

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

FORM 10-Q

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

For the quarterly period ended December 31, 2010

OR

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

For the transition period from _____ to _____

Commission file number: 001-34055



TIMBERLINE RESOURCES CORPORATION

(Exact Name of Registrant as Specified in its Charter)

DELAWARE

(State of other jurisdiction of incorporation or organization)

82-0291227

(I.R.S. Employer Identification No.)

101 EAST LAKESIDE AVENUE

COEUR D'ALENE, IDAHO

(Address of Principal Executive Offices)

83814

(Zip Code)

(208) 664-4859

(Registrant's Telephone Number, including Area Code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

Number of shares of issuer's common stock outstanding at February 11, 2011: 55,806,526

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PART I — FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES

Consolidated Financial Statements

December 31, 2010

Timberline Resources Corporation and Subsidiaries

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TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31, 2010 (unaudited)	September 30, 2010 (audited)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 1,955,397	\$ 4,638,674
Accounts receivable	550,307	908,358
Materials and supplies inventory	1,505,558	1,238,369
Assets held for sale	165,086	319,291
Prepaid expenses and other current assets	445,054	394,557
Current portion of deferred financing cost with related party, net	27,273	27,273
TOTAL CURRENT ASSETS	<u>4,648,675</u>	<u>7,526,522</u>
PROPERTY, MINERAL RIGHTS AND EQUIPMENT:		
Mineral rights	12,302,342	12,162,342
Property and equipment, net	6,885,103	7,099,168
TOTAL PROPERTY, MINERAL RIGHTS AND EQUIPMENT	<u>19,187,445</u>	<u>19,261,510</u>
OTHER ASSETS:		
Investment in joint venture	621,000	621,000
Restricted cash	380,094	379,952
Deposits and other assets	148,673	148,512
Deferred financing cost with related party, net of current portion	9,091	15,909
Available-for-sale equity security (cost-\$50,000)	566,200	506,600
Goodwill	2,808,524	2,808,524
TOTAL OTHER ASSETS	<u>4,533,582</u>	<u>4,480,497</u>
TOTAL ASSETS	<u>\$ 28,369,702</u>	<u>\$ 31,268,529</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 2,592,469	\$ 2,505,617
Accrued expenses	368,787	550,565
Accrued payroll, benefits and taxes	288,467	674,106
Current portion of long term debt	443,215	444,884
Current portion of obligations under capital leases	231,916	287,946
Accrued interest on convertible note payable to related party	41,667	41,667
Customer advances	-	150,000
Deferred revenue	-	45,000
TOTAL CURRENT LIABILITIES	<u>3,966,521</u>	<u>4,699,785</u>
LONG-TERM LIABILITIES:		
Convertible note payable to related party	5,000,000	5,000,000
Long-term debt, net of current portion	611,197	680,969
Obligations under capital leases, net of current portion	311,948	341,316
Asset retirement obligation	372,593	259,467
Deferred income taxes	394,924	852,122
TOTAL LONG-TERM LIABILITIES	<u>6,690,662</u>	<u>7,133,874</u>
COMMITMENTS AND CONTINGENCIES (NOTE 14)	-	-
STOCKHOLDERS' EQUITY:		
Preferred stock, \$0.01 par value; 10,000,000 shares authorized, none issued and outstanding	-	-
Common stock, \$0.001 par value; 100,000,000 shares authorized, 55,795,193 and 55,649,064 shares issued and outstanding, respectively	55,795	55,649
Additional paid-in capital	50,025,215	49,803,825
Accumulated deficit	(32,884,691)	(30,881,204)
Accumulated other comprehensive income:		
Unrealized gain on available-for-sale equity security	516,200	456,600
TOTAL STOCKHOLDERS' EQUITY	<u>17,712,519</u>	<u>19,434,870</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 28,369,702</u>	<u>\$ 31,268,529</u>

See accompanying notes to consolidated financial statements.

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

	Three Months Ended December 31,	
	2010 (unaudited)	2009 (unaudited)
REVENUES	\$ 5,561,736	\$ 3,253,881
COST OF REVENUES	<u>5,003,566</u>	<u>2,523,095</u>
GROSS PROFIT	<u>558,170</u>	<u>730,786</u>
OPERATING EXPENSES:		
Mineral exploration expenses	1,493,239	54,293
Salaries and benefits	479,537	457,288
Insurance expense	120,382	114,139
Professional fees expense	100,395	372,439
Other general and administrative expenses	557,055	449,096
TOTAL OPERATING EXPENSES	<u>2,750,608</u>	<u>1,447,255</u>
LOSS FROM OPERATIONS	<u>(2,192,438)</u>	<u>(716,469)</u>
OTHER INCOME (EXPENSE):		
Other income	502	37,117
Foreign exchange gain	4,790	-
Interest income	1,943	3,392
Related party interest expense	(131,818)	(138,092)
Interest expense	(29,082)	(24,986)
TOTAL OTHER EXPENSE	<u>(153,665)</u>	<u>(122,569)</u>
NET LOSS BEFORE INCOME TAXES	(2,346,103)	(839,038)
INCOME TAX BENEFIT	<u>457,198</u>	<u>-</u>
NET LOSS FROM CONTINUING OPERATIONS	(1,888,905)	(839,038)
LOSS FROM DISCONTINUED OPERATIONS, NET OF TAX	<u>(114,582)</u>	<u>(93,024)</u>
NET LOSS	<u>(2,003,487)</u>	<u>(932,062)</u>
OTHER COMPREHENSIVE INCOME:		
Unrealized gain on available-for-sale equity security	59,600	-
COMPREHENSIVE LOSS	<u>\$ (1,943,887)</u>	<u>\$ (932,062)</u>
NET LOSS PER SHARE AVAILABLE TO COMMON STOCKHOLDERS, BASIC AND DILUTED:		
CONTINUING OPERATIONS	\$ (0.04)	\$ (0.02)
DISCONTINUED OPERATIONS	nil	nil
NET LOSS	<u>\$ (0.04)</u>	<u>\$ (0.02)</u>
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING, BASIC AND DILUTED	<u>55,759,611</u>	<u>38,339,547</u>

See accompanying notes to consolidated financial statements.

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended December 31,	
	2010 (unaudited)	2009 (unaudited)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (2,003,487)	\$ (932,062)
Adjustments to reconcile net loss to net cash provided (used) by operating activities:		
Depreciation and amortization	407,136	343,960
Gain on disposal of equipment	(1,710)	(215)
Stock based compensation	178,536	272,403
Accretion of asset retirement obligation	3,126	-
Amortization of deferred financing cost with related party	6,818	-
Deferred income taxes	(457,198)	-
Loss on disposal of assets held for sale	13,005	-
Inventory write-down	-	60,916
Other non-cash compensation	-	33,845
Changes in assets and liabilities:		
Accounts receivable	358,051	1,382,951
Materials and supplies inventory	(267,189)	73,676
Prepaid expenses and other current assets, deposits and other assets	(50,658)	(180,028)
Accounts payable	86,852	(630,687)
Accrued expenses	(181,778)	(90,420)
Accrued payroll, benefits and taxes	(385,639)	(191,722)
Accrued interest on convertible note payable to related party	-	138,092
Deferred revenue	(45,000)	-
Net cash provided (used) by operating activities	<u>(2,339,135)</u>	<u>280,709</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(199,696)	(60,293)
Change in restricted cash	(142)	(81)
Proceeds from sale of equipment	8,335	18,501
Purchase of mineral rights	(30,000)	(15,000)
Proceeds from sale of assets held for sale	141,200	-
Net cash used by investing activities	<u>(80,303)</u>	<u>(56,873)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on long term debt	(71,441)	(36,920)
Payments on capital leases	(85,398)	(128,940)
Payments on customer advances	(150,000)	(150,000)
Proceeds from exercise of options	43,000	63,241
Proceeds from issuances of stock and warrants, net of stock offering costs	-	2,807,162
Proceeds from exercise of warrants	-	542,972
Net cash provided (used) by financing activities	<u>(263,839)</u>	<u>3,097,515</u>
Net increase (decrease) in cash and cash equivalents	(2,683,277)	3,321,351
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	<u>4,638,674</u>	<u>969,784</u>
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$ 1,955,397</u>	<u>\$ 4,291,135</u>
NON-CASH FINANCING AND INVESTING ACTIVITIES:		
Warrants issued to brokers acting as agents for a private placement	\$ -	\$ 129,517

See accompanying notes to consolidated financial statements.

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2010

NOTE 1 – ORGANIZATION AND DESCRIPTION OF BUSINESS:

Timberline Resources Corporation (“Timberline” or “the Company”) was incorporated in August of 1968 under the laws of the state of Idaho as Silver Crystal Mines, Inc., for the purpose of exploring for precious metal deposits and advancing them to production. On August 27, 2008 we reincorporated into the State of Delaware pursuant to a merger agreement approved by our shareholders on August 22, 2008.

In 2006, the Company acquired Kettle Drilling, Inc. (“Kettle Drilling” or “Kettle”) and its Mexican subsidiary, World Wide Exploration S.A. de C.V. (“World Wide”). Kettle provides drilling services to the mining and mineral exploration industries in North America. In September 2008, Kettle Drilling, Inc. changed its name to Timberline Drilling Incorporated (“Timberline Drilling”). In September 2010, we closed our drilling services operation in Mexico which was operated by World Wide and moved substantially all of the World Wide assets to the United States.

On June 2, 2010, the Company acquired Staccato Gold Resources Ltd. (“Staccato”), a Canadian corporation, engaged in the exploration for precious metal deposits and advancing them to production (See Note 7).

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

- a. *Basis of Presentation* – The accompanying unaudited consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial information, as well as the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of the Company’s management, all adjustments (consisting of only normal recurring accruals) considered necessary for a fair presentation of the interim financial statements have been included. Operating results for the three month period ended December 31, 2010 are not necessarily indicative of the results that may be expected for the full year ending September 30, 2011.

For further information refer to the financial statements and footnotes thereto in the Company’s Annual Report on Form 10-K for the year ended September 30, 2010.

- b. *Reclassifications* – Certain amounts in the prior period financial statements have been reclassified for comparative purposes to conform to current period presentation with no effect on previously reported net loss.
- c. *Net Loss per Share* –Basic EPS is computed as net income (loss) available to common shareholders divided by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur from common shares issuable through stock options, warrants, and other convertible securities.

The dilutive effect of convertible and outstanding securities, in periods of future income as of December 31, 2010 and 2009, would be as follows:

	<u>December 31, 2010</u>	<u>December 31, 2009</u>
Stock options	6,090,308	5,936,499
Warrants	8,050,375	1,697,938
Convertible debt	3,333,333	3,744,006
Total possible dilution	<u>17,474,016</u>	<u>11,378,443</u>

At December 31, 2010 and 2009, the effect of the Company’s outstanding options and common stock equivalents would have been anti-dilutive.

- d. *Asset retirement obligation* – The Company accounts for asset retirement obligations by following the uniform methodology for accounting for estimated reclamation and abandonment costs as prescribed by authoritative accounting guidance. This guidance provides that the fair value of a liability for an asset retirement obligation (“ARO”) will be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The ARO is capitalized as part of the carrying value of the assets to which it is associated, and depreciated over the useful life of the asset. Adjustments are made to the liability for changes resulting from passage of time and changes to either the timing or amount of the original present value estimate underlying the obligation. The Company has an ARO associated with its underground exploration program at the Butte Highlands Gold Project as well as its Lookout Mountain exploration project (see Note 9).

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2010

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (continued):

e. *New accounting pronouncements* – In January 2010, the ASC guidance for fair value measurements was updated to require additional disclosures related to movements of assets among Levels 1 and 2 of the three-tier fair value hierarchy. Also, a reconciliation of purchases, sales, issuance, and settlements of anything valued with a Level 3 method is required. Disclosure regarding fair value measurements for each class of assets and liabilities will be required. The updated guidance was adopted by the Company in its quarter ended December 31, 2009, except for disclosures about the activity in Level 3 fair value measurements which are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Adoption of this updated guidance did not have a material impact on the Company’s consolidated financial statements.

NOTE 3 – FAIR VALUE MEASUREMENTS:

Effective October 1, 2008 for financial assets and liabilities, and October 1, 2009 for non-financial assets and liabilities, the Company has adopted expanded disclosure requirements to include the following information for each major category of assets and liabilities that are measured at fair value on a recurring or non-recurring basis:

- a. the fair value measurement;
- b. the level within the fair value hierarchy in which the fair value measurements in their entirety fall, segregating fair value measurements using quoted prices in active markets for identical assets or liabilities (Level 1), significant other observable inputs (Level 2), and significant unobservable inputs (Level 3);
- c. for fair value measurements using significant unobservable inputs (Level 3), a reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to the following:
 - 1) total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities);
 - 2) the amount of these gains or losses attributable to the change in unrealized gains or losses relating to those assets liabilities still held at the reporting period date and a description of where those unrealized gains or losses are reported;
 - 3) purchases, sales, issuances, and settlements (net); and
 - 4) transfers in and/or out of Level 3.

The table below sets forth our financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2010 and September 30, 2010, and the fair value calculation input hierarchy level that we have determined applies to each asset and liability category.

	<u>December 31,</u> <u>2010</u>	<u>September 30,</u> <u>2010</u>	<u>Input</u> <u>Hierarchy</u> <u>Level</u>
Assets:			
Cash and cash equivalents	\$ 1,955,397	\$ 4,638,674	Level 1
Restricted cash	380,094	379,952	Level 1
Available-for-sale equity security	566,200	506,600	Level 2

NOTE 4 – CUSTOMER ADVANCES:

During the year ended September 30, 2009, Newmont USA Limited (“Newmont”) provided an advance payment for drilling services of \$1,000,000 to the Company and extended its contract with the Company through February 2011. The advance was repaid by twenty monthly payments of \$50,000 beginning May 15, 2009 and ending December 15, 2010. The advance was provided pursuant to a contract change order which did not contain any provisions for interest or prepayment penalties, nor any specified right of offset. As of December 31, 2010 and September 30, 2010, customer advances were none and \$150,000, respectively.

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2010

NOTE 5 – INVESTMENT IN JOINT VENTURE:

In July 2009, the Company entered into a Joint Venture Operating Agreement with Highland Mining, LLC (“Highland”), an entity controlled by Ronald Guill, a director of the Company. The joint venture entity, Butte Highlands JV, LLC (“BHJV”) was created for the purpose of developing and mining the Butte Highlands Gold Project. As a result of its contribution of the Company’s 100% interest in the Butte Highlands Gold Project, carried on its balance sheet at the original purchase price of the Butte Highlands project (\$621,000) to BHJV, the Company holds a 50% interest in BHJV. Under terms of the agreement, the Company’s interest in BHJV will be carried to production by Highland, which will fund all future project exploration and mine development costs.

Under the operating agreement for BHJV, Highland will contribute property and fund all future mine development costs at Butte Highlands. Both the Company’s and Highlands’s share of development costs will be paid from proceeds of future mine production. The BHJV operating agreement stipulates that Highland shall appoint a manager of BHJV and that Highland will manage BHJV until such time as all mine development costs, less \$2 million, are distributed to Highland out of the proceeds from future mine production.

NOTE 6 – AVAILABLE-FOR-SALE EQUITY SECURITY:

Available-for-sale equity security is comprised of 2,980,000 shares of common stock in Rae Wallace Mining Company (“RWMC”), which have been valued as described below. The following table summarizes the Company’s available-for-sale equity security:

	<u>December 31,</u> <u>2010</u>	<u>September 30,</u> <u>2010</u>
Cost	\$ 50,000	\$ 50,000
Unrealized Gain	516,200	456,600
Fair Value	<u>\$ 566,200</u>	<u>\$ 506,600</u>

Management has determined the best measure of fair value to be the bid price of RWMC stock as quoted by the market maker in the stock as of December 31, 2010 and September 30, 2010, which was \$0.19 and \$0.17 per share, respectively.

RWMC is also a related party to the Company (See Note 8).

NOTE 7 – ACQUISITION OF STACCATO GOLD RESOURCES LTD.:

On June 2, 2010, the Company completed its acquisition of all of the issued and outstanding common shares of Staccato Gold Resources Ltd. (“Staccato”), by way of a court approved Plan of Arrangement under the Business Corporations Act (British Columbia) in accordance with the terms of an Arrangement Agreement, dated March 22, 2010, by and between the Company and Staccato. The acquisition was also approved by the Timberline stockholders and Staccato’s securityholders. Staccato was a publicly held Canadian corporation engaged in the exploration of precious metals properties in Nevada. Timberline acquired Staccato in order to further the exploration and development of mineral properties owned or leased by Staccato, as well as to increase the working capital of the Company.

This transaction was accounted for as a business combination. The Company acquired all of the issued and outstanding common shares of Staccato in consideration for the issuance of one share of common stock of the Company for every seven common shares of Staccato and \$0.0001 in cash for each common share of Staccato. In addition, the Company acquired all of the issued and outstanding warrants to purchase common shares of Staccato and options to purchase common shares of Staccato, after giving effect to the exercise and cancellation of certain options immediately prior to closing, in consideration for the issuance by the Company of a warrant to purchase one share of common stock of the Company for every seven Staccato warrants or an option to purchase one share of common stock of the Company for every seven Staccato options, as applicable. Pre-acquisition Timberline shareholders own approximately 74% of the issued and outstanding common stock of the Company as of the acquisition date and former Staccato shareholders own approximately 26%. On a fully diluted basis, Timberline is owned 71% by pre-acquisition Timberline shareholders and 29% by former Staccato shareholders as of the acquisition date.

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2010

NOTE 7 – ACQUISITION OF STACCATO GOLD RESOURCES LTD., (continued):

The purchase price of the transaction was \$15,435,199, consisting of the issuance of 14,301,380 shares of Timberline common stock valued at \$14,444,394; 6,352,437 warrants to purchase one share of Timberline common stock valued at \$889,341; 102,143 options to purchase one share of Timberline common stock valued at \$64,429; and cash of \$37,035. The Company incurred \$214,477 in expenses related to the acquisition, \$205,541 of which are included in professional fees expense, \$5,800 are included in mineral exploration expenses and \$3,136 are included in other general and administrative expenses in the consolidated statement of operations.

Timberline’s common stock issued as consideration was valued based upon the closing price of \$1.01 per share of our common stock on the NYSE Amex on June 2, 2010. The warrants and options that were issued as consideration were valued on that date using the Black-Scholes pricing model, based upon the following principal assumptions:

	Warrants	Options
Risk-free interest rate	0.38%	0.22% - 1.30%
Dividend yield	N/A	N/A
Volatility factor	106.1%	57.7% - 121.6%
Remaining period to expiry date – warrants (weighted average)	1.13 years	
Expected term - options		0.60 – 2.90 years

The purchase price allocation of the acquisition is summarized as follows:

Purchase price:	
Shares issued on acquisition	\$ 14,444,394
Warrants	889,341
Options	64,429
Cash	37,035
	<u>\$ 15,435,199</u>
Net assets acquired:	
Cash and cash equivalents	\$ 4,458,068
Other current assets	69,684
Restricted cash	54,258
Mineral rights and equipment, net	12,113,342
Deferred income taxes	(1,260,153)
	<u>\$ 15,435,199</u>

The consolidated statement of operations of the Company for the three months ended December 31, 2010 includes net losses incurred by Staccato of \$910,886 and no revenue since the acquisition date.

The unaudited pro forma financial information for the three months ended December 31, 2009, below, represents the combined results of the Company’s operations as if the Staccato acquisition had occurred at the beginning of the period presented. The unaudited pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have occurred if the acquisition had taken place at the beginning of the periods presented, nor is it indicative of future operating results. The unaudited pro forma loss from continuing operations, net loss and net loss per share available to common stockholders, basic and diluted, for the three months ended December 31, 2009 includes non-recurring severance and professional expenses incurred by Staccato in the amount of \$1,622,248. The amounts presented below for the three months ended December 31, 2010 represent the actual results for the period.

	Three months ended	
	December 31	
	2010	2009
Revenue from continuing operations	\$ 5,561,736	\$ 3,253,881
Net loss from continuing operations	(1,888,905)	(1,285,725)
Net loss	(2,003,487)	(1,378,749)
Net loss per share available to common stockholders, basic and diluted	(0.04)	(0.03)

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2010

NOTE 8 – RELATED PARTY TRANSACTIONS:

Information regarding related party notes payable is as follows at December 31, 2010 and September 30, 2010:

	December 31, 2010	September 30, 2010
Small Mine Development, LLC	\$ <u>5,000,000</u>	\$ <u>5,000,000</u>
Accrued interest on note payable to Small Mine Development, LLC	\$ <u>41,667</u>	\$ <u>41,667</u>

On October 31, 2008, the Company entered into a series of agreements in connection with a \$5 million loan from Small Mine Development, LLC (“SMD”). The loan documents included: a convertible note (the “Convertible Term Note”), a credit agreement (the “Credit Agreement”), a collateral assignment and pledge of stock and security agreement (the “Pledge Agreement”), a security agreement (the “Security Agreement”) and a right of first refusal over the Company’s Butte Highlands property (the “Right of First Refusal”).

The Convertible Term Note has a principal amount of \$5 million and is collateralized with all of the stock of Timberline Drilling, Inc., as well as a Deed of Trust covering the Company’s Butte Highlands property in Silver Bow County, Montana (the “Butte Highlands Property”).

Pursuant to the terms of the Credit Agreement, the Convertible Term Note bears interest at 10% annually, compounded monthly, with interest due at maturity. The Convertible Term Note is convertible by SMD at any time prior to payment of the note in full, at a conversion price of \$1.50 per share. Should the Company issue any form of equity security other than the Company’s common stock, SMD may also convert all or any portion of the outstanding amount under the Convertible Term Note into the new form of equity security at the issuance price of the new form of equity security. Management analyzed the conversion features contained in this note considering the guidance provided in the ASC for derivatives and hedging. Management’s conclusion was that these convertible features are conventional convertible instruments and thus would qualify for equity classification. As conventional convertible instruments, the embedded conversion options qualify for the scope exception provided in the guidance for derivatives and hedging, and therefore would not be bifurcated from the host instrument.

The Convertible Term Note was scheduled to be repaid on or before October 31, 2010, including interest due at maturity. In June 2010, SMD agreed to extend the Maturity Date of the Convertible Term Note to on or before April 30, 2012. All interest accrued through June 30, 2010 was paid by the Company to SMD at that time. The Company also paid a \$50,000 extension fee to SMD in consideration for the extension of the Convertible Term Note. The extension fee has been recorded as a deferred financing cost and is being amortized over the life of the loan. The Convertible Term Note was also amended to require interest accrued subsequent to June 30, 2010 to be paid by the Company to SMD monthly, rather than accruing interest to maturity. All other terms of the loan were unchanged. The Company has accounted for the extension of the Maturity Date as a loan modification.

Under the Right of First Refusal, the Company granted SMD a right of first refusal to purchase the Butte Highlands Property on the same terms as those of any bona fide offer from a third-party upon 60 days’ notice from the Company of any such offer. In addition, the Company granted SMD a right to develop the Butte Highlands Property on the same terms as those of any bona fide offer to develop the property from a third-party upon 60 days’ notice from the Company of any such offer.

Butte Highlands Joint Venture Agreement

On July 22, 2009, the Company entered into an Operating Agreement with Highland Mining, LLC (“Highland”), an affiliate of SMD, to form a 50/50 joint venture for development and mining of the Company’s Butte Highlands Gold Project (See Note 5). Under the terms of the operating agreement, the Company contributed its Butte Highlands property to BHJV for a deemed value of \$2 million, and Highland contributed property and will fund all future mine development costs. Both the Company’s and Highland’s share of costs will be paid out of proceeds from future mine production.

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NOTE 8 – RELATED PARTY TRANSACTIONS, (continued):

Mr. Guill, a director of the Company and an owner of Highland, is the manager of BHJV until such time as income in an amount equal to all mine development costs less \$2 million is distributed to Highland. At that time, a management committee, with equal representation from Highland and the Company, will be the manager of BHJV. Under the terms of the Operating Agreement, Highland will have preferential rights with respect to distributions until the investment by Highland is deemed equal to the investment by the Company.

At December 31, 2010 and September 30, 2010, the Company has a receivable from BHJV for expenses incurred on behalf of BHJV in the amount of \$21,431 and \$30,571, respectively. This amount is included in prepaid expenses and other current assets on the consolidated balance sheets at December 31, 2010 and September 30, 2010.

NOTE 9 – ASSET RETIREMENT OBLIGATION:

The Company has an asset retirement obligation (“ARO”) associated with the underground exploration program at the Butte Highlands Gold Project being performed by BHJV (see Note 5). The ARO resulted from the reclamation and remediation requirements of the Montana Department of Environmental Quality as outlined in the Company’s permit to carry out the exploration program. Estimated reclamation costs at the Butte Highlands Gold Project were discounted using a credit adjusted risk-free interest rate of 5% from the time the Company expects to pay the retirement obligation to the time it incurred the obligation, which is estimated at 12 years.

During the quarter ended December 31, 2010, the Company established an ARO associated with its exploration program at the Lookout Mountain Project. The ARO resulted from the reclamation and remediation requirements of the United States Bureau of Land Management as outlined in the Company’s permit to carry out the exploration program. Estimated reclamation costs at the Lookout Mountain Project were discounted using a credit adjusted risk-free interest rate of 5% from the time the Company expects to pay the retirement obligation to the time it incurred the obligation, which is estimated at 10 years.

The following table summarizes activity in the Company’s ARO:

	<u>2010</u>	<u>2009</u>
Balance at September 30,	\$ 259,467	\$ -
Initial measurement of ARO	110,000	250,089
Accretion expense	<u>3,126</u>	<u>-</u>
Balance at December 31,	<u>\$ 372,593</u>	<u>\$ 250,089</u>

NOTE 10 – INCOME TAXES:

Significant components of income tax benefit during the three months ended December 31, 2010 and 2009 are as follows:

	<u>2010</u>	<u>2009</u>
Current:		
Federal	\$ -	\$ -
State	-	-
Discontinued operations	<u>-</u>	<u>-</u>
Total current income tax benefit	-	-
Deferred:		
Federal	<u>457,198</u>	<u>-</u>
Total deferred income tax benefit	<u>457,198</u>	<u>-</u>
Total income tax benefit	<u>\$ 457,198</u>	<u>\$ -</u>

The federal deferred income tax benefit is realized in the Company’s wholly owned subsidiary, BH Minerals USA, Inc., which is not consolidated with the federal income taxes of the remainder of the Company since BH Minerals USA, Inc. is wholly owned by the Company’s wholly owned Canadian subsidiary, Staccato Gold Resources Ltd.

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NOTE 10 – INCOME TAXES, (continued):

For the fiscal year ending September 30, 2011 the Company anticipates an effective income tax rate of 0% in the United States and 0% in Canada due to the availability of accumulated net operating losses to offset any U.S. and Canadian income taxes.

NOTE 11 – COMMON STOCK, WARRANTS AND PREFERRED STOCK:

Stock Issued for Services

During the three months ended December 31, 2010 and 2009, 36,300 and zero shares of common stock, respectively, were issued to employees of the Company as incentive bonuses under the Company’s 2005 Equity Incentive Plan (amended). The common stock issued during the three months ended December 31, 2010 was valued at the closing price of the Company’s stock on the date of issue of \$1.08 per share, for a total cost of \$39,204 classified under salaries and benefits expense.

Warrants

The following is a summary of the Company’s warrants outstanding:

	Warrants	Weighted Average Exercise Price
Outstanding at September 30, 2010	8,050,375	\$ 3.00
Issued	-	-
Exercised	-	-
Expired	-	-
Outstanding at December 31, 2010 ⁽¹⁾	<u>8,050,375</u>	<u>\$ 3.00</u>

⁽¹⁾ These warrants expire as follows:

Warrants	Price	Expiration Date
1,697,938	\$1.75	March 25, 2011
2,485,488	\$3.34	July 4, 2011
1,744,500	\$3.34	July 18, 2011
1,362,857	\$3.34	August 9, 2011
759,592	\$3.34	August 16, 2011
<u>8,050,375</u>		

Preferred Stock

Timberline is authorized to issue up to 10,000,000 shares of preferred stock, \$.01 par value. The Board of Directors of Timberline is authorized to issue the preferred stock from time to time in series, and is further authorized to establish such series, to fix and determine the variations in the relative rights and preferences as between series, to fix voting rights, if any, for each series, and to allow for the conversion of preferred stock into Common Stock.

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NOTE 12 – STOCK OPTIONS:

The Company has established the 2005 Equity Incentive Plan (as amended by shareholders of the Company on May 28, 2010) to authorize the granting of up to 10,000,000 stock options to employees, directors and consultants. Upon exercise of options, shares are issued from the available authorized shares of the Company. Option awards are granted with an exercise price equal to the fair market value of the Company's stock at the date of grant.

No option awards were granted during the three months ended December 31, 2010 or December 31, 2009. Total compensation cost charged against operations under the plan for employees was \$97,332 and \$169,823 for the three months ended December 31, 2010 and 2009, respectively. These costs are classified under salaries and benefits expense. Total compensation cost charged against operations under the plan for directors and consultants was \$42,000 and \$102,580 for the three months ended December 31, 2010 and 2009, respectively. These costs are classified under other general and administrative expenses.

The following is a summary of the Company's options issued under the Amended 2005 Equity Incentive Plan:

	Options	Weighted Average Exercise Price
Outstanding at September 30, 2010	6,203,641	\$ 0.96
Granted	-	-
Exercised	(113,333)	0.42
Expired and forfeited	-	-
Outstanding at December 31, 2010	<u>6,090,308</u>	<u>\$ 0.97</u>
Exercisable at December 31, 2010	<u>6,042,975</u>	<u>\$ 0.97</u>
Weighted average fair value of options granted during the three months ended December 31, 2010		\$ <u>-</u>

The average remaining contractual term of the options outstanding and exercisable at December 31, 2010 was 3.16 and 3.16 years, respectively. Of the options exercised, 13,333 were on a cashless basis resulting in the issuance of 9,829 shares based on the current price of the Company's stock on the date of exercise. The Company received \$43,000 from the exercise of the remaining 100,000 options. As of December 31, 2010, total unrecognized compensation expense related to options was \$14,560 and the related weighted-average period over which it is expected to be recognized is approximately 0.50 years. The aggregate intrinsic value of options exercised during the three months ended December 31, 2010 and 2009 was \$97,600 and \$231,028, respectively. The aggregate intrinsic value of options outstanding and exercisable as of December 31, 2010 was \$3,088,048 and \$3,051,701, respectively.

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
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NOTE 13 – DISCONTINUED OPERATIONS:

In September 2010, the Company ceased its drilling service operations in Mexico and moved all of the serviceable assets in Mexico to the United States for future use. The results of operations for the Company’s Mexican subsidiary, World Wide Exploration, have been reported in discontinued operations for all periods presented.

The following table details selected financial information included in the loss from discontinued operations in the consolidated statements of operations for the three months ended December 31, 2010 and 2009:

	Three months ended December 31,	
	2010	2009
Revenues	\$ -	\$ 709,747
Cost of revenues	-	(664,790)
Operating expenses	(113,692)	(161,153)
Foreign exchange gain (loss)	(893)	18,957
Interest income	3	2,065
Interest expense	-	(1,005)
Other income	-	3,155
Net loss from discontinued operations, net of tax	<u>\$ (114,582)</u>	<u>\$ (93,024)</u>

The consolidated balance sheet of the Company at December 31, 2010 has assets held for sale of \$165,086 which includes \$139,436 in inventory and \$25,650 in property and equipment resulting from the discontinued operations.

NOTE 14 – COMMITMENTS AND CONTINGENCIES:

Real Estate Lease Commitments

The Company has real estate lease commitments related to its main office in Coeur d’Alene, Idaho, facilities in Butte, Montana and Eureka, Nevada, and offices and a shop of Timberline Drilling in Coeur d’Alene, Idaho. Total office and storage rental expense from continuing operations aggregated \$40,335 and \$58,036 for the three months ended December 31, 2010 and 2009, respectively.

Environmental Contingencies

The Company has in past years been engaged in mining in northern Idaho, which is currently the site of a federal Superfund cleanup project. Although the Company is no longer involved in mining in this or other areas at present, the possibility exists that environmental cleanup or other environmental restoration procedures could remain to be completed or mandated by law, causing unpredictable and unexpected liabilities to arise. At the date of these financial statements, the Company is not aware of any environmental issues or litigation relating to any of its current or former properties.

TIMBERLINE RESOURCES CORPORATION AND SUBSIDIARIES
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NOTE 15 – SEGMENT INFORMATION:

The Company has two operating segments at December 31, 2010: drilling revenues from Timberline Drilling and Timberline’s exploration activities. As a result of the closure of our drilling service operations in Mexico during the year ended September 30, 2010, segment information for the periods presented in the table below has been adjusted to reflect the discontinued operations.

Segment information for the three months ended December 31, 2010 and 2009 are as follows:

	Three months ended December 31,	
	2010	2009
Revenues from continuing operations:		
Timberline	\$ -	\$ -
Timberline Drilling	5,742,557	3,253,881
Elimination of intersegment revenues	(180,821)	-
Total revenues	<u>\$ 5,561,736</u>	<u>\$ 3,253,881</u>
Net income (loss) before income taxes from continuing operations:		
Timberline	\$ (1,850,648)	\$ (1,079,502)
Timberline Drilling	<u>(38,257)</u>	<u>240,464</u>
Net loss before income taxes from continuing operations	<u>\$ (1,888,905)</u>	<u>\$ (839,038)</u>
Identifiable assets:	December 31, 2010	September 30, 2010
Timberline	\$ 15,824,676	\$ 17,577,156
Timberline Drilling	12,318,304	13,172,598
Discontinued operations	<u>226,722</u>	<u>518,775</u>
Total assets	<u>\$ 28,369,702</u>	<u>\$ 31,268,529</u>

During the three months ended December 31, 2010, revenue from transactions with one customer amounted to 10% or more of our total revenues. Newmont accounted for revenue of \$4,574,272 during the three months ended December 31, 2010.

The assets of Timberline Resources are located in the United States. The assets of Timberline Drilling are also located in the United States and their revenues are derived from drilling contracts in the United States. Timberline Resources is not an operating entity at this point insofar as it is not generating revenues from its properties, but the Company is actively exploring several properties for their mining potential.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and related notes appearing elsewhere in this quarterly report.

Forward-Looking Statements

This quarterly report and the exhibits attached hereto contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements concern the Company's anticipated results and developments in the Company's operations in future periods, planned exploration and development of its properties, plans related to its business and other matters that may occur in the future. These statements relate to analyses and other information that are based on forecasts of future results, estimates of amounts not yet determinable and assumptions of management.

Any statements that express or involve discussions with respect to predictions, expectations, beliefs, plans, projections, objectives, assumptions or future events or performance (often, but not always, using words or phrases such as "expects" or "does not expect", "is expected", "anticipates" or "does not anticipate", "plans", "estimates" or "intends", or stating that certain actions, events or results "may", "could", "would", "might" or "will" be taken, occur or be achieved) are not statements of historical fact and may be forward-looking statements. Forward-looking statements are subject to a variety of known and unknown risks, uncertainties and other factors which could cause actual events or results to differ from those expressed or implied by the forward-looking statements, including, without limitation:

- risks related to our properties being in the exploration stage;
- risks related to our mineral operations being subject to government regulation;
- risks related to our ability to obtain additional capital to develop our resources, if any;
- risks related to mineral exploration and development activities;
- risks related to mineral estimates;
- risks related to our insurance coverage for operating risks;
- risks related to the fluctuation of prices for precious and base metals, such as gold, silver and copper;
- risks related to the competitive industry of mineral exploration;
- risks related to our title and rights in our mineral properties;
- risks related to our limited operating history;
- risks related to the possible dilution of our common stock from additional financing activities;
- risks related to potential conflicts of interest with our management;
- risks related to our subsidiaries' activities; and
- risks related to our shares of common stock.

This list is not exhaustive of the factors that may affect our forward-looking statements. Some of the important risks and uncertainties that could affect forward-looking statements are described further in our annual report on Form 10-K for the year ended September 30, 2010, filed with the Securities and Exchange Commission on December 20, 2010. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, believed, estimated or expected. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We disclaim any obligation subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events, except as otherwise required by law.

We qualify all the forward-looking statements contained in this report by the foregoing cautionary statements.

Corporate Background and History

We commenced our exploration stage in January 2004 with the change in the management of the Company. From January 2004 until March 2006, we were strictly a mineral exploration company. With our acquisition of a drilling services company and the acquisition of the Butte Highlands Gold Project, we diversified our business plan to include drilling services and an underground mine with possible gold production. Prior to the purchase of Timberline Drilling (formerly known as Kettle Drilling), the Company had no reported revenues and only had accumulated losses. In June 2010, the Company acquired Staccato Gold Resources Ltd., a Canadian-based resource company listed on the TSX Venture Exchange (“Staccato Gold”), that was in the business of acquiring, exploring and developing mineral properties with a focus on gold exploration in the dominant gold producing trends in Nevada. As a result of this acquisition, we obtained Staccato’s flagship South Eureka Property gold exploration project, which included their flagship gold project, the Lookout Mountain Project (“Lookout Mountain”), and several other projects at various stages of exploration in the Battle Mountain/Eureka gold trend in Nevada, along with Staccato Gold’s wholly owned U.S. subsidiary, BH Minerals USA, Inc.

Corporate Overview

Timberline Resources Corporation’s business is comprised of an exploration division with a focus on advanced-stage precious metals properties, such as its South Eureka Property in Nevada, a 50% carried-to-production interest in the Butte Highlands Joint Venture which is currently in development and targeted to begin gold production in early 2012, and a wholly owned contract diamond drilling subsidiary, Timberline Drilling, which provides cash flow to the Company from its underground and surface drilling operations at operating mines and advanced development and exploration projects.

Our exploration division is focused on district-scale gold projects with the potential for near-term, low-cost development. In addition to the advancement of the properties acquired in Nevada with the Staccato Gold acquisition and the evaluation of other potential properties and projects, the exploration division is responsible for the acquisition and advancement of our Butte Highlands Gold project that is being developed under the terms of our 50/50 joint venture agreement with Highland Mining, LLC.

Timberline’s operating subsidiary, Timberline Drilling, provides both surface and underground drilling services in the United States, with its largest client being Newmont Mining. Timberline Drilling specializes in underground, hard rock core drilling – a niche business that we believe is well-positioned as the industry matures and exploration projects are advanced into producing mines.

On June 2, 2010, the Company closed its acquisition of Staccato Gold . As a result of this acquisition, Timberline acquired Staccato Gold’s South Eureka Property, which includes a partially drill-tested exploration portfolio and the advanced-stage Lookout Mountain Project, located along Nevada’s Battle Mountain – Eureka trend, and approximately \$4.5 million in cash. In conjunction with this acquisition, shares of Timberline’s common stock are now listed on the TSX Venture Exchange in Canada where they trade under the symbol “TBR”, in addition to the Company’s NYSE Amex Equities listing, where the shares of Timberline’s common stock trade under the symbol “TLR”.

Drilling Services

Our underground focus with established customers continues to provide a solid base of operations, with the demand for surface exploration drilling picking up recently given the current strength in pricing for commodities such as gold, silver and copper.

Over the past two years we have successfully established a new corporate culture in our drilling subsidiary and have renewed our focus on underground drilling at established mining operations. We have reduced the layers of management between the head office and operations in the field, streamlined our processes and operations, strengthened our balance sheet, and implemented new employee incentive programs. These objectives were achieved under extremely difficult market conditions, and have resulted in considerable improvements in our operational and financial performance.

During the year ended September 30, 2010, due to a difficult operating environment, declining financial results, and increasing country-related risk, we decided to cease the operations of Timberline Drilling’s wholly-owned Mexican subsidiary, World Wide. World Wide’s drill rigs and related assets were moved back to the U.S. where they will be available for use by Timberline Drilling.

Timberline Drilling’s largest customer is Newmont Mining, with whom we have an operating contract through February 2014. We enjoy a very close working relationship with Newmont, including establishing joint planning and safety review teams. We believe this contract provides a higher degree of certainty in future cash flows for Timberline Drilling while

presenting an excellent foundation for future stability and growth. This also allows us to focus on further improvements in customer service and safety with our largest client. Our relationship with Newmont includes a supplementary agreement to provide deep-hole drilling in Nevada that is expected to provide long-term surface drilling revenue.

As of December 31, 2010, Timberline Drilling had 12 drills of its 24 drills operating and expects to have approximately 15 drills operating by early in the second fiscal quarter.

Exploration Division

South Eureka Property, Nevada

The South Eureka Property, including Lookout Mountain, was the primary asset we acquired in the acquisition of Staccato Gold in June 2010. The acquisition was predicated on the review and assumption that based on historic drill data, favorable metallurgical tests, a number of partially tested mineralized targets, a non-compliant gold resource, and current gold prices; a low-cost, low-grade, heap leachable gold mine could potentially be developed.

The South Eureka Property is located within the southern portion of Nevada's productive Battle Mountain-Eureka gold belt, with Lookout Mountain considered to be an advanced-stage gold project at the beginning of the pre-feasibility stage. The South Eureka Property, exceeding 15,000 acres in size, includes a 4-mile strike length of areas of structurally and stratigraphically controlled gold mineralization, all zones of which are open and will require additional in-fill and step-out drilling. The property has an extensive exploration, drilling, and gold production history by a number of companies since 1975, including Idaho Mining Corp, Norse-Windfall Mining, Amselco, Echo Bay Mines, and Barrick Gold. A total of 533 holes have been drilled on the property, totaling 267,000 feet. Gold mineralization tested to date is typical sediment hosted Nevada gold mineralization.

We are currently executing an aggressive core and rotary drill program at Lookout Mountain that began in August 2010. The program is focused on in-fill, metallurgical, and geotechnical drilling, with a smaller drill program testing a number of out-lying exploration targets. The program objective is to confirm the existing gold resource and incorporate all technical data into a technical report including a NI 43-101 compliant resource, and to supplement the technical data with economic data and parameters into a preliminary economic scoping study.

The Company has completed approximately 30,000 feet of reverse circulation drilling and 8,000 of core drilling during the program that commenced in August 2010. All drilling necessary for incorporation into our upcoming NI 43-101 report have been completed as of mid-January 2011. Samples collected from the core drilling program are currently in bench-scale metallurgical testing. Preliminary metallurgical results from trench and reverse circulation drill samples are positive, and support management's initial assessment regarding the viability for development of a low-cost, low-grade, heap leach gold operation at Lookout Mountain.

Butte Highlands Project, Montana

Our exploration division advanced our Butte Highlands Gold Project on several fronts during the quarter ended December 31, 2010. Our joint venture partner, Highland Mining, LLC, continued to advance the underground ramp to access the mineralized areas. This allowed for underground exploration and the commencement of ore definition drilling, as well as additional project exploration during the remainder of 2010. As of December 31, 2010, the underground ramp had been advanced approximately 4,500 feet toward the expected mineralization.

The application for our Hard Rock Operating Permit was submitted to the Montana Department of Environmental Quality in early May 2010. We, in conjunction with staff from the Butte Highlands Joint Venture, continue to refine the mine and underground exploration planning that is an integral part of our overall mine planning at the Butte Highlands Gold Project. The ongoing exploration and development phase of the program is expected to take approximately one year and, assuming acceptable permitting and geologic results, is expected to be followed by production in early 2012.

We believe the global economic environment and monetary situation favor a solid and relatively steady gold price for the foreseeable future. Volatility is to be expected, however our view is that we don't require higher gold prices in order to advance our business model. As a company, we are focused on continuous improvement at Timberline Drilling, advancing exploration programs on our South Eureka Property and other properties acquired in Nevada, advancing the Butte Highlands Gold Project toward expected gold production in early 2012, and continuing to evaluate new opportunities that fit with our business model. We have evaluated a number of projects and opportunities during the past several months and will continue to do so. We believe the combination of management and the Company's board of directors has the knowledge base to evaluate opportunities – either organically or through mergers and acquisitions – and we continue to do so.

Results of Operations for the Three Month Periods ended December 31, 2010 and 2009

<i>Consolidated Results</i> (\$US)	Three Months Ended December 31,	
	2010	2009
Revenue	\$ 5,561,736	\$ 3,253,881
Gross profit	558,170	730,786
Net income (loss) from continuing operations:		
Timberline Corporate/Exploration	(1,850,648)	(1,079,502)
Timberline Drilling	(38,257)	240,464
Consolidated net loss from continuing operations	(1,888,905)	(839,038)
Loss from discontinued operations, net of tax	(114,582)	(93,024)
Consolidated net loss	\$ (2,003,487)	\$ 932,062)

For the three months ended December 31, 2010, we reported \$5,561,736 in revenue compared to \$3,253,881 in the same period of 2009. Our revenues are derived entirely from Timberline Drilling and our increase from the previous year was primarily due to an increase in the number of drill rigs in service during the quarter. Total gross profit decreased in the quarter ended December 31, 2010 as compared to the previous year due to a reduction in average daily production rates from our operating drills, preparation costs associated with the deployment of surface drilling rigs to new customer sites, as well as higher maintenance costs.

Our consolidated net loss for the three months ended December 31, 2010 was \$2,003,487 compared to a consolidated net loss of \$932,062 for the three months ended December 31, 2009. The increased net loss is primarily attributable to a \$1.4 million increase in exploration expenditures on our mineral properties, offset somewhat by reduced professional fees and recognition of a deferred income tax benefit during the current year.

Timberline Drilling provides drilling services on a contract basis, which often requires long lead times based on drill rig availability. In the past, we have had a backlog related to several customers for drilling services work to be performed in future periods. Due to decreased demand for drilling services, some of our drill rigs are currently idle, and our backlog consists of drilling services work to be performed for one major customer and four other customers. While we have seen increases in requests for proposals for drilling services, and secured additional drilling service contracts for new customers commencing in the second half of the Company's previous fiscal year, we cannot predict if demand for drilling services will increase in future periods.

Timberline Corporate and Exploration Division

(\$US)	Three Months Ended December 31,	
	2010	2009
Exploration expenses:		
Butte Highlands	\$ 37,292	\$ -
South Eureka/Lookout Mountain	1,330,853	-
Other exploration properties	125,094	54,293
Total exploration expenditures	1,493,239	54,293
Non-cash expenses:		
Stock option and stock issuance expense	178,536	272,403
Depreciation, amortization and accretion	(3,496)	8,238
Total non-cash expenses	175,040	280,641
Professional fees expense	94,253	356,259
Interest expense	131,818	138,092
Interest and other income	(6,703)	(34,923)
Other general and administrative expenses	420,199	285,140
Income tax benefit	(457,198)	-
Net loss from continuing operations	\$ (1,850,648)	\$ (1,079,502)

The increase in the after tax net loss for Timberline Corporate and the Exploration division for the quarter ended December 31, 2010 as compared to the previous year's after tax net loss is primarily a result of significantly increased expenditures on mineral exploration activities at our Lookout Mountain Project in Nevada. This increase was offset somewhat by lower stock option expenses, reduced legal and accounting costs, lower interest expense and realization of an income tax benefit during the current period. Other general and administrative expenses were higher as compared to the

previous year as a result of increased costs associated with a redesign of the Company's logo, website and promotional materials as well as the initiation of cash compensation for the Company's board of directors. The income tax benefit during the quarter ended December 31, 2010 arose as a result of a reduction in deferred income tax liabilities assumed upon the acquisition of Staccato Gold Resources Ltd.

Timberline Drilling

(\$US)	Three Months Ended December 31,	
	2010	2009
Total revenue	\$ 5,742,557	\$ 3,253,881
Less elimination of intersegment revenues	(180,821)	-
Revenue	\$ 5,561,736	\$ 3,253,881
Gross profit	558,170	730,786
General and administrative expenses	567,877	470,922
Interest and other expense, net	28,550	19,400
Net income (loss)	\$ (38,257)	\$ 240,464

Timberline Drilling's increase in revenue is attributable to a significantly higher utilization rate of our drill rigs, primarily due to our major customer increasing the number of drills required and an increase in exploration drilling by other customers. Overall the demand for drilling services appears to be increasing during the past several months. Junior resource and exploration stage companies are gaining access to capital for their drilling programs, and, as a result, the overall demand for drilling services continues to show signs of improvement. Timberline Drilling has secured several new contracts with exploration stage companies.

The decline in gross profits compared to the prior year is a function of a reduction in average daily production rates from our operating drills, preparation costs associated with the deployment of surface drilling rigs to new customer sites, as well as higher maintenance costs in the current year.

Increased year over year general and administrative expenses at Timberline Drilling reflect an expected increase in overhead costs to support the increased number of operating drill rigs as compared to the previous year.

In spite of recognizing a small net loss during the quarter ended December 31, 2010, we expect that revenue stability resulting from our drilling contract with Newmont Mining in Nevada, coupled with our continued focus on reducing operating and administrative costs and improving performance efficiencies, will result in a return to positive earnings and cash flow from our drilling subsidiary for the remainder of our 2011 fiscal year.

Discontinued Operations – WWE

(\$US)	Three Months Ended December 31,	
	2010	2009
Revenues	\$ -	\$ 709,747
Cost of revenues	-	(664,790)
Operating expenses	(113,692)	(161,153)
Foreign exchange gain (loss)	(893)	18,957
Interest income	3	2,065
Interest expense	-	(1,005)
Other income	-	3,155
Loss from discontinued operations, net of tax	\$ (114,582)	\$ (93,024)

During the year ended September 30, 2010, due to declining operational and financial results, we decided to cease the operations of Timberline Drilling's wholly-owned Mexican subsidiary, WWE. WWE's drill rigs and related assets were moved back to the U.S. where they are available for use by Timberline Drilling. Expenses during the quarter ended December 31, 2010 reflect the winding down of operations in Mexico. We expect a minimal amount of expenses to be incurred in the second fiscal quarter of 2011 and no further costs to be incurred after that time.

Financial Condition and Liquidity

At December 31, 2010, we had assets of \$28,369,702 consisting of cash in the amount of \$1,955,397; accounts receivable in the amount of \$550,307; materials and supplies inventories valued at \$1,505,558; property, mineral rights and equipment, net of depreciation of \$19,187,445; goodwill related to the acquisition of Timberline Drilling in the amount of \$2,808,524 and other assets of \$2,362,471.

Disruptions in the current credit and financial markets have had a significant material adverse impact on a number of financial institutions and have limited access to capital and credit for many companies. While access to capital has improved recently, these disruptions could, among other things, make it more difficult for us to obtain, or increase our cost of obtaining, capital and financing for our operations. Our access to additional capital may not be available on terms acceptable to us or at all.

We expect to rely upon our existing cash balances and, in part, the cash flow generated by our contract core drilling services subsidiary. While the recent economic instability makes it difficult for the Company's management to accurately predict revenues and resulting cash flows from these services in the 2011 fiscal year, management expects that if commodity prices for gold and silver remain at or near the levels seen in fiscal 2010 that our revenues will increase in step with increased demand for drilling services by both our current customers as well as new customers. While we expect cash flows from our contract core drilling services subsidiary to increase in fiscal 2011 if our revenues increase, if cash flows decline or are insufficient to fund our expenditures, our discretionary exploration activities and other operations will either be curtailed significantly or we will be reliant upon equity financings to continue our exploration activities into the future. The current market conditions could make it difficult or impossible for us to raise necessary funds to meet our capital requirements. If we are unable to obtain financing through equity investments, we will seek multiple solutions including, but not limited to, asset sales, credit facilities or debenture issuances.

At December 31, 2010 the Company has a working capital surplus of \$682,154. Management expects to continue to maintain or increase the amount of working capital via continued improvements in operating cash flows at the Company's drilling subsidiary, monitoring discretionary exploration expenditures, reducing professional and consulting expenses, and potentially obtaining financing through sales of equity investments. Management expects to maintain or improve operating cash flows at the Company's drilling subsidiary by increasing the utilization rate of our drills and closely managing payroll expenses, supplies inventory levels, and general and administrative costs. We plan to continue exploration programs on our material exploration properties, to fund some exploratory activities and drilling on early-stage properties, and to seek additional acquisition opportunities.

As a result of our current cash balance, the ability of our drilling subsidiary to generate cash flows from operations, and our ability to curtail discretionary exploration expenditures as needed, management believes that it has sufficient working capital to meet the Company's ongoing operating expenses for the next 12 months. Additional financing may be required if the Company seeks to undertake further property acquisitions or expand its exploration or drilling services operations.

Off-Balance Sheet Arrangements

We do not have any off balance sheet arrangements that are reasonably likely to have a current or future effect on our financial condition, revenues, results of operations, liquidity or capital expenditures.

Critical Accounting Policies and Estimates

See Note 2 to the financial statements contained elsewhere in this Quarterly Report for a summary of the significant accounting policies used in the presentation of our financial statements. We are required to make estimates and assumptions that affect the reported amounts and related disclosures of assets, liabilities, revenue and expenses. We believe that our most critical accounting estimates are related to asset impairments, asset retirement obligations, and inventory net realizable value.

Our critical accounting policies and estimates are as follows:

Asset Impairments

Significant property acquisition payments for active exploration properties are capitalized. The evaluation of our mineral properties for impairment is based on market conditions for minerals, underlying mineralized material associated with the properties, and future costs that may be required for ultimate realization through mining operations or by sale. If no mineable ore body is discovered, or market conditions for minerals deteriorate, there is the potential for a material

adjustment to the value assigned to mineral properties.

The Company reviews the carrying value of equipment for impairment whenever events and circumstances indicate that the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. In cases where undiscounted expected future cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the fair value of the asset. The factors considered by management in performing this assessment include current operating results, trends and prospects, the manner in which the equipment is used, and the effects of obsolescence, demand, competition, and other economic factors.

Asset Retirement Obligations

The Company has an obligation to reclaim its properties after the surface has been disturbed by exploration methods at the site. As a result we have recorded a liability for the fair value of the reclamation costs we expects to incur in association with our joint venture at the Butte Highlands Gold Project as well as at our Lookout Mountain Project. The Company estimated applicable inflation and credit-adjusted risk-free rates as well as expected reclamation time frames. To the extent that the estimated reclamation costs change, such changes will impact future reclamation expense recorded. A liability is recognized for the present value of estimated environmental remediation (asset retirement obligation) in the period in which the liability is incurred if a reasonable estimate of fair value can be made. The offsetting balance is charged to the related long-lived asset. Adjustments are made to the liability for changes resulting from passage of time and changes to either the timing or amount of the original present value estimate underlying the obligation.

Materials and Supplies Inventory

Inventories consist primarily of parts, operating supplies, drill rods and drill bits. The Company values its materials and supplies inventory, with the exception of drill rods, at the lower of average cost or market. Drill rods are valued using their average cost less an allowance for rod usage on a per-foot drilled basis. The Company reviews the carrying value of inventory for impairment whenever events and circumstances indicate that materials and supplies inventory may no longer be of use by the Company's drilling operation. The Company also periodically assesses the per foot allowance for drill rod usage by assessing the net carrying value of rod inventory relative to the operating condition of rod inventory held by the Company. Allowances are recorded for inventory considered to be in excess or obsolete.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

Conclusions of Management Regarding Effectiveness of Disclosure Controls and Procedures

At the end of the period covered by this report, an evaluation was carried out under the supervision of and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, Randal Hardy ("CEO/CFO") and Chief Accounting Officer, Craig Crowell, ("CAO"), of the effectiveness of the design and operations of the Company's disclosure controls and procedures (as defined in Rule 13a – 15(e) and Rule 15d – 15(e) under the Exchange Act). Based on that evaluation the CEO/CFO and the CAO have concluded that as of the end of the period covered by this report, the Company's disclosure controls and procedures were adequately designed and effective in ensuring that: (i) information required to be disclosed by the Company in reports that it files or submits to the Securities and Exchange Commission under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in applicable rules and forms and (ii) material information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to our management, including our CEO/CFO and CAO, as appropriate, to allow for accurate and timely decisions regarding required disclosure.

Changes in Internal Controls over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

No director, officer or affiliate of Timberline and no owner of record or beneficial owner of more than 5% of our securities or any associate of any such director, officer or security holder is a party adverse to Timberline or has a material interest adverse to Timberline in reference to pending litigation.

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors as previously disclosed in our Form 10-K for the year ended September 30, 2010 which was filed with the SEC on December 20, 2010.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. [RESERVED]

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

- 31.1** Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14 and Rule 15d-14(a), promulgated under the Securities and Exchange Act of 1934, as amended
- 31.2** Certification of Chief Accounting Officer pursuant to Rule 13a-14 and Rule 15d-14(a), promulgated under the Securities and Exchange Act of 1934, as amended
- 32.1** Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act
- 32.2** Certification of Chief Accounting Officer pursuant to Section 906 of the Sarbanes-Oxley Act

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TIMBERLINE RESOURCES CORPORATION

By: /s/ Randal Hardy

Randal Hardy
Chief Executive Officer and Chief Financial Officer
(Principal Executive Officer and Principal Financial Officer)

Date: February 11, 2011

By: /s/ Craig Crowell

Craig Crowell
Chief Accounting Officer
(Principal Accounting Officer)

Date: February 11, 2011

CERTIFICATION

I, Randal Hardy, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Timberline Resources Corporation,
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 11, 2011

By: /s/ Randal Hardy

Randal Hardy
Chief Executive Officer & Chief Financial Officer
Principal Executive and Financial Officer

CERTIFICATION

I, Craig Crowell, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Timberline Resources Corporation,
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 11, 2011

By: /s/ Craig Crowell

Craig Crowell
Chief Accounting Officer
Principal Accounting Officer

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Timberline Resources Corporation (the “Company”) on Form 10-Q for the quarter ended December 31, 2010, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Randal Hardy, Chief Executive Officer and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 11, 2011

By: /s/ Randal Hardy

Randal Hardy
Chief Executive Officer & Chief Financial Officer
Principal Executive and Financial Officer

The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Section 1350 of Chapter 63 of Title 18 of the United States Code) and is not being filed as part of the Report or as a separate disclosure document.

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Timberline Resources Corporation (the “Company”) on Form 10-Q for the quarter ended December 31, 2010, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Craig Crowell, Chief Accounting Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 11, 2011

By: /s/ Craig Crowell

Craig Crowell
Chief Accounting Officer
Principal Accounting Officer

The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Section 1350 of Chapter 63 of Title 18 of the United States Code) and is not being filed as part of the Report or as a separate disclosure document.