

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(Unaudited and Expressed in United States Dollars)

FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015

TERRACE ENERGY CORP.

NOTICE OF NO AUDITOR REVIEW OF CONDENSED CONSOLIDATED 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 condensed consolidated 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 condensed consolidated interim 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

June 29, 2016

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

	April 30, 2016	January 31, 2016
ASSETS		
Current assets		
Cash	\$ 1,798,814	\$ 2,301,811
Restricted cash (Note 8)	-	4,038,780
Accounts receivable	36,390	290,684
Prepays	53,654	60,776
Assets held for sale (Note 4)	26,741,217	-
Total current assets	\$28,630,075	6,692,051
Non-current assets		
Operator's bond	25,000	25,000
Investment in partnership (Note 5)	7,453,487	7,471,522
Exploration and evaluation assets (Note 6)	1,496,941	3,695,298
Property and equipment (Note 7)	87,990	23,257,556
Total assets	\$ 37,693,493	\$ 41,141,427
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current liabilities		
Accounts payable and accrued liabilities (Notes , 9 and 16)	\$ 1,798,263	\$ 1,625,736
Liabilities associated with assets held for sale (Note 4)	1,317,163	-
Credit facility (Note 8)	24,292,220	25,443,375
Total current liabilities	27,407,646	27,069,111
Non-current liabilities		
Convertible notes (Notes 9 and 16)	29,062,480	25,875,415
Decommissioning obligations (Note 10)	-	491,503
Total liabilities	56,470,126	53,436,029
Shareholders' deficit		
Capital stock (Note 11)	47,416,203	47,416,203
Convertible notes – equity component (Note 9)	2,814,173	2,814,173
Stock options reserve (Note 11)	1,034,242	1,034,242
Warrants reserve (Note 11)	6,099	6,099
Translation reserve (Note 2)	(5,855,823)	(684,574)
Deficit	(64,191,527)	(62,880,745)
Total shareholders' deficit	(18,776,633)	(12,294,602)
Total liabilities and shareholders' deficit	\$ 37,693,493	\$ 41,141,427

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 United States Dollars)
 For the three months ended April 30

	2016	2015
Equity loss in partnership (Note 5)	\$ (38,035)	\$ (66,015)
EXPENSES		
Administrative	100,552	224,939
Depreciation	14,868	17,642
Financing (Note 12)	787,690	712,495
Foreign exchange gain	(2,197,944)	1,460,659
Impairment of exploration and evaluation assets	-	375,516
Provision for contract litigation (Note 15)	500,000	-
Investor relations	6,207	178,179
Professional	83,564	113,317
Salaries and benefits (Note 16)	107,473	200,065
Share-based payments (Notes 11 and 16)	-	3,072
Transfer agent and filing fees	31,588	25,999
Travel	900	6,184
	<u>(565,102)</u>	<u>3,318,067</u>
Net income (loss) from continuing operations	527,067	(3,384,082)
Net loss from discontinued operations (Note 4)	(1,837,849)	(1,576,407)
Net loss for the period	(1,310,782)	(4,960,489)
Other comprehensive loss		
Items that may be reclassified subsequently to profit or loss:		
Translation adjustment	(5,171,250)	(261,027)
Comprehensive loss for the period	<u>\$ (6,482,033)</u>	<u>\$ (5,221,516)</u>
Basic and diluted loss per share	\$ (0.01)	\$ (0.06)
Weighted average number of common shares outstanding	<u>87,844,821</u>	<u>87,844,821</u>

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

TERRACE ENERGY CORP.**CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (DEFICIT)**

UNAUDITED – PREPARED BY MANAGEMENT

(Expressed in United States Dollars)

	Capital Stock		Convertible Notes – Equity Component	Stock Options Reserve	Warrants Reserve	Translation Reserve	Deficit	Total Shareholders' Equity
	Shares	Amount						
Balance – January 31, 2015	87,844,821	47,416,203	2,814,173	1,061,669	6,099	(304,795)	(36,956,082)	14,037,267
Effect of change in functional currency (Note 2)	-	-	-	-	-	(1,723,524)	1,280,561	(442,963)
Share-based payments	-	-	-	3,072	-	-	-	3,072
Cumulative translation adjustment	-	-	-	-	-	4,725,259	-	4,725,259
Net loss for the period	-	-	-	-	-	-	(4,960,489)	(4,960,489)
Balance – April 30, 2015	87,844,821	\$ 47,416,203	\$ 2,814,173	\$ 1,064,741	\$ 6,099	\$ 2,696,940	\$(40,636,010)	\$ 13,362,146
Balance – January 31, 2016	87,844,821	\$ 47,416,203	\$ 2,814,173	\$ 1,034,242	\$ 6,099	\$(684,574)	\$(62,880,745)	\$(12,294,602)
Cumulative translation adjustment	-	-	-	-	-	(5,171,249)	-	(5,171,249)
Net loss for the period	-	-	-	-	-	-	(1,310,782)	(1,310,782)
Balance – April 30, 2016	87,844,821	\$ 47,416,203	\$ 2,814,173	\$ 1,034,242	\$ 6,099	\$(5,855,823)	\$(64,191,527)	\$(18,776,633)

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
 For the three months ended April 30
 (Expressed in United States Dollars)

	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss) from continuing operations	\$ 527,067	\$ (3,384,082)
Items not involving cash:		
Accretion of convertible notes	180,501	168,406
Accretion of decommissioning obligations	-	-
Depreciation and depletion	14,868	17,642
Equity loss in partnership	(38,035)	66,015
Share-based payments	-	3,072
Unrealized gain on foreign exchange	(2,246,399)	1,489,376
Impairment of exploration and evaluation assets	-	375,516
Changes in non-cash working capital items:		
Accounts receivable	33,991	(304,084)
Prepays	(3,519)	12,183
Accounts payable and accrued liabilities	1,377,409	(2,543,636)
Operating cash flows from continuing operations	(154,117)	(4,099,592)
Operating cash flows from discontinued operations (Note 4)	(1,276,618)	630,576
Net cash used in operating activities	(1,430,735)	(3,469,016)
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash associated with assets held for sale (Note 4)	(908,374)	-
Exploration and evaluation expenditures	(9,575)	-
Investment in partnership	-	(1,500,000)
Investing cash flows from continuing operations	(917,949)	(1,500,000)
Investing cash flows from discontinued operations (Note 4)	(483,273)	(6,119,107)
Net cash used in investing activities	(1,401,222)	(7,619,107)
CASH FLOWS FROM FINANCING ACTIVITIES		
Principal repayment of Credit Facility	(1,709,820)	-
Net cash used in financing activities	(1,709,820)	-
Foreign exchange effect on cash	-	12,537
Change in cash for the period	(4,541,777)	(11,075,586)
Cash, beginning of the period	6,340,591	26,494,024
Cash, end of the period	\$ 1,798,814	\$ 15,418,438

Supplemental cash flow information (Note 18)

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

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

1. NATURE OF OPERATIONS AND GOING CONCERN

Terrace Energy Corp. (the “Company” or “Terrace”) was incorporated on July 6, 2006 under the *Business Corporations Act* (British Columbia) and previously named Terrace Resources Inc. The Company is in the business of acquiring, exploring for and developing conventional onshore oil and gas properties in the United States.

The Company’s head office is located at Suite 270 – 666 Burrard Street, Vancouver, British Columbia, Canada V6C 2X8. The registered and records office is located at Suite 1000 – 595 Howe Street, Vancouver, British Columbia, Canada V6C 2T5.

The Company is classified as 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”.

For the quarter ended April 30, 2016, the Company reported a net loss of \$1.3 million and a comprehensive loss of \$6.5 million. For the year ended January 31, 2016, the Company reported a net loss of \$27.2 million and a comprehensive loss of \$27.6 million. As of April 30, 2016, the Company had working capital of \$1.2 million. The working capital is impacted by the classification of the assets of our Terrace STS, LLC entity to assets held for sale and to the classification of the \$24.3 million of debt related to the Company’s secured credit facility as a current liability due to non-compliance with certain covenants under the agreement as of January 31, 2016 and the resulting default asserted by the lender during February 2016. In May 2016 the lender exchanged the debt for equity in the subsidiary that held the debt obligation (see Note 8). As of April 30, 2016, working capital excluding the assets held for sale and associated liabilities and the debt related to the credit facility was \$90,595. However, this includes \$1,192,450 of accrued interest related to the Company’s convertible notes which was forgiven in May 2016 pursuant to a restructuring of those notes (see Note 9). Additionally, the Company had negative cash flow from operating activities for the quarter ended April 30, 2016 and the prior fiscal year. Terrace has limited history of production or profitability and its financial resources will not be sufficient to fund its debt obligations and ongoing activities beyond the near term (see Commitments described in Note 15). These conditions indicate the existence of material uncertainties that may cast significant doubt about the Company’s ability to continue as a going concern. The Company will need to sell assets and/or raise additional capital or seek other strategic alternatives to alternatives to meet its debt obligations and to carry out its future oil and gas acquisition, exploration and development activities. There are no guarantees that the Company will be able to sell assets or raise such additional capital when needed.

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. Management believes that the going concern assumption is appropriate for these condensed consolidated interim financial statements since management continues to seek and evaluate strategic alternatives and financial options to enable the Company to meet its debt obligations and to carry out its future oil and gas acquisition, exploration and development activities. 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.

2. BASIS OF PRESENTATION

Statement of compliance

These unaudited condensed consolidated interim financial statements, including comparatives, have been prepared using accounting policies consistent with International Financial Reporting Standards (“IFRS”), as issued by the International Accounting Standards Board (“IASB”) and in accordance with International Accounting Standards (“IAS”) 34, Interim Financial Reporting. The accounting policies used in the preparation of these condensed consolidated interim financial statements are the same as those applied in the Company’s most recent consolidated annual financial statements for the year ended January 31, 2016. These condensed consolidated interim financial statements should be read in conjunction with the Company’s consolidated annual financial statements for the year ended January 31, 2016. The policies applied in these condensed consolidated interim financial statements are based on IFRS issued and outstanding as of April 30, 2016.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

2. BASIS OF PRESENTATION (Continued)

Statement of compliance (Continued)

The Board of Directors approved the unaudited condensed consolidated interim financial statements on June 28, 2016.

Basis of measurement

These condensed consolidated interim financial statements have been prepared on a historical cost basis, except for certain financial instruments, which are measured at fair value. In addition, these condensed consolidated interim financial statements have been prepared using the accrual basis of accounting, except for cash flow information.

Functional and presentation currency

The functional currency of the Company is the Canadian dollar (“CAD”), as it is presently reliant upon the Canadian capital markets to fund its activities. The functional currencies of the Company’s foreign subsidiaries are the CAD and the United States dollar (“USD”). The Company changed the functional currency of certain subsidiaries from CAD to USD with effect from February 1, 2015. The change in functional currency arose due to changing sources of recent and expected future sources of financing. The change in functional currency was applied prospectively. The assets, liabilities and equity of the subsidiaries were translated from CAD to USD at the exchange rate on the date of change in functional currency. The resulting exchange differences were recognized in other comprehensive loss. These condensed consolidated interim financial statements are presented in USD, as substantially all of the Company’s assets and operations are situated in the USA. Assets and liabilities are translated into the presentation currency using the exchange rate in effect on the consolidated statement of financial position date, shareholders’ equity accounts are translated into the presentation currency using the historical exchange rate, and revenues and expenses are translated at the average rate for the period, which approximates the exchange rate in effect on the transaction date. Exchange gains and losses on translation are included as a separate component in shareholders’ equity as “translation reserve”.

3. SIGNIFICANT ACCOUNTING POLICIES

Use of judgments and estimates

The preparation of condensed consolidated interim financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and reported amounts of assets and liabilities, revenues and expenses. Actual results may differ from these estimates.

Following are the accounting policies subject to such judgments and the key sources of estimation uncertainty that the Company believes could have the most significant impact on the reported results and financial position.

Reserves

The estimate of oil and natural gas reserves is integral to the calculation of the amount of depletion charged to the consolidated statements of operations and comprehensive loss and is also a key determinant in assessing whether the carrying value of any of the Company’s development and production assets have been impaired. Changes in reported reserves can impact asset carrying values and the decommissioning provision due to changes in expected future cash flows. The Company’s reserves are evaluated and reported on by independent reserve engineers at least annually in accordance with Canadian Securities Administrators’ National Instrument 51-101 *Standards of Disclosure of Oil and Gas Activities* (“NI 51-101”). Reserve estimation is based on a variety of factors including engineering data, geological and geophysical data, projected future rates of production, commodity pricing and timing of future expenditures, all of which are subject to significant judgment and interpretation.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of judgments and estimates (Continued)

Identification of cash-generating units ("CGUs")

The Company's assets are aggregated into CGUs for the purpose of calculating impairment. A CGU is defined as the lowest grouping of assets that generate identifiable cash inflows that are largely independent of cash inflows of other assets or groups of assets. The allocation of assets into CGUs requires significant judgment and interpretation with respect to the way in which management monitors operations.

Recoverability of asset carrying values

At each reporting date, the Company assesses its petroleum and natural gas properties and exploration and evaluation assets for possible impairment, to determine if there is any indication that the carrying amounts of the assets may not be recoverable. An assessment is also made at each reporting date to determine whether there is an indication that previously recognized impairment losses no longer exist or have decreased. Determination as to whether and how much an asset is impaired, or no longer impaired, involves management estimates on highly uncertain matters, such as future commodity prices, discount rates, production profiles, operating costs, future capital costs and reserves.

A material adjustment to the carrying value of the Company's property and equipment and exploration and evaluation assets could arise as a result of changes to these estimates and assumptions.

Classification of exploration and evaluation assets

The application of the Company's accounting policy for exploration and evaluation assets requires management to make certain judgments as to future events and circumstances and as to whether economic quantities of reserves will be found so as to assess if technical feasibility and commercial viability have been achieved.

Assets held for sale

Judgment is required in determining whether an asset meets the criteria for classification as "assets held for sale" in the consolidated statements of financial position. Criteria considered by management include the existence of and commitment to a plan to dispose of the assets, the expected selling price of the assets, the expected timeframe of the completion of the anticipated sale and the period of time any amounts have been classified within assets held for sale. The Company reviews the criteria for assets held for sale each quarter and reclassifies such assets to or from this financial position category as appropriate. In addition, there is a requirement to periodically evaluate and record assets held for sale at the lower of their carrying value and fair value less costs to sell.

Joint arrangements

Judgment is required to determine when the Company has joint control over an arrangement, which requires an assessment of the relevant activities and when the decisions in relation to those activities require unanimous consent. Judgment is also required to classify a joint arrangement. Classifying the arrangement requires the Company to assess their rights and obligations arising from the arrangement including whether the arrangement is structured through a separate vehicle, in which case, judgment is also required to assess the rights and obligations arising from the legal form of the separate vehicle, terms of the contractual arrangement and other relevant facts and circumstances. This assessment often requires significant judgment, and a different conclusion on joint control and whether the arrangement is a joint operation or a joint venture, may materially impact the accounting. Management has assessed the investment in partnership as a joint venture.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of judgments and estimates (Continued)

Functional currency

The determination of the functional currency for the Company and each of its subsidiaries was based on management's judgment of the underlying transactions, events and conditions relevant to each entity.

Going concern

The assessment of the Company's ability to continue as a going concern and to raise sufficient funds to pay its ongoing operating expenditures, meet its liabilities for the ensuing year, and to fund planned and contractual exploration programs, involves significant judgment based on historical experience and other factors, including expectation of future events that are believed to be reasonable under the circumstances.

Principles of consolidation

The condensed consolidated interim financial statements include the financial statements of the Company and its controlled subsidiaries. All intercompany transactions, balances, revenues and expenses are eliminated in full on consolidation.

Name of subsidiary	Place of Incorporation	Percentage ownership
Terrace US Holdings Inc.	USA	100%
Terrace Operating LLC	USA	100%
Terrace Cutlass LLC	USA	100%
Terrace STS, LLC ("Terrace STS")	USA	100%
TEC Operating, LLC	USA	100%
Terrace BWP, LLC	USA	100%
Terrace Investment Holdings, Inc.	USA	100%
TEC Olmos, LLC	USA	100%

4. ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

During the quarter ended April 30, 2016, the Company entered into a letter of intent with its secured lender to exchange whereby the lender to the Terrace STS, LLC entity converted its secured debt at the date of the transaction into 95% of the membership units of Terrace STS (see Note 8 and Note 19(a)). The Company continues to own the remaining 5% and will operate Terrace STS pursuant to a management contract as well as certain incentives whereby the Company may earn an additional interest in Terrace STS cash flows after certain financial milestones are achieved. As such, the assets and associated liabilities have been reclassified to assets held for sale as of the date of the financial statements.

Assets reclassified to assets held for sale as of April 30, 2016 from:

Cash	\$ 908,374
Accounts receivable	220,303
Prepays	10,641
Exploration and evaluation assets (Note 6)	2,437,262
Property and equipment (Note 7)	32,294,162
Accumulated depreciation and depletion	(9,129,525)
Balance as of April 30, 2016	\$ 26,741,217

Cash maintained by the Terrace STS, LLC entity will no longer be included in the consolidated assets of the Company following the exchange of Debt for equity with the secured lender. Accordingly, the cash has been

TERRACE ENERGY CORP.**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015

(Expressed in United States Dollars)

4. ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS (Continued)

reclassified to assets held for sale. Liabilities totaling \$1,317,163 consisting of accounts payable and accrued liabilities of \$804,685 and decommissioning obligations of \$512,478 were reclassified from accounts payable and accrued liabilities to liabilities associated with assets held for sale. The credit facility liability associated with the assets held for sale has not been reclassified to liabilities associated with assets held for sale as it was exchanged for equity in the subsidiary and deemed to be consideration pursuant to the exchange transaction.

As the cash flows related to the operations of Terrace STS, LLC as well as Terrace Cutlass LLC, which was disposed of during December 2015, are clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity, the financial performance of the two projects within these entities for the comparative period have been presented separately as discontinued operations in the consolidated statements of loss and comprehensive loss and statement of cash flows.

The reported net loss from the discontinued operations is comprised of the following:

	2016	2015
Revenue		
Oil and gas sales	\$ 299,689	\$ 1,936,312
Direct operating expenses		
Production and operating	565,984	450,458
Depreciation and depletion (Note 7)	-	1,730,689
	<u>(266,295)</u>	<u>(244,835)</u>
Other expenses		
Financing	1,459,205	1,031,474
Salaries and benefits (Note 16)	112,349	300,098
	<u>1,571,554</u>	<u>1,331,572</u>
Net loss from discontinued operations, net of tax	<u>\$ (1,837,849)</u>	<u>\$ (1,576,407)</u>

The reported cash flows from the discontinued operations are as follows:

	2016	2015
Net loss from discontinued operations, net of tax	\$ (1,837,849)	\$ (1,576,407)
Depreciation and depletion (Note 7)	-	1,730,689
Accretion of decommissioning obligations	2,566	-
Non-cash interest expense	558,665	476,294
Operating cash flows from discontinued operations	<u>(1,276,618)</u>	<u>630,576</u>
Exploration and evaluation expenditures	(483,273)	(5,426,160)
Advances for future exploration	-	(692,947)
Acquisition of property and equipment	-	-
Investing cash flows from discontinued operations	<u>\$ (483,273)</u>	<u>\$ (6,119,107)</u>

TERRACE ENERGY CORP.

NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015

(Expressed in United States Dollars)

5. INVESTMENT IN PARTNERSHIP

The Company and its partner, BlackBrush Oil & Gas, LP ("BlackBrush") organized a special purpose limited partnership, the BlackBrush Terrace LP (the "BTLP"), to acquire a 50% operated working interest (the "WI") in certain oil and gas leases covering approximately 147,000 gross mineral acres in Maverick County, Texas, USA (the "Maverick County Project") from SWEPI LP ("Shell Oil"). The acreage to be acquired includes potential reserves in the Eagle Ford Shale, Buda Limestone and several other intervals of Cretaceous age formations including the newly emerging Pearsall Shale Trend, which have been proven productive on a regional basis. The agreement allows BTLP to secure the WI through a combination of cash payments, which have been made, and drilling obligations. The material terms of the Farmout Agreement between the BTLP and Shell Oil are as follows:

1. the BTLP has made an up-front cash payment of \$13 million;
2. the BTLP has the option, but not the obligation, to earn the assignment of the WI in all of the leases by spending an aggregate \$104 million (\$52 million net to Terrace), including \$52 million (\$26 million net to Terrace) representing Shell Oil's share of costs (the "Carry Payment") on certain qualified expenditures as development of the property progresses over time;
3. upon completion of each well drilled under this agreement, the BTLP may request an assignment of 50% of Shell Oil's interest in such well;
4. upon making the carry payment in full, the BTLP may request an assignment of 50% of Shell Oil's interest in all of the subject leases and shall have the option, but not the obligation, to participate in a 50% working interest in each subsequent well by paying its proportionate share of all development costs for such well unless Shell Oil elects to convert its working interest in a producing formation into a net profits interest; and
5. Shell Oil has the right, but not the obligation, to assume operatorship of any formation in which production has been established at any time within two years after the later of (i) the carry payment being made in full and subsequent assignment of 50% of Shell Oil's interest in the subject leases or (ii) establishment of commercial production from a given formation.

In addition to the previously funded \$13 million up-front payment, as of April 30, 2016, the BTLP has spent approximately \$40 million towards its drilling obligation to Shell Oil. During the year ended January 31, 2016, the BTLP was also successful in renegotiating the schedule under which its long-term obligations under its Farmout Agreement are required. Under the Fourth Amendment to the Farmout Agreement, executed during the fourth quarter of 2015, the BTLP has deferred all further material capital expenditure obligations until calendar year 2017, at which point, the BTLP will be obligated to resume expenditures of \$25 million in 2017 and the remaining balance of the carry payment and drilling obligation (approximately \$38 million) in 2018. The BTLP also retains the option to pay approximately \$2 million in liquidated damages at the end of 2017 if it chooses not to further defer drilling operations at that point. If the carry payment is not satisfied in full by the end of 2018, then the BTLP will be required to pay \$4 million in liquidated damages and the Farmout Agreement will be terminated.

During the year ended January 31, 2016, the BTLP drilled a new Eagle Ford Shale well, the Chittim #10H, which was successfully completed during July 2015. The BTLP also performed a minimal completion on one of the previously drilled Buda Limestone wells, the Chittim #4H. Prior to these activities, the Company sought and came to an agreement with its partner wherein to preserve capital, the Company would not contribute its share of costs to drill and complete these additional wells. As a result, the Company's 50% ownership interest in the BTLP was reduced from 50% to approximately 44%. In accordance with the provisions of the BTLP agreement, the Company is not entitled to any revenue and expense allocations or distribution of revenue proceeds from the Chittim #10H well.

TERRACE ENERGY CORP.**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015

(Expressed in United States Dollars)

5. INVESTMENT IN PARTNERSHIP (Continued)

The carrying value of \$7,453,487 at April 30, 2016 (January 31, 2016 - \$7,471,522), which includes \$24,436,840 (January 31, 2016 - \$24,416,840) in advances, which are capital contributions and represents the Company's share of costs to organize, acquire and fund certain agreed-upon exploration and evaluation activities to date plus the Company's share of the cumulative net loss of the BTLP of \$16,983,353 (January 31, 2016 - \$16,945,318). Revenues and expenses attributable to the sole risk operations conducted by Blackbrush totaling loss of \$72,934 for the quarter ended April 30, 2016 (2015 - \$ nil) are excluded from income and allocated to the partner before allocations of income to the partners in accordance with their original 50%/50% ownership percentages. The Company's share of the BTLP loss recognized during the quarter ended April 30, 2016 was \$38,035 (2015 - \$66,015).

Summary of financial information of the BTLP

<i>As at April 30,</i>	2016	2015
Assets		
Cash	\$ 181,980	\$ 485,853
Other current assets	89,475	67,492
Property and equipment	17,019,589	38,880,145
	\$ 1,791,044	\$ 39,433,490
Liabilities		
Current liabilities	\$ 1,074,625	\$ 2,593,153
Decommissioning obligations	328,855	538,327
Deferred income tax liability	-	188,276
	\$ 1,403,480	\$ 3,319,756
For the quarter ended April 30,		
Revenue	\$ 104,272	\$ 38,667
Direct operating costs		
Production and operating	81,279	73,029
Depreciation and depletion	128,304	38,211
	(105,311)	(72,573)
Operating loss	(105,311)	(72,573)
Other expenses	(43,695)	59,457
	\$ (149,006)	\$ (132,030)
Net loss and comprehensive loss for the period	\$ (149,006)	\$ (132,030)

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

6. EXPLORATION AND EVALUATION ASSETS

	Big Wells	STS Olmos	STS South Expansion	Total
Balance - January 31, 2015	\$ 1,361,439	\$ 2,606,544	\$ -	\$ 3,967,983
Acquisition costs	-	-	1,427,228	1,427,228
Exploration and evaluation	594,185	8,519,256	-	9,113,441
Transfer to property and equipment	-	(8,771,614)	-	(8,771,614)
Expenditures during the year	594,185	(252,358)	1,427,228	1,769,055
Impairment charge	(3,040,953)	-	-	(3,040,953)
Effect of changes in foreign exchange rates	1,085,329	-	(86,116)	999,213
	(1,955,624)	-	(86,116)	(2,041,740)
Balance - January 31, 2016	-	2,354,186	1,341,112	3,695,298
Acquisition costs	-	-	9,575	9,575
Exploration and evaluation	-	83,076	-	83,076
Expenditures during the period	-	83,076	9,575	92,651
Transfer to assets held for sale	-	(2,437,262)	-	(2,437,262)
Effect of changes in foreign exchange rates	-	-	146,254	146,254
	-	-	-	-
Balance - April 30, 2016	\$ -	\$ -	\$ 1,496,941	\$ 1,496,941

Exploration and evaluation assets consist of the Company's exploration activities, which are pending the determination of economic quantities of commercially producible proven reserves. A review of each exploration project by area is carried out at each reporting date to ascertain whether economical quantities of proven reserves have been discovered and whether such costs should be transferred to depletable property and equipment components. During the quarter ended April 30, 2016, \$Nil (2015 - \$2,762,179) was reclassified to property and equipment.

During the year ended January 31, 2016, indicators of impairment existed leading to a test of recoverable amount for the Big Wells project. The Company recorded additional impairment on its Big Wells project in the amount of \$594,185 related to costs incurred on the Price well, which did not result in any proved or probable reserves being assigned to the well after it was completed. Additionally, during the prior year, the Company determined it was not prudent to use its resources to drill additional wells on its Big Wells project. Accordingly, the Company forfeited its rights under the Farmout Agreement and the Company recorded impairment expense of \$2,446,768 related to the seismic data it had acquired over the acreage. A value in use calculation is not applicable for this project as the Company does not have any expected cash flows from using the property at this stage of operations. In estimating the fair value less costs of disposal, management did not have observable or unobservable inputs to estimate the recoverable amount greater than \$nil. As this valuation technique requires management's judgment and estimates of the recoverable amount, it is classified within Level 3 of the fair value hierarchy.

During October 2015, pursuant to an Area of Mutual Interest Agreement with a partner, the Company, through a wholly owned subsidiary, paid \$1.4 million to acquire a 50% non-operated working interest in approximately 8,000 gross acres (4,000 net acres) immediately south of the Company's Original STS Olmos Leases, depth limited to the Olmos Sandstone and shallower formations "STS South Expansion". This acreage is under a three year primary term lease, after which the acreage may continue to be held by a continuous drilling commitment of three completions per year thereafter.

TERRACE ENERGY CORP.**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015

(Expressed in United States Dollars)

7. PROPERTY AND EQUIPMENT

Cost	Other Equipment	Leaseholds	Oil and Gas	Total
Balance – January 31, 2015	\$ 151,750	\$ 129,106	\$ 23,452,411	\$ 23,733,267
Additions				
Transfer from exploration and evaluation	-	-	8,771,614	8,771,614
Change in value of decommissioning obligations	-	-	70,137	70,137
Expenditures during the year	-	-	8,841,751	8,841,751
Effect of changes in foreign exchange rates	(14,028)	(11,934)	-	(25,962)
Balance – January 31, 2016	137,722	117,172	32,294,162	32,549,056
Effect of changes in foreign exchange rates	16,002	13,615	-	29,617
Reclassified to assets held for sale (Note 4)	-	-	(32,294,162)	(32,294,162)
Balance – April 30, 2016	\$ 153,724	\$ 130,787	\$ -	\$ 284,511
Accumulated depreciation and depletion				
Balance – January 31, 2015	\$ 73,085	\$ 33,842	\$ 4,352,946	\$ 4,459,873
Charge for year	41,578	21,301	4,776,579	4,839,458
Effect of changes in foreign exchange rates	(3,657)	(4,174)	-	(7,831)
Balance – January 31, 2016	111,006	50,969	9,129,525	9,291,500
Charge for period	14,777	5,200	-	19,977
Reclassified to assets held for sale (Note 4)	-	-	(9,129,525)	(9,129,525)
Effect of changes in foreign exchange rates	10,777	3,792	-	14,569
Balance – April 30, 2016	\$ 136,560	\$ 59,961	\$ -	\$ 196,521
Net book value				
Balance – January 31, 2015	\$ 26,716	\$ 66,203	\$ 23,164,637	\$ 23,257,556
Balance – April 30, 2016	\$ 17,164	\$ 70,826	\$ -	\$ 87,990

8. CREDIT FACILITY

On June 6, 2014, Terrace STS, a wholly owned subsidiary of the Company, entered into a senior unsecured term credit facility (the "Credit Facility"), which is non-recourse to the Company, to fund the development of its STS Olmos Project in McMullen and LaSalle counties in south Texas. At inception, the aggregate amount of the Credit Facility was \$75 million, of which \$50 million was available to be drawn at the discretion of Terrace STS. The original term of the facility was four years with cash interest of LIBOR (with a floor of 1%) plus 7% plus accrued principal ("PIK") interest of 5% per annum. Cash interest was to be paid monthly; principal and PIK interest were to be paid upon maturity on May 31, 2018.

TERRACE ENERGY CORP.**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015

(Expressed in United States Dollars)

8. CREDIT FACILITY (Continued)

During the year ended January 31, 2015, the Terrace STS made an initial draw of \$25 million and received net proceeds of \$24 million after deducting the agreed-upon transaction cost of \$1 million. Terrace STS also incurred \$1.4 million of legal and other additional costs, which have been netted against the balance outstanding under the facility and were being amortized into interest expense over the term of the credit facility.

Balance at January 31, 2015	\$	23,451,243
Financing costs incurred		(145,302)
Amortization of financing costs		808,560
PIK interest		1,328,874
		<hr/>
Balance at January 31, 2016		25,443,375
Financing costs incurred		-
Amortization of financing costs		220,525
PIK interest		338,140
Principal repayment		(1,709,820)
		<hr/>
Balance at April 30, 2016	\$	24,292,220

The Company was restricted from utilizing funds drawn under the Credit Facility or funds generated from the operations of its STS Olmos Project for anything other than operating costs and ongoing development activities at the STS Olmos Project. At April 30, 2016, the Company had \$908,374 (January 31, 2016 - \$4,038,780) of restricted funds for its STS Olmos Project. The terms of the Credit Facility also provided for certain other covenants, including the requirement to maintain certain financial condition covenants. The financial condition covenants consisted of the quarter-end requirement to maintain an asset coverage ratio of 1.25 to 1, to maintain a current ratio of 1 to 1 and a leverage ratio that limits the amount of debt outstanding relative to earnings before income taxes, depreciation and amortization ranging from 2 to 1 up to 3.25 to 1 depending on the period.

As at January 31, 2015, the Terrace STS was not in compliance with the asset coverage ratio and the leverage ratio pursuant to the agreement. The lender provided Terrace STS a waiver of the non-compliance at January 31, 2015 and for the expected non-compliance for the quarter ended April 30, 2015. In addition, the lender agreed to adjust the asset coverage ratio to 5.5 to 1, 4.2 to 1 and 3.6 to 1 at July 31, 2015, October 31, 2015 and January 31, 2016, respectively, and to adjust the leverage ratio requirement to 0.9 to 1, 0.9 to 1 and 0.95 to 1 at July 31, 2015, October 31, 2015 and January 31, 2016, respectively. As a condition of the waivers and reset of the covenants granted by the lender, Terrace STS agreed to increase the interest rate margin from 7% to 8% beginning June 1, 2016 and pledged the assets of Terrace STS as collateral to the Credit Facility. In addition, Terrace STS agreed to reduce the amount available to be drawn under the facility to the \$25 million that is outstanding as of January 31, 2016. Terrace STS also agreed to devise a plan acceptable to the lender to enhance the overall capitalization of Terrace STS by August 31, 2015. At October 31, 2015 and at January 31, 2016, Terrace STS was not in compliance with the adjusted leverage ratio requirement. The Company and its financial advisor continued to evaluate financial options and strategic alternatives that could ultimately result in an enhanced capitalization of Terrace STS; however, the Company was unable to provide a satisfactory plan to the lender. As a result of the non-compliance of the credit agreement requirements, the lender declared a default during February 2016 and asserted default interest of 5% per annum back to the original date of non-compliance of August 31, 2015.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

8. CREDIT FACILITY (Continued)

Terrace STS was unable to cure the default with its secured lender. The Company and the lender, as a consequence, entered into an agreement in May 2016 whereby the lender converted its secured debt, in the approximate amount of \$25,453,967 (including accrued default interest) at the date of the transaction into 95% of the membership units of Terrace STS (see Note 19(a)). The Company continues to own the remaining 5% and will operate Terrace STS pursuant to a management contract that provides for service fees of approximately \$40,000 per month, as well as certain incentives whereby the Company may earn an additional interest in Terrace STS cash flows after certain financial milestones are achieved. Terrace STS is the owner of the Company's STS Olmos Project and NW AWP Project, which presently consists of interest in 19 gross producing wells and approximately 3,300 net undeveloped acres.

As a result of the default, the Company has classified the Credit Facility amounts as a current liability, as it does not have an unconditional right to defer its settlement for at least twelve months after April 30, 2016, which is required to classify the debt as a non-current liability.

The impact of the disposal to the consolidated statement of financial position of the Company is described in Note 19(c) and the at April 30, 2016 the assets and liabilities related to Terrace STS have been treated as held for sale in the consolidated statement of financial position (Note 4).

9. CONVERTIBLE NOTES

During 2013, the Company completed two non-brokered private placements of convertible, unsecured promissory notes in the aggregate principal amount of CAD \$40,000,000. The original notes were due April 2, 2018, paid interest of 8% per annum and were convertible into 20,000,000 common shares of the Company at CAD \$2.00 per share. In October 2014, the Company obtained approval for an arrangement under the *Business Corporations Act* (British Columbia) pursuant to which all of the issued and outstanding notes were exchanged for new 8% convertible unsecured notes of the Company due April 2, 2018 and governed by a trust indenture (the "Existing Notes"). The Existing Notes contained substantially similar economic terms as the original notes, including the same interest rate, maturity date and conversion price; however, the New Notes were listed for trading on the Exchange.

At April 30, 2016, CAD \$38,590,000 (January 31, 2016 - CAD \$38,590,000) of the Existing Notes were outstanding.

The following table reconciles the carrying amount of the Existing Notes from January 31, 2015 through April 30, 2016:

	Liability	Equity	Total
Balance, January 31, 2015	\$ 27,844,656	\$ 2,814,173	\$ 30,658,829
Accretion of discount	599,305	-	599,305
Conversion to common shares	(168,272)	(15,803)	(184,075)
Effect of changes in foreign exchange rates	(3,871,429)	-	(3,871,429)
Balance, January 31, 2016	25,875,415	2,814,173	28,689,588
Accretion of discount	180,501	-	180,501
Effect of changes in foreign exchange rates	3,006,564	-	3,006,564
Balance, April 30, 2016	\$ 29,062,480	\$ 2,814,173	\$ 31,876,653

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

9. CONVERTIBLE NOTES (Continued)

In response to the current market conditions and the financial position of the Company, the quarterly interest payment due January 31, 2016 was not paid. Under the trust indenture in place at January 31, 2016, an event of default would only occur if the Company failed to make an interest payment within the 15 day cure period provided for in the indenture, in respect of two consecutive interest payment dates. As such, the Company was not in default as of January 31, 2016 for failing to make the January 31, 2016 payment. Subsequent to January 31, 2016, the Company proposed a plan of arrangement (the "Arrangement") under the *Business Corporations Act* (British Columbia) pursuant to which all of the Existing Notes would be exchanged for new convertible secured notes of the Company (the "New Notes") due April 2, 2021 (the "Maturity Date"), which are governed by a new trust indenture. The Company has recorded \$1,192,450 of accrued interest related to the notes at April 30, 2016 which was forgiven at the time of the transaction.

During May 2016, the Arrangement was approved by the holders of the Existing Notes and the Supreme Court of British Columbia granted a final order approving the Arrangement. As of May 13, 2016, holders of the Existing Notes are entitled to receive \$1,000 in principal amount of New Notes for each \$1,000 principal amount of Existing Notes held by such noteholder. All interest owing to noteholders on the Existing Notes to the date of such exchange was forgiven at the time of exchange. While the Existing Notes are unsecured, the New Notes are a secured obligation of the Company, guaranteed by a general security agreement against all of the Company's assets, which includes the shares of the two United States holding companies, Terrace US Holdings LLC and Terrace Investment Holdings, Inc., but not the assets of these subsidiaries. Additionally, the New Notes are interest-free, but subject to a maturity bonus equal to 5% of the aggregate total principal amount of the New Notes payable on the Maturity Date (the "Maturity Bonus") (see Note 19(b)). If the New Notes are redeemed in accordance with their terms at any time within 180 days prior to the Maturity Date, one-half of the Maturity Bonus will be payable. The Maturity Bonus will be payable, at the Company's election, in cash or through the issuance of common shares of the Company at a price equal to the volume weighted average of the Company's common shares on its principal stock exchange for the ten trading days prior to any such issuance.

The Company has the right to convert all or part of the New Notes into common shares at any time if the market price of the common shares on the Exchange trades at CAD \$0.70 or higher for a period of 30 consecutive trading days. The conversion price under the New Notes is \$0.50 per share, compared to \$2.00 per share under the Existing Notes. Holders of the New Notes may convert all or part of the outstanding principal amount of their convertible notes at the conversion price at any time during the term of the convertible notes. As of the date of this report, CAD \$38,590,000 of the New Notes are outstanding and convertible into 77,180,000 shares. Under the terms of the New Notes, the holders are no longer entitled to require the Company to redeem the convertible notes in the event of a change of control of the Company.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

10. DECOMMISSIONING OBLIGATIONS

The Company's decommissioning obligations result from its ownership interest in oil and gas assets, including well sites and gathering systems. The total decommissioning obligation is estimated based on the Company's ownership interest in all wells and facilities, estimated costs to reclaim and abandon these wells and facilities, and the estimated timing of the costs to be incurred in future years.

Balance, January 31, 2015	\$ 474,257
Change in value of decommissioning obligations	70,137
Accretion expense	10,040
Settled obligations	(73,596)
Effect of changes in foreign exchange rates	<u>10,665</u>
Balance, January 31, 2016	491,503
Accretion expense	2,566
Settled obligations	(1,718)
Effect of changes in foreign exchange rates	20,127
Reclassified to assets held for sale (Note 4)	<u>(512,478)</u>
Balance, January 31, 2016	\$ -

Subsequent to January 31, 2016, the lender exchanged the outstanding obligations under the Credit Facility for equity in Terrace STS under which the debt was issued, which is fully described in Note 8. As a result \$512,478 of the decommissioning obligation outstanding at April 30, 2016 will no longer be an obligation of the Company. (Note 19(c)).

11. CAPITAL STOCK

The Company has unlimited authorized common shares without par value. At April 30, 2016, the Company has 87,844,321 (January 31, 2016 - 87,844,321) shares outstanding.

Share issues

During the quarters ended April 30, 2016 and April 30, 2015, the Company did not issue any common shares.

Restricted share units

The Company has a restricted share unit plan (the "RSU Plan") that permits the issuance of an aggregate of 3,682,182 RSUs to eligible participants, as described in the RSU Plan. RSUs do not confer on the holder any right to vote at a meeting of the shareholders of the Company. Common shares reserved for issuance under outstanding RSUs must be included in the calculation of common shares remaining available for reservation pursuant to options granted under the 10% rolling option plan. The number of common shares reserved for issuance, together with any other compensation arrangements, to any one person in any twelve-month period will not exceed 5% of the issued and outstanding common shares. The number of common shares reserved for issuance together with any other compensation arrangements granted to all technical consultants will not exceed 2% of the issued and outstanding common shares. The number of RSUs granted to any one person cannot exceed 5% of the issued and outstanding common shares.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

11. CAPITAL STOCK (Continued)

Restricted share units (Continued)

As at April 30, 2016, the Company has 1,100,000 (January 31, 2015 – 1,200,000) RSUs outstanding with a grant date fair value of CAD \$2,742,208 based on the stock prices at the time of grant. Each RSU, upon vesting, gives the holder the right to receive one common share. Unless otherwise approved by the Company's Board of Directors, all of the RSUs will vest upon the occurrence of a "change of control transaction", as such term is defined in the RSU award agreements. In the absence of a change of control transaction or other acceleration of vesting by the Company's Board of Directors, unvested RSUs will expire ten years from the date of grant. Vested RSUs will be settled, at the election of the Company, by way of: (i) issuance of common shares from treasury; (ii) payment to the RSU holder of an amount of cash equal to the market price of the common shares on the vesting date; or (iii) any combination thereof.

The Company recognizes compensation expense for the expected number of RSUs expected to vest over the vesting period. As of April 30, 2016, there are no contemplated transactions that would give rise to vesting; therefore, no compensation expense has been recognized.

Convertible notes

As at April 30, 2016 and January 31, 2016, the Company had issued and outstanding convertible notes with a face value of CAD \$38,590,000 convertible into 19,295,000 common shares (Note 9).

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 of 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 shares reserved 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 ten years from the date of grant. Vesting terms vary and will be determined at the time of grant by the Board of Directors.

Share-based payments

The Company uses a Black-Scholes method of accounting to fair value the share-based payments arising from the grant of stock options. Under this method, the Company recorded share-based payments expense of \$nil for the quarter ended April 30, 2016 (2015 - \$3,072) with a corresponding credit to reserves. These amounts represent the value of options vested during the period.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

11. CAPITAL STOCK (Continued)

Outstanding stock options and warrants

Stock option transactions and the number of stock options outstanding as at April 30, 2016 are summarized as follows:

Number of Options	Number of Options Exercisable	Exercise Price (CAD)	Expiry Date	Weighted Average Remaining Contractual Life (Years)
1,650,000	1,650,000	\$ 0.12	June 22, 2016	0.15
250,000	250,000	\$ 0.19	July 15, 2016	0.21
250,000	250,000	\$ 0.21	September 16, 2016	0.35
250,000	250,000	\$ 0.19	October 18, 2016	0.46
250,000	250,000	\$ 0.67	December 16, 2016	0.63
150,000	150,000	\$ 1.35	July 8, 2017	1.19
2,800,000	2,800,000			0.30

The weighted average exercise price of the outstanding stock options at April 30, 2016 is CAD \$0.26 (2015 - CAD \$0.26). There have been no stock options granted during the quarter ended April 30, 2016 and the year ended January 31, 2016. There were 100,000 (2015 - Nil) options with an exercise price of CAD \$0.53 that expired during the year ended January 31, 2016.

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

	Number of Warrants	Weighted Average Exercise Price (CAD)	Expiry Date
Balance – April 30, 2016 and 2015	500,000	\$ 0.18	June 21, 2016

12. FINANCING EXPENSES

	Three months ended April 30,	
	2016	2015
Continuing Operations:		
Interest expense	\$ 607,189	\$ 544,089
Accretion of convertible notes	180,501	168,406
Total financing expense from continuing operations	787,690	712,495
Discontinued Operations:		
Interest expense	897,974	555,180
Accretion of decommissioning obligations	2,566	-
Amortization of financing costs	220,525	158,422
PIK interest	338,140	317,872
Total financing expense from discontinued operations	1,459,205	1,031,474
Total	\$ 2,246,895	\$ 1,743,969

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

13. FINANCIAL INSTRUMENTS

The Company has classified its financial instruments as follows:

- Cash and restricted cash – as FVTPL;
- Accounts receivable and operators bond – as loans and receivables; and
- Accounts payable and accrued liabilities, credit facility and convertible notes – 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, accounts receivable and accounts payable and accrued liabilities approximate their fair values due to the short-term maturity of these financial instruments. The fair value of the operator's bond also approximates its carrying value.

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 credit risk associated with cash is mitigated since the cash is held at major financial institutions with high credit ratings. Accounts receivable consists primarily of trade receivables outstanding from operators of its oil and gas interests. To mitigate this risk, the Company regularly reviews the collectability of accounts receivable to ensure there is no indication that these amounts will not be fully recoverable. The Company has no balances past due or impaired.

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 is exposed to interest rate risk on its credit facility whereby interest is based on LIBOR and its convertible notes which have a fixed interest rate.

(ii) Foreign currency risk

Foreign currency risk is the risk that the future cash flow of financial instruments will fluctuate as a result of changes in foreign exchange rates. The Company's functional currency is CAD and its subsidiaries functional currencies are CAD and USD. Transactions relating to its oil and gas properties are in USD. Therefore, the Company is impacted by changes in the exchange rate between the Canadian and US dollars.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

13. FINANCIAL INSTRUMENTS (Continued)

Credit risk (Continued)

(ii) Foreign currency risk (Continued)

The following assets and liabilities represent the Company's exposure to foreign currency risk:

	April 30, 2016 (USD)	January 31, 2016 (USD)
Cash	\$ 1,728,437	\$ 2,075,512
Accounts receivable	-	6,800
Operator's bond	25,000	25,000
Accounts payable and accrued liabilities	(538,685)	(8,167)
Net	\$ 1,214,752	\$ 2,099,145

Based on the above net exposure as at, a 5% change in the Canadian/US exchange rate would impact the Company's net loss and comprehensive loss by approximately \$60,738 (January 31, 2016 - \$104,957). The assets and liabilities with exposure to foreign currency risk are those which are denominated in a different currency than the currency determined to be the functional currency of the respective entity as of the end of the period.

(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. Subsequent to the end of the period, the amounts outstanding under the credit facility were converted into equity which the previous lender now holds (see Note 8). Accordingly, as of the date of this report there are no amounts due under the credit facility. The credit facility has been terminated and the assets and liabilities of Terrace STS are no longer attributable to the Company following the transaction. In addition the Company reached an agreement with its noteholders and the notes outstanding at January 31, 2016 have been exchanged for new notes in the face amount of CAD \$38,590,000 that do not pay interest and are due on April 2, 2021. The \$555,579 of accrued interest related to the notes at January 31, 2016 was forgiven at the time of the transaction.

As at April 30, 2016, excluding the assets held for sale and associated liabilities, the Company had cash of \$1,798,814, accounts receivable of \$36,930, prepaids of \$53,654 and current liabilities of \$605,805 (excluding the \$1,192,458 of accrued interest forgiven in the note exchange). The current liabilities are due within three months of April 30, 2016.

TERRACE ENERGY CORP.**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015

(Expressed in United States Dollars)

13. FINANCIAL INSTRUMENTS (Continued)**Liquidity risk (Continued)**

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 its share of estimated exploration and evaluation costs. The Company has a working capital deficit and available resources combined with future cash flow from operations will not be sufficient to fund its share of the agreed-upon estimated costs of proposed future development activities. As a consequence, the Company will have to secure new sources of capital, which is not assured, to maintain its interests in such proposed development and there is no assurance such capital could be obtained.

Classification of financial instruments

The following table sets forth the Company's financial assets and financial liabilities measured at fair value by level within the fair value hierarchy as at January 31, 2016.

	Level 1	Level 2	Level 3
Cash	\$ 1,798,814	\$ -	\$ -
Credit facility	-	-	(27,276,969)
Convertible notes	(6,150,781)	-	-
	<u>\$ (4,351,967)</u>	<u>\$ -</u>	<u>\$ (27,276,969)</u>

The following table sets forth the Company's financial assets and financial liabilities measured at fair value by level within the fair value hierarchy as at January 31, 2016.

	Level 1	Level 2	Level 3
Cash	\$ 6,340,591	\$ -	\$ -
Credit facility	-	-	(26,939,154)
Convertible notes	(13,776,239)	-	-
	<u>\$ (7,435,648)</u>	<u>\$ -</u>	<u>\$ (26,939,154)</u>

14. CAPITAL DISCLOSURES

The Company considers its capital under management to be shareholders' equity, convertible notes and the Credit Facility. 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, 2015. As at January 31, 2016, the Company is not subject to any externally imposed capital requirements; however, the Credit Facility is subject to certain restrictions (see Note 8).

15. COMMITMENTS AND CONTINGENCIES

The Company has a commitment to make monthly rental payments pursuant to an office rental agreement in Vancouver, British Columbia, which commenced July 1, 2013 for a term of seven years. The lease requires total annual payments of CAD \$72,511 in years three, four and five, and CAD \$76,198 in years six and seven. In December 2015, the Company entered into a sublease of the office space commencing February 1, 2016 through the remaining term of the lease for CAD \$58,992 per year.

The Company has a commitment to make monthly rental payments pursuant to an office rental agreement in Houston, Texas, through October 31, 2017. The lease requires total annual payments of \$71,775 and \$56,700 for the twelve months ended January 31, 2017 and the final nine months on the lease, respectively.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

15. COMMITMENTS AND CONTINGENCIES (Continued)

Total rent expense net of sublease payments included in the condensed consolidated statements of operations and comprehensive loss for the quarter ended April 30, 2016 amounted to \$46,196 (2015 - \$54,841).

At April 30, 2016 the Company had convertible notes outstanding that have been exchanged for New Notes in the face amount of CAD \$38,590,000 that do not pay interest and are due on April 2, 2021 (Note 9).

The Company has interests in certain exploration and evaluation assets, which are subject to certain expenditure commitments (Notes 5 and 6).

During the year ended January 31, 2015, the Company acquired non-proprietary 3-D seismic data over its Big Wells project at a cost of approximately \$2.3 million as part of a multi-year commitment to purchase additional 3-D seismic data at a volume discounted value of approximately \$4.7 million over the next two years. The additional data was to be selected at the Company's discretion to aid in the evaluation of the expansion of its existing projects (including offsetting acreage surrounding its STS Olmos project) and/or new projects developed over the next two years. Under the current agreement, the Company was committed to purchase additional data in each of 2015 and 2016 at a cost of \$2,362,500 per year; however, the Company is currently reassessing its data requirements in light of the current commodity price environment. Consequently, the Company has notified the data provider that it does not intend to take advantage of the discounted pricing and that the Company does not expect to purchase the remaining data under the agreement.

During April 2015, the Company entered into an agreement, through a wholly owned subsidiary, to earn a 75% working interest and a 52.5% net revenue interest, as to the Olmos formation only, in certain leases covering initially 640 gross mineral acres in LaSalle County, Texas. Under the terms of this agreement, the Company was required to commence drilling a well (paying 100% of the cost) on this acreage by late September 2015 or pay liquidated damages of \$500,000. Due to the severe drop in commodity prices, the Company declared the agreement to be in a state of "force majeure" in accordance with the applicable terms of the agreement, effectively placing its obligations on hold until market conditions improve sufficiently to allow for economic development of the acreage. The farmor disputed this declaration and filed suit to enforce the liquidated damages clause of the agreement. In June 2016 the court upheld the farmor's motion for summary judgement. Accordingly the Company has recorded a provision in the amount of the asserted liquidated damages. The Company will continue to vigorously defending its position. The Company believes this suit to be without merit, intends to appeal the court ruling, and has counter-sued the farmor for damages relating to breach of contract.

16. RELATED PARTY TRANSACTIONS

Key management personnel include executive officers and directors of the Company. Compensation of the Company's key management personnel is comprised of the following:

	Three months ended April 30,	
	2016	2015
Short-term compensation	\$ 242,531	\$ 360,981
Share-based payments	-	1,536
	<u>\$ 242,531</u>	<u>\$ 362,517</u>

Included in accounts payable and accrued liabilities as at January 31, 2016 are amounts payable to key management personnel totalling \$8,374 (January 31, 2016 - \$5,235).

At April 30, 2016, convertible notes held by key management personnel and their close family members totalled CAD \$3,230,000 (January 31, 2016 - CAD \$3,230,000). Interest accrued on these convertible notes totalled CAD \$64,600 during the quarter (2015 - CAD \$63,007).

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

16. RELATED PARTY TRANSACTIONS (Continued)

All related party amounts included in accounts receivable and accounts payable and accrued liabilities are due on demand.

17. SEGMENTED INFORMATION

The Company has one operating segment, which is the acquisition, exploration and development of oil and gas properties. Geographic segmentation of the Company's non-current assets is as follows:

April 30, 2016			
	USA	Canada	Total
Exploration and evaluation assets	\$ 1,496,941	\$ -	\$ 1,496,941
Property and equipment	12,002	75,988	87,990
Investment in partnership	7,453,486	-	7,453,486
	<u>\$ 8,962,429</u>	<u>\$ 75,988</u>	<u>\$ 9,038,417</u>

January 31, 2016			
	USA	Canada	Total
Exploration and evaluation assets	\$ 3,695,298	\$ -	\$ 3,695,298
Property and equipment	23,171,811	85,745	23,257,556
Investment in partnership	7,471,522	-	7,471,522
	<u>\$ 34,338,631</u>	<u>\$ 85,745</u>	<u>\$ 34,424,376</u>

Exploration and development activities and producing properties are located in the US and oil and gas revenues are derived from US operations.

18. SUPPLEMENTAL CASH FLOW INFORMATION

During the quarter ended April 30, 2016, the Company:

- a) transferred \$25,601,899 from exploration and evaluation and property and equipment to assets held for sale;
- b) had accounts payable and accrued liabilities of \$400,197 related to exploration and evaluation expenditures;

During the quarter ended April 30, 2015, the Company:

- a) transferred \$2,762,179 from exploration and evaluation assets to property and equipment;
- b) had accounts payable and accrued liabilities of \$1,930,814 related to exploration and evaluation expenditures; and
- c) paid \$1,051,284 of interest, received \$nil of interest and paid \$nil income taxes.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2016 AND 2015
(Expressed in United States Dollars)

19. EVENTS AFTER THE REPORTING PERIOD

- a) In May 2016, the lender exchanged the outstanding obligations under the Credit Facility for equity in Terrace STS under which the debt was issued, which is fully described in Note 8. This transaction will result in the Company losing control of Terrace STS and will deconsolidate Terrace STS. The impact of the deconsolidation is shown below in Note 19(c).
- b) In May 2016, the Company completed an Arrangement under the *Business Corporations Act* (British Columbia) pursuant to which all of the Existing Notes were exchanged for new convertible secured notes of the Company due April 2, 2021, which is fully described in Note 9.
- c) The following is an unaudited consolidated pro forma statement of financial position as if the above transactions had occurred as at April 30, 2016:

<i>As at April 30,</i>	2016
Assets	
Current assets	\$ 1,888,860
Non-current assets	10,415,030
Total assets	<u>\$ 12,303,890</u>
Liabilities and Shareholders' Deficit	
Current liabilities	\$ 705,812
Non-current liabilities ⁽¹⁾	29,085,172
Total liabilities	<u>29,790,984</u>
Shareholders' deficit ⁽¹⁾	<u>(17,487,094)</u>
Total liabilities shareholders' deficit	<u>\$ 12,303,890</u>

⁽¹⁾ The impact of the extinguishment of debt of the Existing Notes and the allocation between debt and equity of the New Notes has not been reflected, as it has not been determined yet.