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

FOR THE NINE AND THREE MONTHS ENDED OCTOBER 31, 2015 AND 2014

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 Chartered Professional Accountants of Canada for a review of interim financial statements by an entity's auditor.

Vancouver, Canada

December 29, 2015

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

	October 31, 2015	January 31, 2015 Restated (Note 4)
ASSETS		
Current assets		
Cash (Note 10)	$ 7,733,913	$ 26,494,024
Accounts receivable (Notes 10 and 18)	716,811	1,482,629
Prepaids	143,379	268,875
Assets held for sale (Note 5)	44,642	1,762,845
Total current assets	8,638,745	30,008,373
Non-current assets		
Operators bond	25,000	25,000
Investment in partnership (Note 6)	10,941,479	16,622,882
Advances for future exploration (Notes 7 and 10)	177,433	475,797
Exploration and evaluation assets (Notes 8 and 10)	5,676,323	3,967,983
Property and equipment (Notes 9 and 10)	21,232,741	19,273,394
Total assets	$ 46,691,721	$ 70,373,429
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (Note 18)	$ 690,453	$ 4,566,006
Credit facility (Note 10)	24,250,620	-
Total current liabilities	24,941,073	4,566,006
Non-current liabilities		
Credit facility (Note 10)	-	23,451,243
Convertible notes (Notes 11 and 18)	27,549,281	27,844,656
Decommissioning obligations (Note 12)	572,831	474,257
Total liabilities	53,063,185	56,336,162
Shareholders' equity (deficit)		
Capital stock (Note 13)	47,416,203	47,416,203
Convertible notes – equity component (Note 11)	2,814,173	2,814,173
Stock options reserve (Note 13)	1,064,741	1,061,669
Warrants reserve (Note 13)	6,099	6,099
Translation reserve (Note 2)	(1,395,477)	(304,795)
Deficit	(56,277,203)	(36,956,082)
Total shareholders’ equity (deficit)	(6,371,464)	14,037,267
Total liabilities and shareholders’ equity	$ 46,691,721	$ 70,373,429

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
(Expressed in United States Dollars)

	For the nine months ended October 31, 2015	For the nine months ended October 31, 2014	For the three months ended October 31, 2015	For the three months ended October 31, 2014
REVENUE				
Oil and gas sales (net of royalties)	$ 4,725,624	$ 5,286,246	$ 877,779	$ 1,240,376
DIRECT OPERATING EXPENSES				
Production and operating	1,742,649	1,490,255	739,319	530,849
Depreciation and depletion (Note 9)	4,797,588	3,259,393	1,124,867	1,847,423
Operating income	(1,814,613)	536,598	(986,407)	(1,137,896)
Equity loss in partnership (Note 6)	(7,867,755)	(138,679)	(7,761,742)	(52,776)
	(9,682,368)	397,919	(8,748,149)	(1,190,672)
GENERAL AND ADMINSTRATIVE EXPENSES				
Administrative	662,251	545,038	210,845	114,455
Foreign exchange (gain) loss	(1,688,972)	(1,083,466)	(2,429,669)	(702,667)
Impairment (Notes 5 and 8)	4,751,342	2,082,295	1,720,233	2,100,760
Financing (Note 14)	4,943,900	3,358,197	1,750,781	1,590,555
Investor relations	332,629	296,758	76,001	153,561
Professional	373,109	529,212	65,487	183,633
Salaries and benefits (Note 18)	1,469,324	1,225,752	476,247	473,683
Share-based payments (Notes 13 and 18)	3,072	129,131	-	29,180
Transfer agent and filing fees	51,712	94,286	9,192	50,181
Travel	20,947	69,539	7,063	13,443
	10,919,314	7,246,742	1,886,180	4,006,784
Net loss for the period	(20,601,682)	(6,848,823)	(10,634,329)	(5,197,456)
Other comprehensive loss				
Items that may be reclassified subsequently to profit or loss:				
Cumulative translation adjustment	(1,090,682)	(1,430,936)	(1,415,708)	(1,341,971)
Comprehensive loss for the period	$ (21,692,364)	$ (8,279,759)	$ (12,050,037)	$ (6,539,427)
Basic and diluted income (loss) per share	$ (0.23)	$ (0.09)	$ (0.12)	$ (0.06)
Weighted average number of common shares outstanding	87,844,321	79,753,271	87,844,321	87,834,404

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
(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, 2014	**74,434,321**	**$ 27,421,256**	**$ 2,829,976**	**$ 924,942**	**$ 17,239**	**$ (448,289)**	**$ (8,103,382)**	**$ 22,641,742**
Short form prospectus	12,443,000	21,279,272	-	-	-	-	-	21,279,272
Share issue costs	-	(1,617,969)	-	-	-	-	-	(1,617,969)
Exercise of convertible notes	117,500	210,966	(16,052)	-	-	-	-	194,914
Exercise of warrants	850,000	138,429	-	-	-	-	-	138,429
Fair value of warrant exercises	-	11,140	-	-	(11,140)	-	-	-
Share-based payments	-	-	-	129,131	-	-	-	129,131
Cumulative translation adjustment	-	-	-	-	-	(1,430,936)	-	(1,430,936)
Net loss for the period	-	-	-	-	-	-	(6,848,823)	(6,848,823)
Balance – October 31, 2014	**87,844,821**	**$ 47,443,094**	**$ 2,813,924**	**$ 1,054,073**	**$ 6,099**	**$(1,879,225)**	**$(14,952,205)**	**$ 34,485,760**
Balance – January 31, 2015 Restated (Note 4)	**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)	-	-	-	-	-	(1,992,239)	1,280,561	(711,678)
Share-based payments	-	-	-	3,072	-	-	-	3,072
Cumulative translation adjustment	-	-	-	-	-	901,557	-	901,557
Net loss for the period	-	-	-	-	-	-	(20,601,682)	(20,601,682)
Balance – October 31, 2015	**87,844,821**	**$ 47,416,203**	**$ 2,814,173**	**$ 1,064,741**	**$ 6,099**	**$(1,395,477)**	**$(56,277,203)**	**$ (6,371,464)**

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
(Expressed in United States Dollars)
For the nine months ended October 31

	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss for the period	$(20,601,682)	$ (6,848,823)
Items not involving cash:		
Accretion of convertible notes	479,111	500,450
Accretion of decommissioning obligations	6,030	-
Depreciation and depletion	4,797,588	3,259,393
Equity loss in partnership	7,867,755	138,679
Share-based payments	3,072	129,131
Non-cash interest expense	869,679	285,485
Impairment of assets held for sale	1,718,203	1,590,158
Impairment of exploration and evaluation assets	3,033,139	492,137
Unrealized (gain) loss on foreign exchange	(1,639,148)	(258,833)
Changes in non-cash working capital items:		
Accounts receivable	718,259	1,019,591
Prepaids	173,055	(87,666)
Accounts payable and accrued liabilities	(2,469,660)	(711,981)
Net cash used in operating activities	(5,044,599)	(492,279)
CASH FLOWS FROM INVESTING ACTIVITIES		
Exploration and evaluation expenditures	(11,758,015)	(14,592,406)
Advances for future exploration	298,363	(442,278)
Acquisition of property and equipment	-	(24,977)
Investment in partnership	(2,186,351)	(3,138,000)
Net cash used in investing activities	(13,646,003)	(18,197,661)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from issuance of shares	-	19,661,303
Proceeds from credit facility (net of transaction cost)	-	22,561,884
Exercise of warrants	-	138,429
Financing costs	(70,302)	-
Net cash provided by financing activities	(70,302)	42,361,616
Foreign exchange effect on cash	793	54,715
Change in cash for the period	(18,760,111)	23,726,391
Cash, beginning of the period	26,494,024	11,097,174
Cash, end of the period	$ 7,733,913	$ 34,823,565

Supplemental cash flow information (Note 20)

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

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 1012 - 1030 West Georgia Street, Vancouver, British Columbia, Canada V6E 2Y3. Its registered and records office is located at 10th Floor, 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 three and nine months ended October 31, 2015, the Company reported a net loss of $10.6 million and $20.6 million, respectively, and had a working capital deficiency of $16.3 million. For the three and nine months ended October 31, 2015, the Company reported a comprehensive loss of $12.1 million and $21.7 million, respectively. The working capital deficit is due 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 October 31, 2015 (see Note 10). Additionally, the Company had negative cash flow from operating activities in its most recently completed financial year ended January 31, 2015 and year to date through October 31, 2015. 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 17). 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 meet its debt obligations and to carry out its future oil and gas acquisition, exploration and development activities. The Company may also attempt to reach agreements with its creditors to change the payment terms or convert all or a portion of the debt obligations into equity in Terrace or certain of its subsidiaries. There are no guarantees that the Company will be able to reach such agreements with its creditors, 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 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, 2015, except for the Company's functional currency assessment of certain of its subsidiaries. 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, 2015. The policies applied in these condensed consolidated interim financial statements are based on IFRS issued and outstanding as of October 31, 2015.

2. BASIS OF PRESENTATION (Continued)

Statement of compliance (Continued)

The Board of Directors approved the unaudited condensed consolidated interim financial statements on December 29, 2015.

Basis of measurement

These condensed consolidated 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 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 futures 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 condensed 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 condensed 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.

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 determining 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 condensed 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.

(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.

Principles of consolidation

The condensed consolidated 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	USA	100%
TEC Operating, LLC	USA	100%
Terrace BWP, LLC	USA	100%
Terrace Investment Holdings, Inc.	USA	100%
TEC Olmos, LLC	USA	100%

4. RESTATEMENT

During the nine-month period ended October 31, 2015, the Company identified a non-cash mathematical error in translation of property and equipment to its reporting currency resulting in a restatement of the previously issued financial statements for the year ended January 31, 2015. The mathematical error in translation caused an overstatement of exploration and evaluation assets and property and equipment of approximately $3.2 million and an overstatement of foreign exchange gain of approximately $4.3 million and approximately $1.07 million of translation adjustment loss resulting in comprehensive loss understatement by $3.2 million for the year ended January 31, 2015.

The following table outlines the effect of the changes made to the financial statements as originally filed:

Impact on the Statements of Financial Position as at January 31, 2015:

	Previously Reported	Change	Restated
Exploration and evaluation assets	$ 4,235,900	$ (267,917)	$ 3,967,983
Property and equipment	22,268,239	(2,994,845)	19,273,394
Total assets	$ 73,636,191	$ (3,262,762)	$ 70,373,429
Translation reserve	$ (1,380,307)	$ 1,075,681	$ (304,795)
Deficit	(32,617,808)	(4,338,443)	(36,956,082)
Total shareholders' equity	17,300,029	(3,262,762)	14,037,267
Total liabilities and shareholders' equity	$ 73,636,191	$ (3,262,762)	$ 70,373,429

(Expressed in United States Dollars)

4. RESTATEMENT (Continued)

Impact on the Statements of Operations and Comprehensive Loss for the year ended January 31, 2015:

	Previously Reported		Change		Restated	
Foreign exchange gain	$	4,965,318	$	(4,338,274)	$	627,044
Net loss for year		(24,514,426)		(4,338,274)		(28,852,700)
Translation adjustment		(932,018)		1,075,512		143,494
Comprehensive loss for year	$	(25,446,444)	$	(3,262,762)	$	(28,709,206)
Basic and diluted loss per share	$	(0.30)			$	(0.35)

All adjustments affected only non-cash items; therefore there was no impact to cash provided by operating activities and also no impact to cash used in investing activities or cash provided by financing activities. There was no impact on the statement of operations and comprehensive loss for the nine months ended October 31, 2014.

5. ASSETS HELD FOR SALE

The Company has actively marketed the working interest assets comprising the Cutlass Eagle Ford Development and in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, the assets and liabilities associated with the Company's interests in the project were reclassified from their respective financial position classifications to "assets held for sale".

During the period ended October 31, 2015 the Company determined that the current operations of the property were no longer economic. Accordingly, the Company recorded an impairment in the amount of $1,718,203 to reduce the carrying value of the asset to the expected fair value less cost to sell. During December 2015, the operator was assigned the asset and assumed the abandonment obligation and all remaining obligations between the two parties were eliminated. No cash was exchanged in the transaction.

In accordance with IFRS 5, the assets and liabilities associated with the Company's interests in Cutlass are reclassified from their respective financial position classifications to "assets held for sale" and adjusted as follows:

Assets reclassified to Assets Held for Sale as of January 31, 2015 from:		
Exploration and evaluation assets (Note 7)	$	3,094,834
Property and equipment (Note 8)		6,154,229
Accumulated depreciation and depletion		(1,542,534)
ARO liability, net		(6,969)
Impairment		(6,151,913)
Effect of foreign exchange		215,198
Balance as of January 31, 2015	$	1,762,845
Impairment		(1,718,203)
Balance as of October 31, 2015	$	44,642

During the period ended October 31, 2015, the project generated operating loss of $37,269 (2014 income - $573,475), comprising revenues and expenses of $318,603 and $355,872 (2014 - $1,231,056 and $657,581), respectively.

6. 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% working interest (the "WI") in certain oil and gas leases in Maverick County Texas, USA (the "Maverick County Project") from SWEPI LP ("Shell Oil"). The acreage to be acquired includes potential reserves in the newly emerging Pearsall Shale Trend, as well as the Eagle Ford Shale, Buda Limestone and several other intervals of Cretaceous age formations, which have been proven productive on a regional basis. The BTLP may secure the WI through a combination of cash payments, which have been made, and drilling obligations.

The material terms of the farm-out agreement between the BTLP and Shell Oil are as follows:

1) 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;

2) upon completion of a well drilled under this agreement, the BTLP may request an assignment of 50% of Shell Oil's interest in such well;

3) upon making the Carry Payment in full, the BTLP shall have the option, but not the obligation, to pay 50% of all development costs for the right 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

4) 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.

The BTLP renegotiated the schedule under which the long-term obligations of the BTLP under its farmout agreement with Shell are required. Under the Fourth Amendment to the Farmout Agreement, negotiated during the third 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 (approximately $35 million) in 2018. The BTLP retains the option to pay approximately $2 million in liquidated damages at the end of 2017 if it chooses not to resume drilling operations at that point.

By design, the BTLP partnership agreement allows for adjusting the ownership interests of the limited partnership by introducing third party investors into the partnership and/or allowing either partner to disproportionately fund future capital requirements. In light of the current economic environment, the Company has obtained a commitment from its partner, BlackBrush, to fund Terrace's share of capital obligations for fiscal 2016 on a sole risk basis. As a result, the Company’s partnership interest in the BTLP is expected to be reduced from 50% to approximately 45% and its current obligations carried.

The carrying value of $10,941,479 at October 31, 2015 (January 31, 2015 - $16,622,882), which includes $24,392,716 (January 31, 2015 - $22,179,357) in advances, 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 partnership of $13,451,237 (January 31, 2015 - $5,556,474). Revenues and expenses attributable to the sole risk operations conducted by our partner totaling a loss of $4,429,909 for the quarter ended October 31, 2015 are excluded from income and allocated to our partner before allocations of income to the partners in accordance with their respective ownership percentages. The partnership loss recognized during the current fiscal year was primarily due to an impairment loss (our share $7,709,670) taken by the partnership attributable to

(Expressed in United States Dollars)

6. INVESTMENT IN PARTNERSHIP (Continued)

performance of the initial wells and the precipitous drop in oil prices experienced since late 2014. These initial wells were exploration wells intended to evaluate and confirm the existence of hydrocarbons in multiple formations across the vast acreage covered under the Farmout Agreement. Fifty percent of the costs incurred by the partnership to drill the wells was attributable to Shell's interest and represent deferred purchase cost pursuant to the Farmout Agreement until such time that the drilling obligation has been satisfied.

Summary of financial information of the BTLP

As at October 31,		**2015**		**2014**
Assets				
Cash	$	113,500	$	1,742,375
Other current assets		261,514		1,775,230
Property and equipment		24,757,176		41,348,473
	$	25,132,190	$	44,866,078
Liabilities				
Current liabilities	$	1,750,401	$	4,952,437
Decommissioning obligations		538,327		27,902
	$	2,288,728	$	4,980,339

For the nine months ended October 31,		**2015**		**2014**
Revenue	$	328,009	$	247,905
Direct operating costs				
Production and operating		203,346		192,260
Depreciation and depletion		388,376		134,263
Operating loss		(263,713)		(78,618)
Other expenses		147,575		198,746
Impairment		19,754,130		-
Loss before income taxes		(20,165,418)		(277,364)
Deferred income tax expense		-		-
Net loss and comprehensive loss for the period	$	(20,165,418)	$	(277,364)

7. 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 $177,433 at October 31, 2015 (January 31, 2015 - $475,797).

(Expressed in United States Dollars)

8. EXPLORATION AND EVALUATION ASSETS

	Big Wells	STS Olmos	Terrace Operating	Total
Balance - January 31, 2014	**$ -**	**$ 1,231,887**	**$ -**	**$ 1,231,887**
Acquisition costs	2,350,136	97,958	-	2,448,094
Exploration and evaluation	6,743,526	12,271,878	-	19,015,404
Transfer to property and equipment		(10,216,633)	-	(10,216,633)
Expenditures during the year	9,093,662	2,153,203	-	11,246,865
Impairment charge	(6,656,569)	(492,135)	-	(7,148,704)
Effect of changes in foreign exchange rates (Note 4)	(1,075,654)	(286,411)	-	(1,362,065)
	(7,732,223)	(778,546)	-	(8,510,769)
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	8,330,709	-	8,924,894
Transfer to property and equipment	-	(6,697,535)	-	(6,697,535)
Expenditures during the year	594,185	1,633,174	1,427,228	3,654,587
Impairment charge	(3,033,139)	-	-	(3,033,139)
Effect of changes in foreign exchange rates	1,077,515	-	9,377	1,086,892
	(1,955,624)	-	9,377	(1,946,247)
Balance – October 31, 2015	**$ -**	**$ 4,239,718**	**$ 1,436,605**	**$ 5,676,323**

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 period ended October 31, 2015, $6,697,535 (2014 - $1,591,757) was reclassified to property and equipment.

During the year ended January 31, 2015, the Company recorded a charge of $492,135 to reflect the impairment in value on acquired acreage at the STS project, which had certain title deficiencies and are unlikely to be cured. The Company also recorded impairment on its Big Wells project in the amount of $6,656,569 related to the Price well, which did not result in any proved or probable reserves being assigned to the well after it was completed.

During the period ended October 31, 2015, 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 period, the Company determined it is 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 $2,438,954 related to the seismic data it had acquired over the acreage.

During October 2015 the Company’s wholly owned subsidiary, Terrace Operating, LLC acquired a 50% interest in the rights to the Olmos Sandstone on 8,000 gross acres immediately adjacent to our existing STS Olmos Project acreage for payment of $1.4 million. The leasehold has a three year primary term and does not require any near term drilling to maintain the lease

(Expressed in United States Dollars)

9. PROPERTY AND EQUIPMENT

Cost	Other Equipment	Leaseholds	Oil and Gas	Total
Balance – January 31, 2014	**$ 163,907**	**$ 129,106**	**$ 15,911,760**	**$ 16,204,773**
Additions	27,976	-	-	27,976
Transfer from exploration and evaluation	-	-	10,216,633	10,216,633
Change in value of decommissioning obligations	-	-	337,534	337,534
Expenditures during the year	27,976	-	10,554,167	10,582,143
Reclassified from assets held for sale (Note 4)	-	-	6,154,229	6,154,229
Effect of changes in foreign exchange rates	(40,133)	-	(3,013,516)	(3,053,649)
Reclassified to assets held for sale (Note 4)	-	-	(6,154,229)	(6,154,229)
Balance – January 31, 2015	**$ 151,750**	**$ 129,106**	**$ 23,452,411**	**$ 23,733,267**
Additions				
Transfer from exploration and evaluation	-	-	6,697,535	6,697,535
Change in value of decommissioning obligations	-	-	70,137	70,137
Expenditures during the year	-	-	6,767,672	6,767,672
Effect of changes in foreign exchange rates	(4,221)	(3,592)	-	(7,813)
Balance – October 31, 2015	**$ 147,529**	**$ 125,514**	**$ 30,220,083**	**$ 30,493,126**
Accumulated depreciation and depletion				
Balance – January 31, 2014	**$ 31,988**	**$ 13,800**	**$ 2,493,330**	**$ 2,539,118**
Reclassified from assets held for sale (Note 4)	-	-	1,454,739	1,454,739
Charge for year	51,304	24,769	4,016,980	4,093,053
Reclassified to assets held for sale (Note 4)	-	-	(1,542,534)	(1,542,534)
Effect of changes in foreign exchange rates	(10,207)	(4,727)	(2,069,569)	(2,084,503)
Balance – January 31, 2015	**$ 73,085**	**$ 33,842**	**$ 4,352,946**	**$ 4,459,873**
Charge for year	32,085	16,299	4,749,204	4,797,588
Effect of changes in foreign exchange rates	1,366	1,558	-	2,924
Balance – October 31, 2015	**$ 106,536**	**$ 51,699**	**$ 9,102,150**	**$ 9,260,385**
Net book value				
Balance – January 31, 2015	**$ 78,665**	**$ 95,264**	**$ 19,099,465**	**$19,273,394**
Balance – October 31, 2015	**$ 40,993**	**$ 73,815**	**$ 21,117,933**	**$21,232,741**

10. CREDIT FACILITY

On June 6, 2014, Terrace STS, LLC ("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 Terrace Energy Corp, 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 Company's discretion. The original term of the facility is 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 to be paid monthly; principal and PIK interest paid upon maturity on May 31, 2018. Early repayment is permitted under certain conditions.

(Expressed in United States Dollars)

10. CREDIT FACILITY (Continued)

During the year ended January 31, 2015, the Company made an initial draw of $25 million and received net proceeds of $24 million after deducting the agreed-upon transaction cost of $1 million. The Company also incurred $1.4 million of legal and other additional costs, which has been netted against the balance outstanding under the facility and will be amortized into interest expense over the life of the credit facility.

Balance at January 31, 2014	$	-
Draws		25,000,000
Financing costs incurred		(2,438,116)
Amortization of financing costs		280,006
PIK interest		609,955
Effect of changes in foreign exchange rates		(602)
Balance at January 31, 2015	$	23,451,243
Financing costs incurred		(70,302)
Amortization of financing costs		(117,889)
PIK interest		987,568
Balance at October 31, 2015	$	24,250,620

The Company is restricted from utilizing funds drawn under the Credit Facility or funds generated from the operations of its STS Olmos Project for anything other than for operating costs and ongoing development activities at the STS Olmos Project. At October 31, 2015, the Company had $4,537,557 of restricted funds for its STS Olmos Project. The terms of the Credit Facility also provides for certain other covenants including the requirement to maintain certain financial condition covenants. The financial condition covenants consist 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 EBITDA ranging from 2 to 1 up to 3.25 to 1 depending on the period.

As at January 31, 2015, the Company was not in compliance with the asset coverage ratio and the leverage ratio covenants pursuant to the agreement. During May 2015, the lender provided the Company a waiver of the non-compliance at January 31, 2015 and for the expected non-compliance for the quarter ending 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, the Company agreed to increase the interest rate margin from 7% to 8% beginning June 1, 2016 and to pledge the assets of Terrace STS as collateral to the Credit Facility. In addition, the Company agreed to reduce the amount available to be drawn under the facility to the $25 million that is currently outstanding. The remaining undrawn amounts under the Credit Facility may be made available to the Company, at the Lender’s discretion, depending upon project performance and market conditions The Company also agreed to advance to Terrace STS, LLC any proceeds received from the sale of the Cutlass oil and gas assets. Finally, the Company also agreed to devise a plan acceptable to the lender to enhance the overall capitalization of the Terrace STS, LLC entity by August 31, 2015.

As of October 31, 2015, the Company was not in compliance with the adjusted leverage ratio requirement. Additionally, the Company and its financial advisor continue to evaluate financial options and strategic alternatives which could ultimately result in an enhanced capitalization of the Terrace STS, LLC, however to date the Company has been unable to provide a satisfactory plan to the lender. The lender has not declared a default as a result of the non-compliance of the credit agreement requirements. The Company is in ongoing discussions with its lender to explore strategic alternatives at both the corporate level and directly involving Terrace STS, LLC which would enhance the entity’s capitalization. One option being considered is a possible sale of all or a portion of the Terrace STS, LLC assets, with proceeds being used toward reducing the amounts outstanding against the Credit Facility. The

(Expressed in United States Dollars)

10. CREDIT FACILITY (Continued)

Company is in active discussions with third parties regarding various alternatives. The lender has also suggested possible options involving them as a solution, including potentially converting all or a portion of the debt into equity in the Terrace STS, LLC subsidiary. The Company does not have the ability to remedy this non-compliance without an agreement from the lender. As a result, the lender may exercise any and all remedies available under applicable law. Accordingly, the Company has classified the Credit Facility amounts as a current liability in accordance with IAS 1, paragraph 74 as it does not have an unconditional right to defer its settlement for at least twelve months after October 31, 2015 which is required to classify the debt as non-current.

The following assets of Terrace STS were pledged at October 31, 2015:

Cash	$	4,537,557
Accounts receivable		631,404
Advances for future exploration		177,269
Exploration and evaluation assets		4,239,718
Property and equipment		21,117,933
	$	30,703,881

11. CONVERTIBLE NOTES

During the year ended January 31, 2014, the Company completed two non-brokered private placements of convertible, unsecured promissory notes in the aggregate principal amount of CAD $40,000,000. The convertible notes are due April 2, 2018, pay interest of 8% per annum and are convertible into 20,000,000 common shares of the Company at CAD $2.00 per share.

The Company held a special meeting of the holders of its notes on October 8, 2013 and obtained approval for an arrangement under the *Business Corporations Act* (British Columbia) pursuant to which all of the issued and outstanding notes would be exchanged for new 8% convertible unsecured notes of the Company due April 2, 2018 and governed by a trust indenture (the "New Notes"). The Supreme Court of British Columbia granted a final order approving the exchange, and on October 15, 2014 the Notes were exchanged for the New Notes. The New Notes have substantially similar economic terms as the Notes, including the same interest rate, maturity date and conversion price. Each note holder received an equal principal amount of New Notes under the arrangement as it presently holds notes. The New Notes are listed for trading on the Exchange.

The Company has the right to convert all or part of the New Notes into common shares at any time after April 2, 2014 if the market price of the common shares on the Exchange trades at CAD $2.80 or higher for a period of 30 consecutive trading days. In addition, the Company has a limited right to redeem all or part of the New Notes at any time after April 2, 2015 by offering cash equal to 1.00 multiplied by the principal amount that is called for redemption.

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. In the event of a change of control of the Company, where a person acquires more than 50% of the outstanding common shares of the Company, holders of convertible notes will be entitled to require the Company to redeem the convertible notes.

At October 31, 2015, CAD $38,590,000 (2014 - CAD $38,590,000) of the New Notes were outstanding and convertible into 19,295,000 (2014 – 19,295,000) common shares.

(Expressed in United States Dollars)

11. CONVERTIBLE NOTES (Continued)

The following table reconciles the carrying amount from January 31, 2014 through October 31, 2015:

	Liability	Equity	Total
Balance, January 31, 2014	**$ 31,285,052**	**$ 2,829,976**	**$ 34,115,028**
Net 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, 2015	**$ 27,844,656**	**$ 2,814,173**	**$ 30,658,829**
Net accretion of discount	479,111	-	479,111
Effect of changes in foreign exchange rates	(774,486)	-	(774,486)
Balance, October 31, 2015	**$ 27,549,281**	**$ 2,814,173**	**$ 30,363,454**

12. 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 net 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, 2014	**$ 102,008**
Change in value of decommissioning obligations	337,534
Accretion expense	14,296
Effect of changes in foreign exchange rates	20,419
Balance, January 31, 2015	**$ 474,257**
Change in value of decommissioning obligations	70,137
Accretion expense	6,030
Effect of changes in foreign exchange rates	22,407
Balance, October 31, 2015	**$ 572,831**

13. CAPITAL STOCK

The Company has unlimited authorized common shares without par value. At October 31, 2015, the Company has 87,844,321 (January 31, 2015 – 87,844,321) shares outstanding.

Share issues

During the nine months ended October 31, 2015, the Company did not issue any common shares.

During the year ended January 31, 2015, the Company issued:

a) 12,443,000 common shares for gross proceeds of CAD $23,019,550 at a price of CAD $1.85 per share via a short form prospectus. Share issue costs of CAD $1,774,407, which include CAD $1,496,271 of agents' fees, were paid in connection with the public offering.

b) 117,500 common shares on the conversion of CAD $235,000 convertible notes.

c) 850,000 common shares for proceeds of CAD $153,000 on the exercise of 850,000 warrants at an exercise price of CAD $0.18 per warrant.

d) 4,935,000 common shares for gross proceeds of CAD $10,610,250 at a price of CAD $2.15 per share via a short form prospectus. Share issue costs of CAD $980,508, which include $636,615 of agents' fees, were paid in connection with the public offering.

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.

The Company has issued 1,200,000 RSUs. 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 five 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 October 31, 2015, there are no contemplated transactions that would give rise to vesting; therefore, no compensation expense has been recognized.

(Expressed in United States Dollars)

13. CAPITAL STOCK (Continued)

Convertible notes

As at October 31, 2015, the Company had issued and outstanding convertible notes with a face value of CAD $38,590,000 convertible into 19,295,000 common shares. At October 31, 2014, 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 11).

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 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 fair value method of accounting for all share-based payments arising from the grant of stock options. Under this method, the Company recorded share-based payments expense of $3,072 for the period ended October 31, 2015 (2014 - $129,131) with a corresponding credit to reserves. These amounts represent the value of options vested during the years.

Outstanding stock options and warrants

Stock option transactions and the number of stock options outstanding as at October 31, 2015 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	.64
250,000	250,000	$ 0.19	July 15, 2016	.71
250,000	250,000	$ 0.21	September 16, 2016	.85
250,000	250,000	$ 0.19	October 18, 2016	.97
250,000	250,000	$ 0.67	December 16, 2016	1.13
150,000	150,000	$ 1.35	July 8, 2017	1.69
2,800,000	2,800,000			.80

The weighted average exercise price of the outstanding stock options at October 31, 2015 is CAD $0.26 (January 31, 2015 - CAD $0.27). There have been no stock options granted during the nine months ended October 31, 2015 and during year ended January 31, 2015. There were 100,000 options that expired during the nine months ended October 31, 2015, $nil during the year ended January 31, 2015.

(Expressed in United States Dollars)

13. CAPITAL STOCK (Continued)

Outstanding stock options and warrants (Continued)

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

	Number of Warrants	Weighted Average Exercise Price (CAD)	Expiry Date
Balance – January 31, 2014	1,350,000	$ 0.18	June 21, 2016
Exercised	(850,000)	$ 0.18	
Balance – January 31, 2015 and October 31, 2015	500,000	$ 0.18	June 21, 2016

14. FINANCING EXPENSES

	Nine months ended October 31, 2015	2014
Interest expense	$ 3,509,389	$ 2,641,353
Accretion of convertible notes	479,111	510,434
PIK interest	987,568	285,485
Other	(32,168)	(79,075)
Total	$ 4,943,900	$ 3,358,197

15. FINANCIAL INSTRUMENTS

The Company has classified its financial instruments as follows:

- Cash – as FVTPL;
- Accounts receivable and operators bond – as loans and receivables; and
- Accounts payable and accrued liabilities, liabilities associated with assets held-for-sale, 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, accounts payable and accrued liabilities, and liabilities associated with assets held-for-sale approximate their fair values due to the short-term maturity of these financial instruments. The fair value of the operators 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

(Expressed in United States Dollars)

15. FINANCIAL INSTRUMENTS (Continued)

Credit risk (Continued)

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.

(ii) Interest rate risk (Continued)

The Company is exposed to interest rate risk on its credit facility whereby interest is based on LIBOR.

(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.

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

	October 31, 2015 (USD)	January 31, 2015 (USD)
Cash	$ 2,902,639	$ 25,251,968
Accounts receivable	-	1,439,871
Operators bond	25,000	25,000
Accounts payable and accrued liabilities	(113,819)	(4,530,587)
Credit facility	-	(25,609,954)
Net	$ 2,813,820	$ (3,423,702)

Based on the above net exposure as at October 31, 2015, a 5% change in the Canadian/US exchange rate would impact the Company's net loss and comprehensive loss by approximately $140,691 (January 31, 2015 - $171,185). The assets and liabilities with exposure to foreign currency risk are those which are denominated in a different currency than the currency determined to the functional currency of the respective entity as of the end of the period.

(Expressed in United States Dollars)

15. FINANCIAL INSTRUMENTS (Continued)

Market risk (Continued)

(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, 2015, the Company had cash of $7,733,913 accounts receivable of $716,811, current liabilities of $690,453 amounts outstanding under the Credit Facility of $26,597,523 and convertible notes outstanding totaling CAD $38,590,000. The current liabilities are due within three months of year-end, and the Credit Facility and convertible notes mature May 31, 2018 and April 2, 2018, respectively. Additionally, the Company had negative cash flow from operating activities in its most recently completed financial year ended January 31, 2015 and year to date through October 31, 2015. 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 17). 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 meet its debt obligations and to carry out its future oil and gas acquisition, exploration and development activities. The Company may also attempt to reach agreements with its creditors to change the payment terms or convert all or a portion of the debt obligations into equity in Terrace Energy or certain of its subsidiaries. As described in Note 10, the Company is not in compliance with the covenants of its Credit Facility and as a result the lender may exercise any and all remedies available under applicable law or otherwise to include a possible demand to repay a portion or all of the amounts outstanding under the agreement. If that were to occur, the Company will likely be unable to meet such demand with the liquidity resources available to satisfy such demand.

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 October 31, 2015.

	Level 1	Level 2	Level 3
Cash	$ 7,733,913	$ -	$ -
Credit facility	(26,597,523)	-	-
Convertible notes	(16,232,887)	-	-
	$ (35,096,497)	$ -	$ -

(Expressed in United States Dollars)

15. FINANCIAL INSTRUMENTS (Continued)

Classification of financial instruments (Continued)

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, 2015.

	Level 1	Level 2	Level 3
Cash	$ 26,494,024	$ -	$ -
Credit facility	(25,609,954)	-	-
Convertible notes	(13,661,789)	-	-
	$ (12,777,719)	$ -	$ -

16. CAPITAL DISCLOSURES

The Company considers its capital under management to be shareholders' equity, convertible notes and 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 October 31, 2015, the Company is not subject to any externally imposed capital requirements; however, the Credit Facility is subject to certain restrictions (see Note 10).

17. 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 $70,500 and $75,600 for the twelve months ended October 31, 2016 and 2017 respectively.

Total rent expense included in the condensed consolidated statements of operations and comprehensive loss for the period ended October 31, 2015 amounted to $134,735 (2014 - $115,643).

The Company is required to pay interest, calculated at 9% per annum, on outstanding Credit Facility balances at the end of each month (Note 10). The Credit Facility principal balance is also increased monthly by accrued PIK interest of 5% per annum. The principal including accrued PIK interest will be due upon maturity on May 31, 2018.

The Company is required to pay interest, calculated at 8% per annum, on outstanding convertible notes at the end of each fiscal quarter (Note 11). The Company has estimated that it must pay approximately CAD $800,000 each quarter subsequent to October 31, 2015 until the notes are converted or repaid.

The Company has interests in certain exploration and evaluation assets, which are subject to certain expenditure commitments (Notes 6 and 8).

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

(Expressed in United States Dollars)

17. COMMITMENTS AND CONTINGENCIES (Continued)

data is 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 is 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 development plans, timing and data requirements in light of the current commodity price environment. The Company has initiated discussions with the provider to restructure this agreement and eliminate any commitments to purchase additional data. There can be no assurances that these discussions will result in modifying the existing agreements, including the remaining commitments of the Company to purchase additional data.

During April 2015, the Company entered into agreements, 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 these agreements, the Company is 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 has disputed this declaration and has filed suit to enforce the liquidated damages clause of the agreement. The Company believes this suit to be without merit, has counter-sued, and is vigorously defending its position. Due to the early stage of this litigation, The Company is unable to estimate the ultimate outcome of the dispute or any amount of obligation that may arise due to this litigation.

18. 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:

	Period ended October 31, 2015	2014
Short-term compensation	$ 1,080,529	$ 982,176
Share-based payments	1,536	131,232
	$ 1,082,065	$ 1,113,408

Included in accounts receivable as at October 31, 2015 are advances to key management personnel totaling $47,562 January 31, 2015 - $47,562) for expenses incurred by the Company on their behalf.

At October 31, 2015, convertible notes held by key management personnel and their close family members totalled CAD $3,230,000 (January 31, 2015 - CAD $3,230,000). Interest paid these convertible notes totalled CAD $193,269 during the period (2014 - $152,140).

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

(Expressed in United States Dollars)

19. 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:

	October 31, 2015		
	USA	**Canada**	**Total**
Advances for future exploration	$ 177,433	$ -	$ 177,433
Exploration and evaluation assets	5,676,323	-	5,676,323
Property and equipment	21,128,009	104,732	21,232,741
Investment in partnership	10,941,479	-	10,941,479
	$ 37,923,244	$ 104,732	$ 38,027,976

	January 31, 2015		
	USA	**Canada**	**Total**
Advances for future exploration	$ 475,797	$ -	$ 475,797
Exploration and evaluation assets (Note 4)	3,967,983	-	3,967,983
Property and equipment (Note 4)	19,138,164	135,230	19,273,394
Investment in partnership	16,622,882	-	16,622,882
	$ 40,204,826	$ 135,230	$ 40,340,056

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

20. SUPPLEMENTAL CASH FLOW INFORMATION

During the nine months ended October 31, 2015, the Company:

a) transferred $6,697,535 from exploration and evaluation assets to property and equipment;

b) had accounts payable and accrued liabilities of $456,733 related to exploration and evaluation expenditures; and

c) paid $3,509,389 of interest, received $nil of interest and paid $nil income taxes.

During the nine months ended October 31, 2014, the Company:

a) transferred $1,591,757 from exploration and evaluation assets to property and equipment;

b) transferred $11,140 from equity reserves to capital stock on the exercise of warrants;

c) transferred $226,802 from the liability component of convertible notes and $16,052 from the equity component of convertible notes to capital stock on the conversion of convertible notes; and

d) had accounts payable and accrued liabilities of $674,721 related to exploration and evaluation expenditures.