$1,139,262 was transferred to share capital from contributed surplus.

7. CONTRIBUTED SURPLUS

	\$
Balance, July 31, 2007	2,197,268
Fair value of stock options granted	3,936,231
Fair value of stock options exercised transferred to share capital	(1,139,261)
Fair value of warrants issued pursuant to private placements	469,164
Fair value of warrants exercised transferred to share capital	(538,301)
Balance, July 31, 2008	4,925,101
Fair value of warrants issued pursuant to private placements	49,743
Balance, July 31, 2009	4,974,844

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8. SHARE PURCHASE WARRANTS

The following table summarizes the continuity of share purchase warrants:

	Number of Warrants	Weighted Average Exercise Price \$
Balance July 31, 2007	30,921,658	0.15
Issued	9,022,383	0.30
Exercised	(12,828,780)	0.13
Expired	(8,963,878)	0.19
Balance, July 31, 2008	18,151,383	0.22
Issued	9,687,720	0.06
Expired	(19,939,103)	0.21
Balance, July 31, 2009	7,900,000	0.05

As at July 31, 2009, the following share purchase warrants were outstanding:

Number of warrants outstanding	Exercise price \$	Expiry date
7,900,000	0.05	February 25, 2010

9. STOCK OPTIONS

The Company has a stock option plan for the benefit of directors, officers, employees and consultants administered by the Board of Directors, in which up to 10% of the issued and outstanding common shares are reserved for issuance. All share options granted vest immediately.

The following table summarizes the continuity of the Company's stock options:

	Number of options	Weighted average exercise price \$
Outstanding, July 31, 2007	13,311,355	0.11
Granted	27,704,868	0.15
Exercised	(14,099,855)	0.11
Forfeited	(10,629,868)	0.20
Outstanding, July 31, 2008	16,286,500	0.12
Cancelled	(16,286,500)	0.12
Outstanding, July 31, 2009	—	—

The fair value of stock options vested during the year was \$nil (2008 - \$3,936,231) which was recorded as contributed surplus and charged to operations.

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9. STOCK OPTIONS (continued)

The fair value of stock options granted was estimated using the Black-Scholes option pricing model assuming no expected dividends and the following weighted average assumptions:

	2009	2008
Risk-free interest rate	–	2.9 – 4.2%
Expected life (in years)	–	5
Expected volatility	–	152-161%

10. RELATED PARTY TRANSACTIONS

During the years ended July 31, 2009 and 2008, the Company was involved in the following related party transactions:

- (a) Management fees of \$84,240 (2008 – \$117,500) were paid to the former Chief Executive Officer of the Company.
- (b) Management fees of \$98,725 (2008 - \$nil) were paid to the President of the Company.
- (c) Management fees of \$9,000 (2008 - \$nil) were paid to a director of the Company, who was appointed and resigned during the year.
- (d) Management fees of \$45,000 (2008 - \$nil) were incurred to the former Chief Financial Officer of the Company.
- (e) Management fees of \$15,000 (2008 - \$nil) were incurred to the Chief Financial Officer of the Company.
- (f) Professional fees of \$63,339 (2008 - \$172,884) were incurred to an accounting firm of which a former director is a partner.
- (g) As at July 31, 2009, the Company owes \$21,292 (2008 - \$nil) to the former Chief Financial Officer of the Company which is non-interest bearing, unsecured, and due on demand.
- (h) As at July 31, 2009, the Company owes \$7,750 (2008 - \$nil) to the Chief Financial Officer of the Company which is non-interest bearing, unsecured, and due on demand.

These transactions were in the normal course of operations and have been recorded at their exchange amounts, which are the amounts agreed upon by the transacting parties.

11. CAPITAL MANAGEMENT

The Company manages its capital to maintain its ability to continue as a going concern and to provide returns to shareholders and benefits to other stakeholders. The capital structure of the Company consists of cash and cash equivalents and equity comprised of issued share capital, contributed surplus and deficit.

The Company manages its capital structure and makes adjustments to it in light of economic conditions. The Company, upon approval from its Board of Directors, will balance its overall capital structure through new share issues or by undertaking other activities as deemed appropriate under the specific circumstances.

The Company is not subject to externally imposed capital requirements and the Company's overall strategy with respect to capital risk management remains unchanged from the year ended July 31, 2008.

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12. FINANCIAL INSTRUMENTS

(a) Fair Values

The fair values of financial instruments, which include cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, and amounts due to related parties, approximate their carrying values due to the relatively short-term maturity of these instruments.

(b) Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company limits its exposure to credit loss by placing its cash and cash equivalents with high credit quality financial institutions. The carrying amount of financial assets represents the maximum credit exposure. The Company performs ongoing credit evaluations, does not require collateral and establishes an allowance for doubtful accounts based on the age of the receivable and the specific identification of receivables the Company considers at risk.

(c) Foreign Exchange Rate Risk

The Company operates in Canada and U.S. The Company is exposed to foreign exchange risk due to fluctuations in exchange rate of U.S. dollar. Foreign exchange risk arises from purchase transactions as well as financial assets and liabilities denominated in U.S. dollars.

(d) Interest Rate Risk

The Company's cash and cash equivalents and restricted cash contain highly liquid investments that earn interest at market rates. The Company manages its interest rate risk by maximizing the interest earned on excess funds while maintaining the liquidity necessary to fund daily operations. Fluctuations in market interest rates do not have a significant impact on the Company's results of operations due to the short term to maturity of the investments held.

(e) Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company currently settles its financial obligations out of cash. The ability to do this relies on the Company raising equity financing in a timely manner and by maintaining sufficient cash in excess of anticipated needs.

(f) Price Risk

The Company is exposed to price risk with respect to commodity prices. The Company's ability to raise capital to fund exploration and production activities is subject to risks associated with fluctuations in the market price of commodities.

13. LEGAL PROCEEDINGS

(a) In fiscal 2008, litigation was brought against the Company by a drilling contractor. Settlement payment was made and accepted by the contractor. During fiscal 2009, the contractor sued the Company for an additional \$151,554 but the lawsuit was subsequently dropped.

(b) During the year ended July 31, 2009, the Company was sued for \$23,174 relating to a builders' lien for work performed on a minerals lease. A default judgment of \$24,717 was entered against the Company on May 12, 2010. This amount was recorded in accrued liabilities as at July 31, 2009.

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14. SEGMENTED INFORMATION

The Company operates in one reportable operating segment, oil and gas exploration and development. Segmented information by geographic area is as follows:

	Canada	United States	Total
2009	\$	\$	\$
Revenue	186,125	11,390	197,515
Oil and gas properties	2,290,223	4,142,408	6,432,631
2008	\$	\$	\$
Revenue	552,524	89	552,613
Oil and gas properties	5,162,738	4,629,691	9,792,429

15. INCOME TAXES

The tax effect (computed by applying the Canadian federal and provincial statutory rate) of the significant temporary differences, which comprise future tax assets and liabilities, are as follows:

	2009	2008
	\$	\$
Canadian statutory income tax rate	30.00%	30.50%
Income tax recovery at statutory rate	(1,120,326)	(1,279,813)
Tax effect of:		
Permanent differences and other	(468,796)	1,151,806
Change in enacted tax rates	406,292	—
Expiry of non-capital loss	98,300	232,974
Change in valuation allowance	1,072,258	(1,072,881)
Future income tax recovery	(12,272)	—

The significant components of future income tax assets and liabilities are as follows:

	2009	2008
	\$	\$
Future income tax assets		
Non-capital losses carried forward	1,416,996	1,429,248
Capital losses carried forward	44,897	54,775
Property and equipment	1,628	895
Resource properties	2,377,540	1,251,433
Share issuance costs	39,527	71,979
Total gross future income tax assets	3,880,588	2,808,330
Valuation allowance	(3,880,588)	(2,808,330)
Net future income tax asset	—	—

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15. INCOME TAXES (continued)

As at July 31, 2009, the Company has non-capital losses carried forward of \$5,667,983, which are available to offset future years' taxable income.

As at July 31, 2009, the Company is in arrears on filing its statutory income tax returns and the amounts presented above are based on estimates. The actual losses available could differ from these estimates.

16. RESTATEMENT

The Company has restated its consolidated financial statements as at July 31, 2008 and for the year then ended. These financial statements have been restated to reflect the asset retirement obligation liability of \$78,750 which was missing as a result of an error made in consolidating the Company's financial accounts. This error also resulted in the foreign exchange gain being overstated/net loss understated by the same amount. There was no effect on net loss per share.

a) Balance Sheet

	As at July 31, 2008		
	As reported	Adjustment	As restated
	\$	\$	\$
Liabilities			
Asset retirement obligations	268,155	78,750	346,905
Shareholders' equity			
Deficit	(25,961,345)	(78,750)	(26,040,095)

b) Statement of Operations

	For the year ended July 31, 2008		
	As reported	Adjustment	As restated
	\$	\$	\$
Operating expenses			
Foreign exchange loss (gain)	(186,091)	78,750	(107,341)
Net loss	(4,196,108)	(78,750)	(4,274,858)

c) Statement of Cash Flows

	For the year ended July 31, 2008		
	As reported	Adjustment	As restated
	\$	\$	\$
Operating activities			
Net loss for the year	(4,196,108)	(78,750)	(4,274,858)
Investing activities:			
Additions to oil and gas properties	(5,786,796)	78,750	(5,708,046)