

MONTELLO RESOURCES LTD.

Consolidated Financial Statements
Years Ended July 31, 2010 and 2009
(Expressed in Canadian dollars)

AUDITORS' REPORT

To the Shareholders of
Montello Resources Ltd.

We have audited the consolidated balance sheets of Montello Resources Ltd. as at July 31, 2010 and 2009 and the consolidated statements of operations, comprehensive loss, deficit, and cash flows for the years 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 audits.

We conducted our audits 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, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Saturna Group Chartered Accountants LLP

Vancouver, Canada

December 14, 2010



MONTELLO RESOURCES LTD.

Consolidated balance sheets
As at July 31, 2010 and 2009
(Expressed in Canadian dollars)

	2010	2009
	\$	\$
Assets		
Current Assets		
Cash and cash equivalents	5,745	297,962
GST receivable	55,993	37,553
Prepaid expenses	–	5,101
	61,738	340,616
Restricted cash	–	30,343
Oil and gas properties (Note 3)	6,427,810	6,432,631
	6,489,548	6,803,590
Liabilities and Shareholders' Equity		
Current Liabilities		
Accounts payable and accrued liabilities	944,690	903,111
Due to related parties (Note 10)	49,869	29,042
Loans payable (Note 4)	100,000	–
	1,094,559	932,153
Asset retirement obligations (Note 5)	55,404	47,596
	1,149,963	979,749
Shareholders' Equity		
Share capital (Note 6)	30,712,240	30,712,240
Contributed surplus (Note 7)	4,974,844	4,974,844
Deficit	(30,347,499)	(29,863,243)
	5,339,585	5,823,841
	6,489,548	6,803,590

Nature of operations and continuance of business (Note 1)
Subsequent events (Note 16)

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, 2010 and 2009

(Expressed in Canadian dollars)

	2010	2009
	\$	\$
Revenue		
Oil and gas sales	7,521	197,515
Royalty expense	–	(23,871)
	7,521	173,644
Operating expenses		
Bad debts (recovery)	(21,395)	473,768
Depletion, depreciation and accretion	7,808	165,767
Foreign exchange loss (gain)	(20,197)	13,327
General and administrative	451,205	696,304
Oil and gas expenditures	73,446	68,101
Production costs	910	254,127
Write-down of oil and gas properties	–	2,330,661
Write-down of property and equipment	–	7,009
	491,777	4,009,064
Loss before income taxes	(484,256)	(3,835,420)
Future income tax recovery	–	12,272
Net loss and comprehensive loss for the year	(484,256)	(3,823,148)
Deficit, beginning of year	(29,863,243)	(26,040,095)
Deficit, end of year	(30,347,499)	(29,863,243)
Loss per share, basic and diluted	–	(0.02)
Weighted average shares outstanding	199,325,406	194,488,381

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

MONTELLO RESOURCES LTD.

Consolidated statements of cash flows

Years ended July 31, 2010 and 2009

(Expressed in Canadian dollars)

	2010	2009
	\$	\$
Operating activities		
Net loss for the year	(484,256)	(3,823,148)
Items not affecting cash:		
Depletion, depreciation and accretion	7,808	165,767
Future income tax recovery	–	(12,272)
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
GST receivable	(18,440)	(37,553)
Prepaid expenses	5,101	59,997
Accounts payable and accrued liabilities	41,579	(412,135)
Due to related parties	20,827	29,042
	(427,381)	(1,165,411)
Investing activities		
Additions to oil and gas properties	–	(297,498)
Restricted cash	30,343	316
Proceeds from sale of oil and gas properties	4,821	889,302
	35,164	592,120
Financing activities		
Proceeds from loans payable	100,000	–
Issuance of shares, net of issuance costs	–	280,593
	100,000	280,593
Decrease in cash and cash equivalents	(292,217)	(292,698)
Cash and cash equivalents, beginning of year	297,962	590,660
Cash and cash equivalents, end of year	5,745	297,962
Cash and cash equivalents consists of:		
Cash	5,745	258,062
Term deposits	–	39,900
	5,745	297,962
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, 2010 and 2009

(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 \$30,347,499 and has a working capital deficiency of \$1,032,821. 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, 2009, the Company adopted CICA Handbook Section 3064, "Goodwill and Intangible Assets", which replaces Section 3062, "Goodwill and Intangible Assets", and Section 3450, "Research and Development Costs". This revision establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

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 were required to be adopted for the year ended July 31, 2010. The adoption of this section did not have a material effect on the Company's consolidated financial statements.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2010 and 2009

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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, allowance for doubtful accounts, 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.

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. Proceeds from the sale of properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would alter the rate of depletion by more than 20%.

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.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2010 and 2009

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

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.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2010 and 2009

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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, 2010, the Company had nil (2009 – 7,900,000) dilutive potential shares outstanding.

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.

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.

Future Changes in Accounting Standards

In August 2009, AcSB issued CICA Handbook Section 3251, "Equity" in response to issuing Section 1602, "Non-controlling Interests". The amendments require non-controlling interests to be recognized as a separate component of equity. The amendments apply only to entities that have adopted Section 1602. The adoption of this section is not expected to have a material impact on the Company's consolidated financial statements.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2010 and 2009

(Expressed in Canadian dollars)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Future Changes in Accounting Standards (continued)

In January 2009, the Accounting Standards Board (“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 February 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 February 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 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, 2010. Management is currently assessing the impact of adopting IFRS and it has not yet determined its effect on the Company’s consolidated financial statements.

Reclassifications

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

3. OIL AND GAS PROPERTIES

	Cost \$	Accumulated depletion \$	Disposals \$	2010 Net carrying value \$	2009 Net carrying value \$
Canada	4,669,774	2,379,551	–	2,290,223	2,290,223
United States	4,142,408	–	(4,821)	4,137,587	4,142,408
	8,812,182	2,379,551	(4,821)	6,427,810	6,432,631

During the year ended July 31, 2008, the Company purchased 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, 2010, the depletion calculation excluded undeveloped land and unproved properties of \$4,606,463 (2009 - \$4,611,284) from the cost centres.

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2010 and 2009

(Expressed in Canadian dollars)

3. OIL AND GAS PROPERTIES (continued)

As at July 31, 2010, the Company applied the ceiling test to its oil and gas properties as at July 31, 2010, and determined there was \$nil impairment to the properties (2009 - \$2,330,661). The following independent petroleum engineering benchmark prices were used:

	OIL WTI US\$/STB	GAS GRP \$/MMBTU
2011	83	5.08
2012	86	5.60
2013	90	6.30
2014	93	6.80
2015	96	7.10
Percentage change thereafter	+/-2%	+/-2%

4. LOANS PAYABLE

As at July 31, 2010, the Company owes a total of \$100,000 for loan proceeds received from a unrelated party. The loans bear interest at 10% per annum (starting on November 1, 2010 for \$62,500 and starting on December 1, 2010 for \$37,500), are unsecured, and due on April 30, 2011.

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, 2010, the Company has estimated the net present value of its total asset retirement obligations to be \$55,404 (2009 - \$47,596) based on total estimated cash flows to settle the obligations of \$138,450 (2009 - \$138,450). These obligations are expected to be settled during the period from 2011 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:

	2010 \$	2009 \$
Balance, beginning of year	47,596	346,905
Liabilities disposed through capital dispositions	—	(266,664)
Changes in prior year estimates	1,652	(69,616)
Accretion	6,156	36,971
Balance, end of year	55,404	47,596

MONTELLO RESOURCES LTD.

Notes to the consolidated financial statements

Years ended July 31, 2010 and 2009

(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, 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 and 2010	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.

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

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Notes to the consolidated financial statements

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(Expressed in Canadian dollars)

7. CONTRIBUTED SURPLUS

	\$
Balance, July 31, 2008	4,925,101
Fair value of warrants issued pursuant to private placements	49,743
Balance, July 31, 2009 and 2010	4,974,844

8. SHARE PURCHASE WARRANTS

The following table summarizes the continuity of share purchase warrants:

	Number of Warrants	Weighted Average Exercise Price \$
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
Expired	(7,900,000)	0.05
Balance, July 31, 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 stock 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, 2008	16,286,500	0.12
Cancelled	(16,286,500)	0.12
Outstanding, July 31, 2009 and 2010	-	-

10. RELATED PARTY TRANSACTIONS

During the years ended July 31, 2010 and 2009, the Company was involved in the following related party transactions:

- (a) Management fees of \$nil (2009 – \$84,240) were paid to the former Chief Executive Officer of the Company.
- (b) Management fees of \$120,000 (2009 - \$98,725) were incurred to the President of the Company.
- (c) Management fees of \$3,174 (2009 - \$9,000) were paid to a former director of the Company.
- (d) Management fees of \$nil (2009 - \$45,000) were incurred to the former Chief Financial Officer of the Company.

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10. RELATED PARTY TRANSACTIONS (continued)

- (e) Management fees of \$90,000 (2009 - \$15,000) were incurred to a company controlled by the Chief Financial Officer of the Company.
- (f) Professional fees of \$nil (2009 - \$63,339) were incurred to an accounting firm of which a former director is a partner.
- (g) As at July 31, 2010, the Company owes \$21,292 (2009 - \$21,292) to the former Chief Financial Officer of the Company which is non-interest bearing, unsecured, and due on demand.
- (h) As at July 31, 2010, the Company owes \$6,126 (2009 - \$nil) to the President of the Company which is non-interest bearing, unsecured, and due on demand.
- (i) As at July 31, 2010, the Company owes \$22,451 (2009 - \$7,750) to a company controlled by 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, 2009.

12. FINANCIAL INSTRUMENTS AND RISKS

(a) Fair Values

Assets and liabilities measured at fair value on a recurring basis were presented on the Company's balance sheet as at July 31, 2010 as follows:

	Fair Value Measurements Using			Balance, July 31, 2010 \$
	Quoted prices in active markets for identical instruments (Level 1) \$	Significant other observable inputs (Level 2) \$	Significant unobservable inputs (Level 3) \$	
Cash	5,745	–	–	5,745

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

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12. FINANCIAL INSTRUMENTS (continued)

(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 PROCEEDING

During the year ended July 31, 2009, the Company was sued for \$40,700 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. During the year ended July 31, 2010, the default judgment increased by \$15,983 to \$40,700, of which \$25,217 was paid in May 2010 and the remaining amount of \$15,483 was paid subsequent to year end.

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Years ended July 31, 2010 and 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:

2010	Canada \$	United States \$	Total \$
Revenue	7,521	–	7,521
Oil and gas properties	2,290,223	4,137,587	6,427,810

2009	Canada \$	United States \$	Total \$
Revenue	186,125	11,390	197,515
Oil and gas properties	2,290,223	4,142,408	6,432,631

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:

	2010 \$	2009 \$
Canadian statutory income tax rate	28.41%	29.21%
Income tax recovery at statutory rate	(137,577)	(1,120,326)
Tax effect of:		
Permanent differences and other	9,483	(468,796)
Change in enacted tax rates	3,899	406,292
Expiry of non-capital loss	95,608	98,300
Change in valuation allowance	28,587	1,072,258
Future income tax recovery	–	(12,272)

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

	2010 \$	2009 \$
Future income tax assets		
Non-capital losses carried forward	1,463,911	1,416,996
Capital losses carried forward	44,897	44,897
Property and equipment	1,628	1,628
Resource properties	2,377,540	2,377,540
Share issuance costs	21,200	39,527
Total gross future income tax assets	3,909,175	3,880,588
Valuation allowance	(3,909,175)	(3,880,588)
Net future income tax asset	–	–

As at July 31, 2010, the Company has non-capital losses carried forward of \$5,855,641 (2009 - \$5,667,983), which are available to offset future years' taxable income.

As at July 31, 2010, 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.

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16. SUBSEQUENT EVENTS

- (a) On October 31, 2010, the Company issued a promissory note payable for proceeds of \$13,000 which bears interest at 10% per annum beginning on February 1, 2011, is unsecured and due on April 30, 2011.
- (b) On December 10, 2010, the Company issued a promissory note payable for proceeds of \$62,500 which bears interest at 10% per annum beginning on February 1, 2011, is unsecured, and due on April 30, 2011.