TERRACE ENERGY CORP
(formerly Terrace Resources Inc.)

CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(unaudited – prepared by management)

SIX MONTHS ENDED JULY 31, 2011 AND 2010

TERRACE ENERGY CORP.

NOTICE OF NO AUDITOR REVIEW OF CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

The accompanying unaudited interim financial statements of Terrace Energy Corp. (the "Company") have been prepared by and are the responsibility of the Company's management. The Company's independent auditor has not performed a review of these financial statements in accordance with the standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

Vancouver, Canada

September 29, 2011

TERRACE ENERGY CORP
(formerly Terrace Resources Inc.)
CONDENSED INTERIM BALANCE SHEETS
(unaudited – prepared by management)

	July 31 2011	January 31 2011	February 1 2010
ASSETS			
Current			
Cash	$ 3,393,498	$ 219,701	$ 290,796
Deposits	24,886	-	-
HST receivable	7,372	1,232	-
	3,425,756	220,933	290,796
Long Term			
Restricted cash	-	2,523,771	2,502,262
	$ 3,425,756	$ 2,744,704	$ 2,793,058
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Accounts payable and accrued liabilities	$ 36,943	$ 18,953	$ 6,098
Shareholders' Equity			
Capital stock (Note 3)	3,766,276	2,880,589	2,880,589
Contributed surplus (Note 3)	261,649	87,950	87,950
Accumulated other comprehensive loss	196	-	-
Deficit	(639,308)	(242,788)	(181,579)
	3,388,813	2,725,751	2,786,960
	$ 3,425,756	$ 2,744,704	$ 2,793,058

Subsequent events (Note 7)

The accompanying notes are an integral part of these financial statements.

TERRACE ENERGY CORP
(formerly Terrace Resources Inc.)
CONDENSED INTERIM CONSOLIDATRED STATEMENTS OF OPERATIONS AND COMPRHENSIVE LOSS
(unaudited – prepared by management)
FOR THE SIX AND THREE MONTHS ENDED JULY 31

	For the Six Months Ended July 31 2011	For the Six Months Ended July 31 2010	For the Three Months Ended July 31 2011	For the Three Months Ended July 31 2010
EXPENSES				
Bank charges	$ 308	$ 136	$ 168	$ 59
Administrative	4,539	9,811	1,289	3,311
Professional	114,721	28,574	43,795	19,208
Transfer agent and filing fees	39,088	16,855	18,378	8,928
Business investigation costs	75,682	5,983	19,773	4,094
Stock-based compensation	173,699	-	173,699	-
Loss before other items	408,037	61,359	257,102	35,600
OTHER ITEM				
Interest income	(10,745)	(10,553)	(4,950)	(9,554)
Foreign exchange gains	(772)	-	(1,087)	-
	(11,712)	(10,553)	(6,037)	(9,554)
Net loss and comprehensive loss for the period	$ 396,520	$ 50,806	$ 251,065	$ 26,046
Basic earnings per share	$ (0.01)	$ (0.01)	$ (0.01)	$ (0.00)
Weighted average number of shares outstanding	33,048,488	35,167,535	30,881,821	30,881,821

The accompanying notes are an integral part of these financial statements.

TERRACE ENERGY CORP
(formerly Terrace Resources Inc.)
CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
(unaudited – prepared by management)

	Capital Stock					
	Shares	Amount	Contributed Surplus	Accumulated Other Comprehensive Income	Deficit	Total Shareholders' Equity
Balance, February 1, 2010	30,881,821	$ 2,880,589	$ 87,950	$ -	$ (181,579)	$ 2,786,960
Loss and comprehensive loss	-	-	-	-	(24,760)	(24,760)
Balance, April 30, 2010	30,881,821	2,880,589	$ 87,950	-	$ (206,339)	2,762,200
Loss and comprehensive loss		-	-	-	(26,046)	(26,046)
Balance, July 31, 2010	30,881,821	2,880,589	87,950	-	(232,385)	2,736,154
Loss and comprehensive loss	-	-	-	-	4,026	4,026
Balance, October 31, 2010	30,881,821	2,880,589	$ 87,950	-	(228,359)	2,740,180
Loss and comprehensive loss	-	-	-	-	(14,429)	(14,429)
Balance, January 31, 2011	30,881,821	2,880,589	87,950	-	(242,788)	2,725,751
Loss and comprehensive loss	-	-	-	-	(145,455)	(145,455)
Balance, April 30, 2011	30,881,821	2,880,589	87,950	-	(388,243)	2,580,296
Private placement	10,000,000	466,770	433,230	-	-	900,000
Share issue costs	-	(14,313)	-	-	-	(14,313)
Stock-based compensation	-	-	173,699	-	-	173,699
Other comprehensive income	-	-	-	196	-	196
Loss and comprehensive loss	-	-	-	-	(251,065)	(251,065)
Balance, July 31, 2011	40,881,821	$ 3,333,046	$ 694,879	$ 196	$ (639,308)	$ 3,388,813

The accompanying notes are an integral part of these financial statements

TERRACE ENERGY CORP
(formerly Terrace Resources Inc.)
CONDENSED INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited – prepared by management)
FOR THE SIX ANDTHREE MONTHS ENDED JULY 31

	For the Six Months Ended July 31 2011	For the Six Months Ended July 31 2010	For the Three Months Ended July 31 2011	For the Three Months Ended July 31 2010
CASH FLOW FROM OPERTAING ACTIVITIES				
Net loss for the period	$ (396,520)	$ (50,806)	$ 251,065	$ (26,046)
Stock-based compensation	173,699	-	173,699	-
Changes in non-cash working capital items:				
(Increase) decrease in accounts receivable	(6,140)	(2,961)	3,029	(1,614)
(Increase) in deposits	(24,886)	-	(23,888)	-
Increase (decrease) in accounts payable and accrued liabilities	17,553	(5,432)	(24,547)	(3,360)
Net cash used in operating Activities	(236,314)	(59,199)	(122,772)	(31,020)
CASH FLOWS FROM INVESTING ACTIVITIES				
Decrease (increase) Restricted cash	2,523,771	(10,553)	2,534,061	(9,554)
CASH FLOWS FROM FINANCING ACTIVITIES				
Proceeds from the issuance of shares	900,000	-	900,000	-
Share issue costs	(14,313)	-	(14,313)	-
Net cash provided by financing activities	885,687	-	885,687	-
Effect of exchange rate on cash	653	-	653	-
Change in cash for the period	3,173,797	(69,752)	3,297,629	(40,574)
Cash, beginning of period	219,701	290,796	95,869	261,619
Cash, end of period	$ 3,393,498	$ 221,045	$ 3,393,498	$ 221,045
Cash paid during the period for interest	$ -	$ -	$ -	$ -
Cash paid during the period for taxes	$ -	$ -	$ -	$ -

The accompanying notes are an integral part of these financial statements.

1. NATURE AND CONTINUANCE OF OPERATIONS

Terrace Energy Corp. (the "Company") was incorporated on July 6, 2006 under the Business Corporations Act (British Columbia) and previously named Terrace Resources Inc.

The Company was classified as a capital pool corporation ("CPC") as defined in TSX Venture Exchange (the "Exchange") Policy 2.4. In June 2009, the Company completed a transaction whereby four other CPCs purchased common shares of the Company and distributed them to their respective shareholders upon dissolution. At the particular time, the Company was required to place $2,500,000 into a segregated account, which could not be accessed without Exchange approval. These funds, together with accrued interest, are now available for general working capital purposes.

In June, 2011 the Company's subsidiary Terrace Operating, LLC ("TOL") and Eagle Energy Development Company ("EEDC"), entered into a farmout agreement, whereby TOL is entitled to acquire up to an 87.5% working interest and a 65.1875% net revenue interest in certain leases and farmout lands by funding all costs associated with and acting as operator on the re-entry and fracture stimulation and completion of an existing well or a substitute well. EEDC is at arm's length to the Company. The farmout agreement constituted the Company's "qualifying transaction". The Company is now a Tier 2 Oil and Gas issuer and its common shares trade on the Exchange under the symbol "TZR".

These condensed interim consolidated financial statements have been prepared on a going concern basis which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business The Company has no history of revenues or operating cash flows. The continuing operations of the Company are therefore dependent upon its ability to raise additional capital as required and future profitable operations, neither of which is assured. These financial statements do not include adjustments to amounts and classifications of assets and liabilities that might be necessary should the Company be unable to continue operations.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

These consolidated financial statements have been prepared in accordance with International Accounting Standard 34 Interim Financial Reporting ("IAS 34") as issued by the International Accounting Standards Board ("IASB"). The policies applied in these interim financial statements are based on International Financial Reporting Standards ("IFRS") issued and outstanding as at September 28, 2011, the date the Board of Directors approved these interim financial statements for issue. Any subsequent changes to IFRS that are issued and effective as at January 31, 2012, could result in a restatement of these interim financial statements.

This is the first year in which the Company's interim financial statements are prepared in accordance with IFRS and, as a result, IFRS 1, "First-time Adoption of International Financial Reporting Standards," has been applied. Prior to the adoption of IFRS, the Company's financial statements were prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). As this is the first year in which the Company's interim financial statements are prepared in accordance with IFRS, disclosure of the elected transition exemptions and reconciliation and explanation of accounting policy differences compared to Canadian GAAP have been provided in Note 6.

2. SIGNIFICANT ACCOUNTING POLICIES (Continued

These condensed interim financial statements should be read in conjunction with the Company's January 31, 2011 annual financial statements, which were prepared in accordance with Canadian GAAP, and the Company's interim financial statements as at and for the three months ended April 30, 2011, which include additional disclosures on the transition to IFRS and the IFRS disclosures included in Note 5.

Use of judgments and estimates

The preparation of these consolidated financial statements requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported expenses during the period. Actual results could differ from these estimates.

Significant assumptions about the future and other sources of estimation uncertainty that management has made at the end of the reporting period, that could result in a material adjustment to the carrying amounts of assets and liabilities in the event that actual results differ from assumptions made, relate to, but are not limited to, the following:

i) The inputs used in calculating the fair value for stock-based compensation expense included in operations.
ii) The inputs used in calculating the fair value of warrants included in units issued in private placements.
iii) The valuation of shares issued in non-cash transactions.

Principles of consolidation

The consolidated financial statements include the financial statements of the Company and its controlled subsidiary, Terrace Operating LLC. Control is achieved when the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

All inter-company transactions, balances, income and expenses are eliminated in full on consolidation.

Financial instruments

All financial instruments are classified as one of the following: held-to-maturity, loans and receivables, held-for-trading, available-for-sale or other financial liabilities. Financial assets and liabilities held-for-trading are measured at fair value with gains and losses recognized in net income. Financial assets held-to-maturity, loans and receivables, and other financial liabilities are measured at amortized cost using the effective interest method. Available-for-sale instruments are measured at fair value with unrealized gains and losses recognized in other comprehensive income (loss) and reported in shareholders' equity. Any financial instruments may be designated as held-for-trading upon initial recognition.

Transaction costs that are directly attributable to the acquisition or issue of financial instruments that are classified as other than held-for-trading, which are expensed as incurred, are included in the initial carrying value of such instruments.

Oil and Gas Properties

The Company follows the full cost method of accounting for oil and natural gas operations, whereby all costs of exploring for and developing oil and natural gas reserves are capitalized and accumulated in cost centres on a country-by-country basis. Costs include land acquisition costs, geological and geophysical changes, carrying charges on non-productive properties and costs of drilling both productive and non-productive wells. General and administrative costs are not capitalized other than to the extent of the Company's working interest in operated capital

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

expenditure programs on which operator's fees have been charged equivalent to standard industry operating agreements.

The costs in each cost centre, including the costs of well equipment, are depleted and amortized using the unit-of production method based on the estimated proved reserves before royalties. Natural gas reserves and production are converted to equivalent barrels of crude oil based on relative energy content. The costs of acquiring and evaluating significant unproved properties are initially excluded from depletion calculations. These 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.

The capitalized costs less accumulated depletion and amortization in each cost centre are limited to an amount equal to the estimated future net revenue from proved reserves (based on prices and costs at the balance sheet date) plus the cost (net of impairment) of unproved properties. The total capitalized costs less accumulated depletion and amortization, site restoration provision and future income taxes of all cost centres is further limited to an amount equal to the future net revenue from proved reserves plus the cost (net of impairments) of unproved properties of all cost centres less estimated future site restoration costs, general and administrative expenses, financing costs and income taxes.

Proceeds from the sale of oil and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion and amortization. Estimated future site restoration and abandonment costs, net of expected recoveries, are provided over the life of the proved reserves using the unit-of- production method. Costs are estimated each year by management based on current regulations, costs, technologies and industry standards.

Asset retirement obligations

The Company recognizes the fair value of a liability for an asset retirement obligation in the year in which it is incurred when a reasonable estimate of fair value can be made. The carrying amount of the related long-lived asset is increased by the same amount as the liability. Changes in the liability for an asset retirement obligation due to the passage of time will be measured by applying an interest method of allocation. The amount will be recognized as an increase in the liability and an accretion expense in the statement of operations. Changes resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows are recognized as an increase or a decrease to the carrying amount of the liability and the related long-lived asset.

As of August 31, 2010 and 2009, the Company does not have any asset retirement obligations.

Comprehensive income

Comprehensive income is the overall change in the net assets of the Company for a period, other than changes attributable to transactions with shareholders. It is made up of net income and other comprehensive income. Other comprehensive income includes gains or losses that Canadian generally accepted accounting principles requires to be recognized in the period but are excluded from net income for that period.

The Company has no items of comprehensive income (loss) in any period presented, accordingly, net loss equals comprehensive loss.

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock-based compensation

The Company accounts for stock-based compensation using a fair value based method with respect to all stock-based payments to directors, employees and non-employees. For directors and employees, the fair value of the options is measured at the date of grant. For non-employees, the fair value of the options is measured on the earlier of the date at which the counterparty performance is completed or the date the performance commitment is reached or the date at which the equity instruments are granted if they are fully vested and non-forfeitable. The fair value of the options is accrued and charged to operations, with the offset credit to contributed surplus. For directors and employees the options are recognized over the vesting period, and for non-employees the options are recognized over the related service period. If and when the stock options are ultimately exercised, the applicable amounts of contributed surplus are transferred to capital stock.

Income taxes

The Company uses the asset and liability method for accounting for income taxes. Under this method of tax allocation, future income tax assets and liabilities are determined based on differences between the financial statement carrying values and their respective income tax basis (temporary differences). Future income tax assets and liabilities are measured using the tax rates expected to be in effect when the temporary differences are likely to reverse. The effect on future income tax assets and liabilities of a change in tax rates is included in operations in the period in which the change is enacted or substantially assured. The amount of future income tax assets recognized is limited to the amount of the benefit that is more likely than not to be realized.

Basic and diluted loss per share

Basic loss per share is calculated using the weighted average number of common shares outstanding during the year. The Company uses the treasury stock method to compute the dilutive effect of options, warrants and similar instruments. Under this method the dilutive effect on loss per share is calculated presuming the exercise of outstanding options, warrants and similar instruments.

It assumes that the proceeds of such exercise would be used to repurchase common shares at the average market price during the year. However, the calculation of diluted loss per share excludes the effects of various conversions and exercise of options and warrants that would be anti-dilutive.

Shares held in escrow, other than where their release is subject to the passage of time, are not included in the calculation of the weighted average number of common shares outstanding.

Revenue recognition

Interest income is recognized as earned at the stated interest rate in the instrument.

New accounting pronouncements

Certain new accounting standards and interpretations have been published that are not mandatory for the July 31, 2011 reporting period. The following standards are assessed not to have any impact on the Company's financial statements:

- IFRS 9, Financial Instruments: effective for accounting periods commencing on or after January 1, 2013.

3. OIL AND GAS PROPERTIES

In June, 2011 the Company's subsidiary, TOL, and EEDC entered into a farmout agreement, whereby TOL is entitled to acquire up to an 87.5% working interest and a 65.1875% net revenue interest in certain leases and farmout lands located in Wharton County, Texas by funding all costs associated with and acting as operator on the re-entry and fracture stimulation and completion of an existing well or a substitute well. All costs incurred to July 31, 2011 in connection with the farmout agreement related to business investigation and as such were expensed during the period.

4. CAPITAL STOCK

On July 31, 2011, the Company had unlimited authorized common shares, without par value and 40,881,821 shares outstanding.

Share issues

On July 21, 2011, the Company completed a private placement of 10,000,000 Units at a purchase price of $0.09 per Unit for gross proceeds of $900,000. Each Unit consisted of one common share and one common share purchase warrant which entitles the holder to acquire one additional common share for a period of five years at an exercise price of $0.18 per share.

The Company allocated $466,770 of the subscription proceeds to share capital and $433,230 to contributed surplus representing the estimated value of the share purchase warrants. The valuation of the warrants was estimated using the Black-Scholes valuation model with a weighted expected volatility of 100%, risk free interest rate of 2.15%, expected life of 5 years and a dividend yield of 0%.

There were no warrants outstanding as at January 31, 2011.

Stock options

The Company has an incentive stock option plan which provides that the Board of Directors of the Company may from time to time, in its discretion, and in accordance with TSX-V requirements, grant to directors, officers, employees and technical consultants to the Company, non-transferable options to purchase common shares, provided that the number of common shares reserved for issuance will not exceed 10% of the issued and outstanding common shares. The number of commons share reserves for issuance pursuant to options granted to all technical consultants will not exceed 2% of the issued and outstanding common shares. The number of options granted to any one person cannot exceed 5% of the issued and outstanding common shares. Such options will be exercisable for a period of up to 10 years from the date of grant. Vesting terms will be determined at the time of grant by the Board of Directors.

Stock-based compensation

The Company uses the Black-Scholes option pricing model to determine the fair value of options granted. During the six months ended July 31, 2011, the Company granted stock options to purchase 1,950,000 shares with a weighted average fair value of $0.08 per option which is being recognized over the vesting period. The estimated fair value of the options was $173,699 and was recognized in the Consolidated Statement of Operations. The stock-based compensation was calculated using an expected volatility of 100%, risk-free rate of 2.23%, expected life 5 years and a nil dividend yield.

4. CAPITAL STOCK (continued)

Outstanding Stock Options and Warrants

Stock option transactions and the number of stock options outstanding are summarized as follows:

	Number	Weighted Average Exercise Price
Balance, February 1, 2011	-	$ -
Granted	2,200,000	0.13
Balance, July 31, 2011	2,200,000	$ 0.13
Options exercisable, July 31, 2011	1,975,000	$ 0.12

The following stock options were outstanding as at July 31, 2011:

Number of options	Number of options exercisable	Exercise Price CAD$	Expiry date
1,950,000	1,950,000	$ 0.12	June 21, 2016
250,000	25,000	0.19	July 15, 2016
2,200,000	1,975,000		

Warrant transactions and the number of warrants outstanding are summarized as follows

	Number of Warrants	Weighted Average Exercise Price	Expiry Date
Balance, January 31, 2011	-	-	-
Granted	10,000,000	0.18	June 21, 2016
Balance, July 31, 2011	10,000,000	$ 0.18	

4. CAPITAL STOCK (continued)

Escrow shares

Of the common shares issued, 22,143,693 are subject to an escrow agreement and may not be transferred without the consent of the Exchange. The escrow agreement provides, among other things, that a total of 3,690,605 common shares will be released from escrow on December 23, 2011 and every six months thereafter.

5. FINANCIAL INSTRUMENTS

The Company has classified its financial instruments as follows:

- Cash and restricted cash - as held-for-trading; and
- Accounts payable and accrued liabilities - as other financial liabilities.

The Company's risk exposure and the impact on the Company's financial instruments are summarized below:

Fair value
The carrying values of cash, restricted cash, and accounts payable and accrued liabilities approximate their fair values because of the short-term maturity of these financial instruments.

Credit risk
Credit risk is the risk of potential loss to the Company if the counterparty to a financial instrument fails to meet its contractual obligations.

The Company's credit risk is primarily attributable to its cash and cash equivalents, deposit and receivables. The Company manages exposure to credit risk on liquid financial assets through maintaining its cash with major Canadian financial institutions, for which management believes the risk of loss to be minimal.

Market risk
Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in the market prices. Market risk is comprised of three types of risk: interest rate risk, foreign currency risk and other price risk..

(i) Interest rate risk

The Company's cash and restricted cash consist of cash held in a bank account that earns interest at variable interest rates. Due to the short-term nature of these financial instruments, fluctuations in interest rates will not have a significant impact on the fair value of the cash of the Company.

(ii) Foreign currency risk

The Company is not exposed to foreign currency fluctuations, as all expenditures incurred are denominated in Canadian dollars.

(iii) Other price risk

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in the market prices, other than those arising from interest rate risk or foreign currency risk. The Company is not exposed to significant other price risk.

5. FINANCIAL INSTRUMENTS (continued)

Liquidity risk

Liquidity risk is the risk that the Company will encounter difficulty in satisfying financial obligations as they become due. The Company manages liquidity risk through maintaining sufficient cash on hand to meet its obligations as they become due. As at July 31, 2011, the Company had cash of $3,393,498 and accrued liabilities of $36,943 due within three months of the period-end.

6. TRANSITION TO IFRS

As stated in Note 2, these are the Company's first condensed interim financial statements for the period covered by the first annual financial statements prepared in accordance with IFRS. There are no differences between Canadian GAAP and IFRS that are applicable to the measurement of the Company's assets and liabilities (i) at the transition date of February 1, 2010; (ii) at January 31, 2011; and (iii) at July 31, 2011. There is no impact on net loss and comprehensive loss for any period presented. Further, there has been no application of any of the exceptions available under IFRS 1 - First Time Adoption of IFRS.

The accounting policies set out in Note 2 have been applied in preparing the financial statements for the period ended July 31, 2011, the comparative information presented in these financial statements for the period ended July 31, 2010, and in the preparation of an opening IFRS balance sheet as February 1, 2010.

7. SUBSEQUENT EVENTS

Subsequent to July 31, 2011, the board of directors granted additional stock options to an officer to purchase 250,000 common shares at an exercise price of $0.21 per share for a period of five years.