TERRACE ENERGY CORP.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(Expressed in Canadian dollars, unless otherwise stated)
(Unaudited – Prepared by Management)

FOR THE SIX AND THREE MONTHS ENDED JULY 31, 2012 AND 2011

TERRACE ENERGY CORP.

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim financial statements of 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 standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

Vancouver, Canada

September 26, 2012

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF FINANCIAL POSITION
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in Canadian Dollars)

		July 31, 2012		January 31, 2012
ASSETS				
Current assets				
Cash	$	5,161,212	$	2,590,292
Accounts receivable (Note 9)		135,414		5,148
Prepaids		70,661		-
Total current assets		5,367,287		2,595,440
Non-current assets				
Reclamation deposit		23,710		23,710
Advances for future exploration (Note 4)		979,000		1,185,168
Exploration and evaluation (Note 5)		7,955,545		1,788,358
Property and equipment (Note 6)		1,467,743		-
Total assets	$	15,793,285	$	5,592,676
LIABILITIES AND SHAREHOLDERS' EQUITY				
Current liabilities				
Accounts payable and accrued liabilities	$	275,415	$	167,113
Non-current liabilities				
Decommissioning obligations (Note 7)		5,243		-
Total liabilities		280,658		167,113
Shareholders' equity				
Capital stock (Note 8)		16,255,342		6,272,512
Reserves (Note 8)		649,405		517,235
Deficit		(1,392,120)		(1,364,184)
Total shareholders' equity		15,512,627		5,425,563
Total liabilities and shareholders' equity	$	15,793,285	$	5,592,676

Nature and continuance of operations (Note 1)
Exploration and evaluation commitments (Note 5)

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

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in Canadian Dollars)

	For the six months ended July 31, 2012	For the six months ended July 31, 2011	For the three months ended July 31, 2012	For the three months ended July 31, 2011
REVENUE				
Oil and gas sales	$ 758,138	$ -	$ 202,382	$ -
DIRECT OPERATING EXPENSES				
Production and operating	79,348	-	48,125	-
Royalties	41,186	-	7,124	-
Depletion and accretion	18,424	-	12,918	-
Gross profit	619,180	-	134,215	-
GENERAL AND ADMINSTRATIVE EXPENSES				
Administrative	244,723	4,847	173,270	1,457
Business investigation costs (Note 11)	-	75,682	-	19,773
Consulting (Note 11)	80,579	-	37,759	-
Foreign exchange (gain) loss	(92,465)	(772)	(61,496)	(1,087)
Interest income	(12,568)	(10,745)	(12,568)	(4,950)
Professional (Note 11)	122,275	114,721	80,916	43,795
Investor relations	69,481	-	38,599	-
Project investigation costs (Note 11)	5,082	-	-	-
Share-based payments	145,670	173,699	70,121	173,699
Transfer agent and filing fees	30,844	39,088	18,262	18,378
Travel	53,495	-	29,532	-
	647,116	396,520	374,395	251,065
Net loss and comprehensive loss for the period	$ (27,936)	$ (396,520)	$ (240,180)	$ (251,065)
Basic and diluted loss per share	$ (0.00)	$ (0.01)	$ (0.00)	$ (0.01)
Weighted average number of shares outstanding	57,578,437	33,048,488	62,289,321	30,881,821

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

TERRACE ENERGY CORP
CONDENSED CONSOLIDATED INTERIM STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in Canadian Dollars)

	Capital Stock					
	Shares	Amount	Equity Reserves	Accumulated Other Comprehensive Loss	Deficit	Total Shareholders' Equity
Balance - January 31, 2011	**30,881,821**	**$ 2,880,589**	**$ 87,950**	**$ -**	**$ (242,788)**	**$ 2,725,751**
Private placement	10,000,000	466,770	433,230	-	-	900,000
Share issue costs	-	(14,313)	-	-	-	(14,313)
Share-based payments	-	-	173,699	-	-	173,699
Other comprehensive income	-	-	-	196	-	196
Loss and comprehensive loss	-	-	-	-	(396,520)	(396,520)
Balance - July 31, 2011	**40,881,821**	**$ 3,333,046**	**$ 694,879**	**$ 196**	**$ (639,308)**	**3,388,813**
Balance - January 31, 2012	**52,919,321**	**$ 6,272,512**	**$ 517,235**	**$ -**	**$ (1,364,184)**	**$ 5,425,563**
Private placement	10,000,000	10,000,000	-	-	-	10,000,000
Share issue costs	-	(48,670)	-	-	-	(48,670)
Exercise of options	150,000	18,000	-	-	-	18,000
Fair value of options exercised	-	13,500	(13,500)	-	-	-
Share-based payments	-	-	145,670	-	-	145,670
Loss and comprehensive loss	-	-	-	-	(27,936)	(27,936)
Balance - July 31, 2012	**63,069,321**	**$ 16,255,342**	**$ 649,405**	**$ -**	**$ (1,392,120)**	**$ 15,512,627**

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

TERRACE ENERGY CORP
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in Canadian Dollars)
For six months ended July 31

	2012	2011
CASH FLOW FROM OPERATING ACTIVITIES		
Loss for the period	$ (27,936)	$ (396,520)
Items not involving cash:		
Depletion and accretion	18,424	-
Share-based payments	145,670	173,699
Changes in non-cash working capital items:		
Prepaids	(70,661)	(24,886)
Accounts receivable	(130,266)	(6,140)
Accounts payable and accrued liabilities	108,302	18,186
Net cash provided (used in) operating activities	43,533	(235,661)
CASH FLOWS FROM INVESTING ACTIVITIES		
Restricted cash	-	2,523,771
Advances for future exploration	(979,000)	-
Exploration and evaluation	(5,590,188)	-
Acquisition costs	(813,460)	-
Property and equipment	(59,295)	-
Net cash (used in) provided by investing activities	(7,441,943)	2,523,771
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of shares	10,000,000	900,000
Share issue costs	(48,670)	(14,313)
Exercise of options	18,000	-
Net cash provided by financing activities	9,969,330	885,687
Change in cash for the period	2,570,920	3,173,797
Cash, beginning of period	2,590,292	219,701
Cash, end of period	$ 5,161,212	$ 3,393,498

Supplemental disclosure with respect to cash flows (Note 12)

The accompanying notes are an integral part of these condensed consolidated interim 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's head office is located at 270 – 666 Burrard Street, Vancouver, BC, Canada V6C 2X8.

The Company was classified as a "capital pool corporation" until June 2011 at which time it completed a "qualifying transaction" and became a "Tier 2 Oil and Gas Issuer", as those terms are defined in TSX Venture Exchange (the "Exchange") policies. Its common shares trade on the Exchange under the symbol "TZR".

These condensed consolidated interim 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 a limited history of revenues and 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 condensed consolidated interim 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.

The condensed consolidated interim financial statements of the Company are presented in Canadian dollars, unless otherwise stated, which is the functional currency.

2. BASIS OF PRESENTATION

The condensed consolidated interim financial statements have been prepared on a historical cost basis, except for certain financial instruments that have been measured at fair value.

These condensed consolidated interim financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB"), and interpretations of the IFRS Interpretations Committee ("IFRIC"), applicable to the preparation of interim financial statements, including International Accounting Standards ("IAS") 34 – Interim Financial Reporting.

The policies applied in these condensed consolidated interim financial statements are based on IFRS issued and outstanding as of July 31, 2012. These condensed consolidated interim financial statements were approved for issuance by the Board on September 26, 2012.

Certain prior period amounts have been reclassified to conform to current period presentation.

3. NEW ACCOUNTING POLICIES

<u>Revenue recognition</u>
Revenue from the sale of oil and gas is recorded when title passes to an external party and is based on volumes delivered to customers at contractual delivery points, and rates and collectability are reasonably assured. Delivery is generally at the time the product enters the pipeline. The cost associated with the delivery, including operating and maintenance costs, transportation and production based royalty expenses, are recognized during the same period in which the related revenue is earned and recorded

(Expressed in Canadian Dollars)

3. NEW ACCOUNTING POLICIES (Continued)

New accounting standards and interpretation

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning after January 1, 2013, including IAS 1 *Presentation of Financial Statements*, IAS 19 *Employee Benefits*, IFRS 9 *Financial Instruments,* IFRS *10 Consolidated Financial Statements,* IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interest of Other Entities, and* IFRS 13 *Fair Value Measurement*, and have not been applied in preparing these consolidated financial statements. None of these are expected to have a significant effect on the consolidated financial statements of the Company, except for IFRS 9 *Financial Instruments* ("IFRS 9"), which becomes mandatory for the Company's 2015 consolidated financial statements and could change the classification and measurement of financial assets. The extent of the effects of the new accounting standards on the condensed interim consolidated financial statements has not been determined.

4. ADVANCES FOR FUTURE EXPLORATION

The Company owns varying interests in oil and gas properties subject to joint operating agreements, which provide, among other things, that the Company make advance payments, from time to time, to fund estimated exploration and evaluation costs. The amount of funds advanced, less the Company's share of actual costs incurred by the project operators, was $979,000 at July 31, 2012 (January 31, 2012 - $1,185,168) which consists of advances for future exploration of $510,475 and $468,525 on the STS Olmos and Cutlass projects, respectively. The advances made as at January 31, 2012 were reclassified to conform with the current period presentation.

5. EXPLORATION AND EVALUATION

	Los Patos	STS Olmos	Cutlass	Total
Balance - January 31, 2011	$ -	$ -	$ -	$ -
Acquisition costs	-	1,014,100	376,508	1,390,608
Exploration and evaluation	380,242	66,422	198,507	645,171
Impairment charge	(234,564)	-	-	(234,564)
Incidental sales	(5,678)	(7,179)	-	(12,857)
Expenditures during the year	140,000	1,073,343	575,015	1,788,358
Balance - January 31, 2012	**140,000**	**1,073,343**	**575,015**	**1,788,358**
Acquisition costs	-	-	813,460	813,460
Exploration and evaluation	-	3,621,399	3,153,957	6,775,356
Transfer to property and equipment	-	(1,421,629)	-	(1,421,629)
Expenditures during the period	-	2,199,770	3,967,417	6,167,187
Balance - July 31, 2012	**$ 140,000**	**$ 3,273,113**	**$ 4,542,432**	**$ 7,955,545**

Los Patos

In June 2011, the Company entered into an agreement to earn, through a wholly-owned subsidiary, an 87.5% working interest and a 65.187% net revenue interest in certain leases and farm-out lands covering 320 acres in Wharton County, Texas, by funding all costs associated with the re-fracture, stimulation and completion of an existing, primarily gas, well. The Company fulfilled its obligations under the agreement in 2011 and earned its interests in all of the project acreage. The well was deemed not successful and since the Company has no further exploration plans at this time it has reduced the carrying value of Los Patos to the approximate market cost of leasing comparable acreage on similar terms at the particular time. The Company may choose to explore, joint venture, sell, lease or abandon Los Patos in the future.

5. EXPLORATION AND EVALUATION (Continued)

STS Olmos

In November 2011, the Company entered into an agreement, through a wholly-owned subsidiary, to acquire varying working and net revenue interests, which average 26.88% and 20.16%, respectively, in approximately 14,400 gross acres (3,875 net acres) in LaSalle and McMullen Counties, Texas and an evaluation well . The purchase price was $1,014,100.

The Company's share of the costs to drill and complete the first well was $1,401,347, which was brought into production in February 2012. Upon completion, the costs of the first well and a portion of the acreage acquisition costs, less incidental sales from the evaluation well were transferred from Exploration and Evaluation assets to Property and Equipment. The Company has a 16.87% working interest and a 12.65% net revenue interest in this well.

In May 2012, the Company advanced the additional sum of $2,688,484 representing the operator's estimate of the Company's share of the costs to drill, evaluate and case both the vertical and horizontal extensions of two prospective wells on the STS Olmos project acreage. Drilling and casing of the first well was completed in May, 2012 and the second well in June 2012 at total cost of $2,178,009. The balance of the funds advanced will be applied against future costs to fracture stimulate and complete the two wells. The Company has a 33% working interest and a 25% net revenue interest in these prospective wells and estimates that its share of completion costs will be approximately $3,000,000.

Cutlass

In November 2011, the Company entered into an agreement, through a wholly-owned subsidiary, to earn a 25% working interest and an 18.75% net revenue interest in certain leases covering 3,395 net acres in Dimmit and LaSalle counties, Texas for $376,508 and a commitment to participate in a two well drilling program. In February 2012, the Company acquired an additional 5% working interest and 3.75% net revenue interest for an additional $233,254.

In order to earn the net revenue interests (22.5% in aggregate), the Company agreed to pay 33.33% of all costs, including acreage leases, prospect fees, site preparation and drilling, until the completion of two wells, and thereafter 30% of all costs relating to the lease payments, prospect fees and infrastructure costs covering 1,342 net acres (the "Dimmit County Acreage"). The Company advanced the sum of $2,133,019 in March 2012 representing the operator's estimate of the Company's share of costs to drill, evaluate and case both the vertical and horizontal extensions of a prospective well. This phase of work was completed in July 2012. The Company subsequently advanced the sum of $260,139 to fund the initial phase of well completion. The Company estimates that its share of completion costs will be approximately $1,500,000. In order to secure its interests in all of the Dimmit County Acreage, the Company must participate in the development of one additional well at an estimated cost of $2.7 million. Work on this well is currently scheduled for the second quarter of the Company's 2014 fiscal year.

After the drilling and technical evaluation of the first well on the Dimmit County Acreage, the Company had the right to exercise its option to earn a 22.5% net revenue interest in the remaining 2,053 acres (the "LaSalle County Acreage") at a cost of $813,460, representing the operator's estimate of the Company's share of lease payments. The Company exercised its right under the agreement and made the payment in June 2012. The Company was obligated to fund 33.33% of the cost of an initial well on the La Salle County acreage. In June 2012, the Company advanced the additional sum of $1,453,000 representing the operator's estimate of the Company's share of the drilling, evaluation and casing costs of the vertical extension of the prospective well. To July 31, 2012, the Company's share of costs incurred was $1,019,275. The balance of the funds advanced will be applied against subsequent costs incurred. Upon completion of this development phase the Company will secure its interest in all of the La Salle Acreage. The project operator, with the Company's assistance, intends to evaluate various prospective productive formations which were intercepted before establishing a completion schedule.

(Expressed in Canadian Dollars)

6. PROPERTY AND EQUIPMENT

Costs	**Corporate Assets**	**Producing Assets**	**Total**
Balance – January 31, 2012 and 2011	$ -	$ -	$ -
Additions	42,483	16,812	59,295
Transfer from exploration and evaluation	-	1,421,629	1,421,629
Change in value of decommissioning obligation	-	5,243	5,243
Balance – July 31, 2012	**$ 42,483**	**$ 1,443,684**	**$ 1,486,167**

Accumulated depreciation and depletion	**Corporate Assets**	**Producing Assets**	**Total**
Balance – January 31, 2012 and 2011	$ -	$ -	$ -
Accretion	-	285	285
Depletion	3,602	14,537	18,139
Balance – July 31, 2012	**$ 3,602**	**$ 14,822**	**$ 18,424**

Net book value	**Corporate Assets**	**Producing Assets**	**Total**
Balance – January 31, 2012 and 2011	$ -	$ -	$ -
Balance – July 31, 2012	**$ 38,881**	**$ 1,428,862**	**$ 1,467,743**

7. DECOMMISSIONING OBLIGATIONS

The Company recognizes the fair value of a provision for a decommissioning obligation in the year in which it is incurred when a reasonable estimate of fair value can be made. Although the timing and the amount of the actual expenditures are uncertain, the Company has estimated the present value of the future reclamation obligation arising from its activities to July 31, 2012 to be $5,243 (January 31, 2012 - $nil). The present value of the future reclamation obligation assumes an inflation rate of 2.58% and a discount rate of 2.73%, an undiscounted amount to settle the obligation of $18,904 and the commencement of reclamation activities after the life of the wells, which is estimated at 20 years.

	July 31, 2012	**January 31, 2012**
Balance, beginning of the period	$ -	$ -
Addition to decommissioning obligations	4,958	-
Accretion expense	285	-
Balance, end of the period	$ 5,243	$ -

8. CAPITAL STOCK

On July 31, 2012, the Company had unlimited authorized common shares, without par value and 63,069,321 (January 31, 2012 -52,919,321) shares outstanding.

Share issues

During the six months ended July 31, 2012, the Company issued common shares as follows:

a) In May, 2012, the Company closed a private placement of 10,000,000 common shares at a purchase price of $1.00 per share for gross proceeds of $10,000,000. Share issue costs of $48,670 were paid in relation to the private placement.

b) In July, 2012, the Company issued 150,000 common shares on the exercise of stock options at a purchase price of $0.12 per share for gross proceeds of $18,000.

During the year ended January 31, 2012, the Company issued common shares as follows:

a) In June, 2011, the Company closed 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 entitled the holder to acquire one additional common share for a period of five years at an exercise price of $0.18.

   The Company allocated $544,200 of the subscription proceeds to capital stock and $355,800 to reserves based on their relative fair values as of the placement announcement date. 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 2.19%, expected life of 5 years and a dividend yield of 0%. The Company paid $56,264 of share issue costs in relation to the private placement.

b) In December, 2011, the Company closed a private placement of 9,000,000 common shares at a purchase price of $0.25 per share for gross proceeds of $2,250,000.

Escrow shares and warrants

Of the common shares issued, 14,912,461 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 3,827,115 common shares will be released from escrow on December 23, 2012 and the same amount will be released every six months thereafter, until such time all such shares are released from escrow

Of the common shares underlying the outstanding warrants, 3,450,000 are subject to an escrow agreement and cannot be transferred without the consent of the Exchange. The escrow agreement provides that a total of 862,500 warrants will be released from escrow on December 23, 2012 and every six months thereafter, until such time all such shares are released from escrow.

Included in the issued common shares and warrants are 3,000,000 common shares and warrants to purchase 1,800,000 common shares that are subject to voluntary pooling agreement. The agreement provides that the 750,000 common shares and warrants to purchase 450,000 common shares will be released from trading restrictions on December 23, 2012 and every six months thereafter, until such time all such shares are free of trading restrictions.

(Expressed in Canadian Dollars)

8. CAPITAL STOCK (Continued)

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 Exchange 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 common 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 may 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.

Share-based payments

The Company uses a fair value method of accounting for all share-based payments arising from the grant of stock options. Under this method, the Company recorded a share-based payments expense of $145,670 (2011 - $173,699) for the six ended July 31, 2012, with a corresponding credit to reserves. The fair value of the stock options granted during the six months ended July 31, 2012 is estimated as at the date of the grant using the Black-Scholes pricing model assuming he following weighted average assumptions:

	2012	**2011**
Risk-free interest rate	1.16%	-
Expected life	-	-
Annualized volatility	107.49%	-
Pre-vest forfeiture rate	2.00%	-
Dividend rate	0%	-

During the six months ended July 31, 2012, the company granted 150,000 (2011 – nil) options with a fair value of $150,164, which is being expensed over the vesting periods of the options.

(Expressed in Canadian Dollars)

8. CAPITAL STOCK (Continued)

Outstanding stock options and warrants

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

	Number of Stock Options	Weighted Average Exercise Price
Balance - January 31, 2011	-	$ -
Granted	3,050,000	0.20
Exercised	(150,000)	0.12
Balance - January 31, 2012	2,900,000	$ 0.20
Granted	150,000	1.35
Exercised	(150,000)	0.12
Balance - July 31, 2012	2,900,000	$0.27

The weighted average trading price at the date the options were exercised during the period ended July 31, 2012 was $0.75 (year ended January 31, 2012 - $1.32).

The following stock options were outstanding as at July 31, 2012:

Number of options	Number of options exercisable	Exercise price	Expiry Date
1,650,000	1,650,000	$ 0.12	June 22, 2016
250,000	100,000	$ 0.19	July 15, 2016
250,000	62,500	$ 0.21	September 16, 2016
250,000	62,500	$ 0.19	October 18, 2016
100,000	40,000	$ 0.53	November 25, 2016
250,000	62,500	$ 0.67	December 16, 2016
150,000	15,000	$ 1.35	July 8, 2017
2,900,000	1,992,500		

As at July 31, 2012, the value of non-vested share based payments not yet recognized was $317,658, which will be recognized over the next 36 months.

(Expressed in Canadian Dollars)

8. CAPITAL STOCK (Continued)

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
Exercised	(2,887,500)	$ 0.18	
Balance - January 31, 2012 and July 31, 2012	7,112,500	$ 0.18	

The weighted average trading price at the date the warrants were exercised during the period ended July 31, 2012 was $nil (year ended January 31, 2012 - $0.74).

9. FINANCIAL INSTRUMENTS

The Company has classified its financial instruments as follows:

- Cash and restricted cash - as FVTPL;
- Accounts receivable – as loans and receivables; 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, accounts receivable, and accounts payable and accrued liabilities approximate their fair values due to 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 accounts receivable. 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. Accounts receivable is comprised from the sale of oil and gas.

9. FINANCIAL INSTRUMENTS (Continued)

Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to 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

To the extent that payments made or received on the Company's monetary assets and liabilities are affected by changes in prevailing market interest rates, the Company is exposed to interest rate cash flow risk.

To the extent that changes in prevailing market interest rates differ from the interest rates in the Company's monetary assets and liabilities, the Company is exposed to interest rate price risk.

The Company's exposure to interest rate risk is minimal.

(ii) Foreign currency risk

The Company's principal asset is located in the United States. As at the date of this report, the majority of the Company's cash was held in Canadian dollars and was therefore subject to fluctuation against the United States dollar. Based on the balances as at July 31, 2012, if the US dollar had weakened (strengthened) against the Canadian dollar, with all other variables held constant, by 1%, the change to net loss would be approximately $2,500. There would be no effect on other comprehensive loss. The Company does not use derivatives or similar instruments to manage currency risk.

(iii) Other price risk

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to 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.

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, 2012, the Company had cash of $5,161,212, accounts receivable from the sale of oil and gas of $135,414 and accounts payable and accrued liabilities of $275,415 due within three months of the period-end.

10. CAPITAL DISCLOSURES

The Company considers its capital under management to be shareholders' equity. The Company's capital management objectives are to ensure the Company continues as a going concern, as well as to maintain optimal returns to shareholders and benefits for other stakeholders. The Board of Directors does not establish quantitative criteria for management, but rather relies on management expertise to sustain future development. Management will adjust the capital structure as necessary to achieve the objectives.

The Company's capital management strategy has not changed from January 31, 2012. At July 31, 2012, the Company is not subject to any externally imposed capital requirements.

11. RELATED PARTY TRANSACTIONS

During the period ended July 31, 2012, the Company:

(i) Paid or accrued $76,532 (2011 - $nil) for consulting services officer of the Company of which $7,007 was capitalized, $1,345 (2011 - $nil) was for project investigations, $nil (2011 - $2,931) was for business investigations to an officer and director of the Company;

(ii) Paid or accrued $6,306 (2011 - $nil) for administrative services to a firm where an officer of the Company is a principal;

(iii) Paid or accrued $9,000 (2011 - $nil) for accounting services to a firm where an officer of the Company is a partner;

(iv) Paid or accrued $56,814 (2011 - $nil) for legal services and $10,470 (2011 - $nil) in share issue costs to a law firm of which the former corporate secretary of the Company is a principle; and

(v) Paid or accrued $nil (2011 - $3,000) for accounting services to a former officer of the Company.

Total compensation paid to key management personnel was $160,532 (2011 - $5,932).

12. SUPPLEMENTAL CASH FLOW INFORMATION

During the six months ended July 31, 2012, the Company

(a) transferred $1,421,629 from Exploration and Evaluation assets to Property and Equipment;

(b) transferred $13,500 from equity reserves to share capital on the exercise of the stock options.