TERRACE ENERGY CORP.

CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

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

FOR THE NINE AND THREE MONTHS ENDED OCTOBER 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

December 28, 2012

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

	October 31, 2012	January 31, 2012
ASSETS		
Current assets		
Cash	$ 1,511,632	$ 2,590,292
Accounts receivable (Note 9)	339,980	5,148
Prepaids	73,444	-
Total current assets	1,925,056	2,595,440
Non-current assets		
Operators bond	23,710	23,710
Advances for future exploration (Note 4)	254,221	1,185,168
Exploration and evaluation (Note 5)	6,355,442	1,788,358
Property and equipment (Note 6)	7,138,716	-
Total assets	$ 15,697,145	$ 5,592,676
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (Note 9)	$ 283,759	$ 167,113
Non-current liabilities		
Decommissioning obligations (Note 7)	7,851	-
Total liabilities	291,610	167,113
Shareholders' equity		
Capital stock (Note 8)	16,255,342	6,272,512
Reserves (Note 8)	754,192	517,235
Deficit	(1,603,999)	(1,364,184)
Total shareholders' equity	15,405,535	5,425,563
Total liabilities and shareholders' equity	$ 15,697,145	$ 5,592,676

Nature and continuance of operations (Note 1)
Exploration and evaluation commitments (Note 5)
Subsequent Event (Note 13)

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 nine months ended October 31, 2012	For the nine months ended October 31, 2011	For the three months ended October 31, 2012	For the three months ended October 31, 2011
REVENUE				
Oil and gas sales	$ 1,090,157	$ -	$ 332,019	$ -
DIRECT OPERATING EXPENSES				
Production and operating	116,514	-	37,166	-
Royalties	46,755	-	5,569	-
Depletion and accretion	43,379	-	24,955	-
Gross profit	883,509	-	264,329	-
GENERAL AND ADMINSTRATIVE EXPENSES				
Administrative	384,186	56,429	139,463	51,582
Business investigation costs (Note 11)	-	93,557	-	17,875
Consulting (Note 11)	99,370	75,031	18,791	75,031
Foreign exchange (gain) loss	(79,113)	(3,538)	13,352	1,654
Interest income	(18,987)	(10,745)	(6,419)	-
Professional (Note 11)	146,826	121,179	24,551	6,458
Investor relations	92,553	-	23,072	-
Project investigation costs (Note 11)	5,082	77,949	-	77,949
Share-based payments	250,457	181,794	104,787	8,095
Transfer agent and filing fees	34,299	42,929	3,455	3,841
Impairment of oil and gas properties	140,000	-	140,000	-
Travel	68,651	8,823	15,156	8,823
	1,123,324	643,408	476,208	251,308
Net loss and comprehensive loss for the period	$ (239,815)	$ (643,408)	$ (211,879)	$ (251,308)
Basic and diluted loss per share	$ (0.00)	$ (0.02)	$ (0.00)	$ (0.01)
Weighted average number of shares outstanding	59,428,845	35,733,673	63,069,321	40,881,821

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		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	-		-		181,794		-		181,794
Loss and comprehensive loss	-		-		-		(643,408)		(643,408)
Balance - October 31, 2011	**40,881,821**	**$**	**3,333,046**	**$**	**702,974**	**$**	**(886,196)**		**3,149,824**
Balance - January 31, 2012	**52,919,321**	**$**	**6,272,512**	**$**	**517,235**	**$**	**(1,364,184)**	**$**	**5,425,563**
Private placement	10,000,000		10,000,000		-		-		10,000,000
Share issue costs	-		(48,670)		-		-		(48,670)
Exercise of options	150,000		18,000		-		-		18,000
Fair value of options exercised	-		13,500		(13,500)		-		-
Share-based payments	-		-		250,457		-		250,457
Loss and comprehensive loss	-		-		-		(239,815)		(239,815)
Balance - October 31, 2012	**63,069,321**	**$**	**16,255,342**	**$**	**754,192**	**$**	**(1,603,999)**	**$**	**15,405,535**

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 nine months ended October 31

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Loss for the period	$ (239,815)	$ (643,408)
Items not involving cash:		
Depletion and accretion	43,379	-
Share-based payments	250,457	181,794
Impairment of oil and gas properties	140,000	
Changes in non-cash working capital items:		
Prepaids	(73,444)	-
Accounts receivable	(334,832)	(4,477)
Accounts payable and accrued liabilities	117,150	163,853
Net cash used in operating activities	(97,105)	(302,238)
CASH FLOWS FROM INVESTING ACTIVITIES		
Restricted cash	-	2,523,771
Deferred project investigation costs	-	(12,370)
Advances for future exploration	(254,221)	-
Exploration and evaluation	(9,834,676)	(360,959)
Acquisition costs	(813,460)	-
Property and equipment	(48,528)	-
Net cash (used in) provided by investing activities	(10,950,885)	2,150,442
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	(1,078,660)	2,733,891
Cash, beginning of period	2,590,292	219,701
Cash, end of period	$ 1,511,632	$ 2,953,592

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 future development of the Company's oil and gas interests 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 October 31, 2012. These condensed consolidated interim financial statements were approved for issuance by the Board on December 28, 2012.

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

3. NEW ACCOUNTING POLICIES

Revenue recognition

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 $254,221 at October 31, 2012 (January 31, 2012 - $1,185,168) which consists of advances for future exploration on the Company's Cutlass project. 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	-	7,006,130	4,013,714	11,019,844
Transfer to property and equipment	-	(7,126,220)	-	(7,126,220)
Impairment charge	(140,000)	-	-	(140,000)
Expenditures during the period	(140,000)	(120,090)	4,827,174	4,567,084
Balance - October 31, 2012	**$ -**	**$ 953,253**	**$ 5,402,189**	**$ 6,355,442**

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 the Company made the decision to abandon the well and allow the mineral leases to terminate. As a result the Company incurred an impairment charge of $140,000 during the current period.

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 aggregate costs, during the period, to drill, complete and place into production three wells was $7,065,374. These costs and $60,846 of the acreage lease acquisition cost were transferred from Exploration and Evaluation assets to Property and Equipment.

The Company has secured its working and net revenue interests in all of the project acreage subject to participation in the development of additional wells proposed from time to time by the project's operator. The Company is presently reviewing the 2013 project development plan with the operator.

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").

Drilling of the first well on the Dimmit County acreage was substantially completed in June, 2012. The results were subsequently analyzed and a plan to fracture stimulate the well has been developed. The Company's share of well and infrastructure costs to October 31, 2012 was $2,537,568. The Company expects the well to be fracture stimulated and, if successful, placed into production in the first quarter of 2013 at an estimated cost to the Company of $1,200,000.

The Company must participate in the development of a second well on the Dimmit County Acreage at an estimated cost of $2.7 million. Work on this well is currently scheduled for the second quarter of 2013.

After the drilling and technical evaluation of the first well on the Dimmit County Acreage, the Company exercised its option to earn a 22.5% net revenue interest in the remaining 2,053 acres (the "LaSalle County Acreage") at a cost of $580,206. The Company was obligated to fund 33.33% of the cost of an initial well on the La Salle County acreage.

Drilling of the initial well commenced in late June 2012. A vertical hole was completed and results are under analysis. Completion plans for this well and plans for additional development wells will be formulated during the first quarter of 2013 based on analysis of petrophysical and geological information gathered from the well. The Company's share of well and infrastructure costs October 31, 2012 was $1,675,352.

(Expressed in Canadian Dollars)

6. PROPERTY AND EQUIPMENT

Costs	**Corporate Assets**	**Producing Assets**	**Total**
Balance – January 31, 2012 and 2011	$ -	$ -	$ -
Additions	48,528	-	48,528
Transfer from exploration and evaluation	-	7,126,220	7,126,220
Change in value of decommissioning obligation	-	7,347	7,347
Balance – October 31, 2012	**$ 48,528**	**$ 7,133,567**	**$ 7,182,095**

Accumulated depreciation and depletion	**Corporate Assets**	**Producing Assets**	**Total**
Balance – January 31, 2012 and 2011	$ -	$ -	$ -
Accretion	-	540	540
Depletion	7,464	35,375	42,839
Balance – October 31, 2012	**$ 7,464**	**$ 35,915**	**$ 43,379**

Net book value	**Corporate Assets**	**Producing Assets**	**Total**
Balance – January 31, 2012 and 2011	$ -	$ -	$ -
Balance – October 31, 2012	**$ 41,064**	**$ 7,097,652**	**$ 7,138,716**

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 October 31, 2012 to be $7,851 (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.

	October 31, 2012	**January 31, 2012**
Balance, beginning of the period	$ -	$ -
Addition to decommissioning obligations	7,311	-
Accretion expense	540	-
Balance, end of the period	$ 7,851	$ -

8. CAPITAL STOCK

On October 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 nine months ended October 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.

Restricted 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 $250,457 (2011 - $181,784) for the nine months ended October 31, 2012, with a corresponding credit to reserves. The fair value of the stock options granted during the nine months ended October 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%	2.23%
Expected life	5 years	5 years
Annualized volatility	107.49%	100.0%
Pre-vest forfeiture rate	2.00%	2.00%
Dividend rate	0%	0%

During the nine months ended October 31, 2012, the company granted 150,000 (2011 – 2,700,000) options with a fair value of $150,164 (2011 - $181,784), 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 - October 31, 2012	2,900,000	$ 0.27

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

The following stock options were outstanding as at October 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	100,000	$ 0.21	September 16, 2016
250,000	100,000	$ 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	37,500	$ 1.35	July 8, 2017
2,900,000	2,090,000		

As at October 31, 2012, the value of non-vested share based payments not yet recognized was $392,575, 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 October 31, 2012	7,112,500	$ 0.18	

The weighted average trading price at the date the warrants were exercised during the period ended October 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 October 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 $11,762. 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 October 31, 2012, the Company had cash of $1,511,632, accounts receivable from the sale of oil and gas of $277,128 and $62,852 from harmonized sales tax ("HST") receivable from the Canadian tax authorities and accounts payable and accrued liabilities of $283,759 due within three months of the period-end.

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 may not have sufficient working capital and future cash flow from operations to fund its share of the agreed upon estimated costs of proposed development activities. As a consequence, the Company may have to secure new sources of capital, which is not assured, to maintain its interests in such proposed development.

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. As at October 31, 2012, the Company is not subject to any externally imposed capital requirements.

11. RELATED PARTY TRANSACTIONS

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

(i) Paid or accrued $76,532 (2011 - $75,031) for consulting services to a person who since became an 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;

(ii) Paid or accrued $31,498 (2011 - $nil) for administrative services to a firm where an officer of the Company is a principal;

(iii) Paid or accrued $27,125 (2011 - $nil) for accounting services to a firm where an officer of the Company is a principal;

(iv) Paid or accrued $67,284 (2011 - $nil) for legal services to a law firm in which a former officer of the Company is a principal; and

(v) Paid or accrued $nil (2011 - $8,000) for accounting services to a former officer of the Company.

Total compensation paid to key management personnel was $253,657 (2011 - $83,031) which is being expensed over the vesting periods of the options.

12. SUPPLEMENTAL CASH FLOW INFORMATION

During the nine months ended October 31, 2012, the Company:

(a) transferred $7,126,220 from exploration and evaluation to property and equipment;

(b) transferred $1,185,168 from advances on future exploration to exploration and evaluation;

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

During the nine months ended October 31, 2011, the Company:

(a) issued 10,000,000 warrants with a fair value of $433,230 as non-cash share issuance cost in connection with private placement during the period.

13. SUBSEQUENT EVENT

Subsequent to October 31, 2012, the Company announced that its wholly owned subsidiary, Terrace US Holdings, LLC ("Terrace US" and, together with Terrace Energy, "Terrace") has entered into an agreement with Redhawk Resources, LLC ("Redhawk") wherein Redhawk has granted Terrace US an option to acquire interests in certain mineral leases in Finney County, Kansas (the "Option"). Under the terms of the Option, Terrace US may acquire, at any time up to the close of business on April 30, 2013, an 82% working interest and a 65.6% net revenue interest in approximately 15,000 net mineral acres in Finney County, Kansas for approximately US$2.3 million on closing and a commitment to fund 100% of the drilling, development, marketing, leasehold maintenance, and other related costs of the project to a maximum of US$5,365,500. Terrace US would be designated the project's operator upon closing. To secure the Option, Terrace paid Redhawk a US$225,150 non-refundable deposit against the purchase price.