TERRACE ENERGY CORP.
CONSOLIDATED FINANCIAL STATEMENTS
(Expressed in United States Dollars)

JANUARY 31, 2015 and 2014

SmytheRatcliffe
CHARTERED ACCOUNTANTS

INDEPENDENT AUDITORS' REPORT

TO THE SHAREHOLDERS OF TERRACE ENERGY CORP.

We have audited the accompanying consolidated financial statements of Terrace Energy Corp., which comprise the consolidated statements of financial position as at January 31, 2015 and 2014and the consolidated statements of operations and comprehensive loss, changes in shareholders' equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility
Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Terrace Energy Corp. as at January 31, 2015 and 2014, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board.

Smythe Ratcliffe LLP

Chartered Accountants

Vancouver, British Columbia
June 1, 2015

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TERRACE ENERGY CORP.
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
As at January 31
(Expressed in United States Dollars)

	2015	2014
ASSETS		
Current assets		
Cash	$ 26,494,024	$ 11,097,174
Accounts receivable (Notes 9 and 17)	1,482,629	1,939,538
Prepaids	268,875	135,361
Assets held for sale (Note 4)	1,762,845	10,000,000
Total current assets	30,008,373	23,172,073
Non-current assets		
Operators bond	25,000	25,000
Investment in partnership (Note 5)	16,622,882	16,966,553
Advances for future exploration (Notes 6 and 9)	475,797	87,152
Exploration and evaluation assets (Notes 7 and 9)	4,235,900	1,231,887
Property and equipment (Notes 8 and 9)	22,268,239	13,665,655
Total assets	$ 73,636,191	$ 55,148,320
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (Note 17)	$ 4,566,006	$ 1,063,367
Liabilities associated with assets held for sale (Note 4)	-	56,151
Total current liabilities	4,566,006	1,119,518
Non-current liabilities		
Credit facility (Note 9)	23,451,243	-
Convertible notes (Notes 10 and 17)	27,844,656	31,285,052
Decommissioning obligations (Note 11)	474,257	102,008
Total liabilities	56,336,162	32,506,578
Shareholders' equity		
Capital stock (Note 12)	47,416,203	27,421,256
Convertible notes – equity component (Note 10)	2,814,173	2,829,976
Stock options reserve (Note 12)	1,061,669	924,942
Warrants reserve (Note 12)	6,099	17,239
Translation reserve (Notes 2 and 5)	(1,380,307)	(448,289)
Deficit	(32,617,808)	(8,103,382)
Total shareholders’ equity	17,300,029	22,641,742
Total liabilities and shareholders’ equity	$ 73,636,191	$ 55,148,320

Approved on behalf of the Board:

“Eric Boehnke”	“William McCartney”
Eric Boehnke, Director	William McCartney, Director

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

TERRACE ENERGY CORP.
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
For the years ended January 31
(Expressed in United States Dollars)

	2015	2014
REVENUE		
Oil and gas sales	$ 6,725,471	$ 5,718,813
DIRECT OPERATING EXPENSES		
Production and operating	2,322,637	613,300
Depreciation and depletion (Note 8)	4,093,053	1,966,578
Operating income	309,781	3,138,935
Equity income (loss) in partnership (Note 5)	(5,608,528)	52,053
	(5,298,747)	3,190,988
GENERAL AND ADMINSTRATIVE EXPENSES		
Administrative	942,079	853,245
Financing (Note 13)	5,369,808	2,907,120
Foreign exchange gain	(4,965,318)	(570,213)
Impairment of assets held for sale (Note 4)	7,710,967	3,747,259
Impairment of exploration and evaluation assets (Note 7)	7,148,704	-
Investor relations	354,540	463,929
Professional	603,166	679,049
Salaries and benefits (Note 17)	1,718,236	965,859
Share-based payments (Notes 12 and 17)	136,727	426,293
Transfer agent and filing fees	108,000	98,969
Travel	88,770	194,970
	19,215,679	9,766,480
Net loss for the year	(24,514,426)	(6,575,492)
Other comprehensive loss		
Items that may be reclassified subsequently to profit or loss:		
Translation adjustment (Note 5)	(932,018)	(844,438)
Comprehensive loss for the year	$ (25,446,444)	$ (7,419,930)
Basic and diluted loss per share	$ (0.30)	$ (0.10)
Weighted average number of common shares outstanding	81,792,785	64,750,376

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

TERRACE ENERGY CORP.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Expressed in United States Dollars)

	Capital Stock		Convertible Notes – Equity	Stock Options	Warrants	Translation		Total Shareholders'
	Shares	Amount	Component	Reserve	Reserve	Reserve	Deficit	Equity
Balance – January 31, 2013	**63,069,321**	**$ 15,977,713**	**$ -**	**$ 638,649**	**$ 255,342**	**$ 396,149**	**$ (1,527,890)**	**$ 15,739,963**
Short form prospectus	4,935,000	9,923,661	-	-	-	-	-	9,923,661
Share issue costs	-	(917,055)	-	-	-	-	-	(917,055)
Convertible notes – equity component	-	-	2,912,679	-	-	-	-	2,912,679
Exercise of convertible notes	587,500	1,028,276	(82,703)	-	-	-	-	945,573
Exercise of warrants	5,762,500	1,030,558	-	-		-	-	1,030,558
Fair value of warrant exercises	-	238,103	-	-	(238,103)	-	-	-
Share-based payments	80,000	140,000	-	286,293	-		-	426,293
Translation adjustment	-	-	-	-	-	(844,438)	-	(844,438)
Net loss for the year	-	-	-	-	-	-	(6,575,492)	(6,575,492)
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	184,075	(15,803)	-	-	-	-	168,272
Exercise of warrants	850,000	138,429	-	-	-	-	-	138,429
Fair value of warrant exercises	-	11,140	-	-	(11,140)	-	-	-
Share-based payments	-	-	-	136,727	-	-	-	136,727
Translation adjustment	-	-	-	-	-	(932,018)	-	(932,018)
Net loss for the year	-	-	-	-	-	-	(24,514,426)	(24,514,426)
Balance – January 31, 2015	**87,844,821**	**$ 47,416,203**	**$ 2,814,173**	**$ 1,061,669**	**$ 6,099**	**$(1,380,307)**	**$(32,617,808)**	**$ 17,300,029**

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

TERRACE ENERGY CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Expressed in United States Dollars)
For the years ended January 31

	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss for the year	$ (24,514,426)	$ (6,575,492)
Items not involving cash:		
Accretion of convertible notes	599,305	530,462
Accretion of decommissioning obligations	14,296	1,745
Depreciation and depletion	4,093,053	1,966,578
Equity loss (income) in partnership	5,608,528	(52,053)
Share-based payments	136,727	426,293
Impairment of assets held for sale	7,710,967	3,747,259
Non-cash interest expense	889,961	-
Impairment of exploration and evaluation assets	7,148,704	-
Unrealized gain on foreign exchange	(5,053,543)	(1,495,371)
Changes in non-cash working capital items:		
Accounts receivable	456,908	(612,027)
Prepaids	(133,513)	(85,332)
Accounts payable and accrued liabilities	1,717,150	851,690
Net cash used in operating activities	(1,325,883)	(1,296,248)
CASH FLOWS FROM INVESTING ACTIVITIES		
Exploration and evaluation expenditures	(19,734,160)	(20,013,804)
Advances for future exploration	(388,645)	-
Acquisition of property and equipment	(27,976)	(259,763)
Investment in partnership	(5,288,000)	(15,629,867)
Net cash used in investing activities	(25,438,781)	(35,903,434)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from issuance of shares	19,661,303	9,006,606
Proceeds from credit facility (net of transaction cost)	22,561,884	-
Exercise of warrants	138,429	1,030,558
Net proceeds from issuance of convertible notes	-	36,770,203
Net cash provided by financing activities	42,361,616	46,807,367
Foreign exchange effect on cash	(200,102)	(183,960)
Change in cash for the year	15,396,850	9,423,725
Cash, beginning of the year	11,097,174	1,673,449
Cash, end of the year	$ 26,494,024	$ 11,097,174

Supplemental cash flow information (Note 19)

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

1. NATURE OF OPERATIONS

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 unconventional 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”.

These consolidated financial statements have been prepared on a going concern basis, which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business. The Company has 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 consolidated 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 consolidated financial have been prepared in accordance with International Financial Reporting Standards (“IFRS”), as issued by the International Accounting Standards Board (“IASB”).

The Board of Directors approved the audited consolidated financial statements on June 1, 2015.

Basis of measurement

These 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 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 and certain of its subsidiaries is the Canadian dollar (“CAD”), as it is presently reliant upon the Canadian capital markets to fund its activities. However, these consolidated financial statements are presented in United States dollars (“USD”), as substantially all of the Company’s assets and operations are situated in the USA. Assets and liabilities are translated into the presentation currency using the exchange rate in effect on the consolidated statement of financial position date, shareholders’ equity accounts are translated into the presentation currency using the historical exchange rate, and revenues and expenses are translated at the average rate for the period, which approximates the exchange rate in effect on the transaction date. Exchange gains and losses on translation are included as a separate component in shareholders' equity as “translation reserve”.

3. SIGNIFICANT ACCOUNTING POLICIES

Use of judgments and estimates

The preparation of consolidated 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.

Critical accounting judgments

Reserves

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

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.

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of judgments and estimates (Continued)

Critical accounting judgments (Continued)

Assets held for sale

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

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.

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.

Critical accounting estimates

Accounts receivable

Accounts receivable are recorded at the estimated recoverable amount, which involves the estimate of uncollectible accounts.

Decommissioning obligations

Decommissioning costs will be incurred by the Company many years into the future. Amounts recorded for decommissioning obligations require the use of management's best estimates of future decommissioning expenditures, expected timing of expenditures and future inflation rates. The estimates are based on internal and third party information and calculations are subject to changes in laws and regulations, public expectations, prices, discovery and analysis of site conditions, and changes in clean up technology. Actual costs and outflows can differ from estimates and may have a material impact on earnings or financial position. For more information on the Company's decommissioning obligations see Note 11.

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of judgments and estimates (Continued)

Critical accounting estimates (Continued)

Share-based payments

The fair value of share-based payments is subject to the limitations of the Black-Scholes option pricing model that incorporates market data and involves uncertainty in estimates used by management in the assumptions. Because the Black-Scholes option pricing model requires the input of highly subjective assumptions, including the volatility of share prices, changes in subjective input assumptions can materially affect the fair value estimate.

Income taxes

Related assets and liabilities are recognized for the estimated tax consequences between amounts included in the financial statements and their tax base using substantively enacted future income tax rates. Timing of future revenue streams and future capital spending changes can affect the timing of any temporary differences, and accordingly, affect the amount of the deferred tax asset or liability calculated at a point in time. These differences could materially impact earnings.

Principles of consolidation

The 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%

Financial instruments

All financial instruments are classified as one of the following: held-to-maturity, loans and receivables, fair value through profit or loss (“FVTPL”), available-for-sale or other financial liabilities. Financial assets and liabilities at FVTPL are measured at fair value with gains and losses recognized in profit or loss. Financial assets held-to-maturity, loans and receivables, and other financial liabilities are measured at amortized cost using the effective interest method. Available-for-sale instruments are measured at fair value with unrealized gains and losses recognized in other comprehensive loss and reported in shareholders’ equity.

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

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Financial instruments (Continued)

Fair value hierarchy

Fair value measurements of financial instruments are required to be classified using a fair value hierarchy that reflects the significance of inputs in making the measurements. The levels of the fair value hierarchy are defined as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities.
Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
Level 3 – Inputs for the asset or liability that are not based on observable market data.

Foreign currency translation

Transactions denominated in foreign currencies are translated to the respective functional currencies of the Company's entities at exchange rates in effect at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated to the functional currency at the exchange rate prevailing at that date.

Non-monetary assets and liabilities that are measured at fair value in a foreign currency are translated to the functional currency at the exchange rate prevailing as the date of the transaction. Non-monetary items that are measured based on historical cost are translated using the exchange rate in effect at the date of the translation

Foreign currency differences arising on translation are recognized in profit or loss.

Property and equipment and exploration and evaluation assets

Pre-exploration expenditures ("project investigation costs")

Expenditures made by the Company before acquiring the legal right to explore in a specific area do not meet the definition of an asset, and therefore are expensed by the Company as incurred.

Exploration and evaluation expenditures

Costs incurred once the legal right to explore has been acquired are capitalized as exploration and evaluation assets. These assets include, but are not limited to, exploration license expenditures, leasehold property acquisition costs, evaluation costs, including drilling costs directly attributable to an identifiable well and directly attributable general and administrative costs. These costs are accumulated in cost centers by property and are not subject to depletion until technical feasibility and commercial viability has been determined.

Exploration and evaluation assets are assessed for impairment when facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

The technical feasibility and commercial viability of extracting petroleum resources is considered to be determinable when proved and probable reserves are determined to exist. A review of each exploration license or field is carried out, at least annually, to ascertain whether proved and probable reserves have been discovered. Upon determination of proved and probable reserves, exploration and evaluation assets attributable to these reserves are tested for impairment and reclassified to oil and gas properties.

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property and equipment and exploration and evaluation assets (Continued)

Development and production costs

Items of property and equipment, which include oil and gas development and production assets, are measured at cost less accumulated depletion and depreciation and accumulated impairment losses.

Gains and losses on disposal of an item of property and equipment, including oil and gas properties, are determined by comparing the proceeds from disposal with the carrying amount of property and equipment and are recognized in profit or loss.

Subsequent costs

Costs incurred subsequent to the determination of technical feasibility and commercial viability and the costs of replacing parts of property and equipment are recognized as oil and gas properties only when they increase the future economic benefits embodied in the specific asset to which they relate. All other expenditures are recognized in profit or loss as incurred. Such capitalized expenditures generally represent costs incurred in developing proved and/or probable reserves and bringing in or enhancing production from such reserves, and are accumulated on a field or geotechnical area basis. The carrying amount of a replaced or sold component is derecognized. The costs of the day-to-day servicing of property and equipment are recognized in profit or loss as incurred.

Depletion and depreciation

Depletion of oil and gas properties is determined using the unit-of-production method based on production volumes in relation to total estimated proved developed reserves as determined annually by independent engineers and determined in accordance with NI 51-101. Natural gas reserves and production are converted at the energy equivalent of six thousand cubic feet to one barrel of oil.

The calculation of depletion and depreciation of production equipment is based on total capitalized costs less the estimated net realizable value of production equipment and facilities after the proved developed reserves are fully depleted.

Proved developed reserves are estimated using independent reserve engineer reports and represent the estimated quantities of crude oil, natural gas and natural gas liquids, which geological, geophysical and engineering data demonstrate with a 90% degree of certainty to be recoverable in future years from known proved developed reservoirs and which are considered commercially producible.

Such reserves may be considered commercially producible if management has the intention of developing and producing them. Such intention is based upon:

- A reasonable assessment of the future economics of such production;
- A reasonable expectation that there is a market for all or substantially all of the expected oil and gas production; and
- Evidence that the necessary production, transmission and transportation facilities are available or can be made available.

Reserves may only be considered proved developed if supported by actual production. The area of reservoir considered proved is that portion delineated by drilling and defined as oil and/or oil-water contacts, if any, or both. In the absence of information on fluid contacts, the lowest known structural occurrence of oil and gas controls the lower proved limit of the reservoir.

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property and equipment and exploration and evaluation assets (Continued)

Depletion and depreciation (Continued)

Depreciation of other equipment is provided for on a 14% to 20% straight-line basis. Depreciation methods, useful lives and residual values are reviewed at each reporting date.

Assets held for sale

Non-current assets, or disposal groups consisting of assets and liabilities, are classified as held-for-sale if their carrying amounts will be recovered through a sale transaction rather than through continuing use. This condition is met when the sale is highly probable and the asset is available for immediate sale in its present condition.

Non-current assets classified as held-for-sale are measured at the lower of the carrying amount and fair value less costs of disposal, with impairments recognized in profit or loss in the period measured. Non-current assets and disposal groups held-for-sale are presented in current assets and liabilities within the consolidated statements of financial position. Assets held-for-sale are not depreciated, depleted or amortized.

Impairment

Exploration and evaluation assets are assessed for impairment when they are reclassified to developing and producing assets, as oil and gas properties, and also if facts and circumstances suggest that the carrying amount exceeds the recoverable amount.

Exploration and evaluation assets are grouped together with the Company's CGUs when they are assessed for impairment, both at the time of any triggering facts and circumstances as well as upon their eventual reclassification to producing assets (oil and gas properties).

An impairment loss is recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in profit or loss. Impairment losses recognized in respect of CGUs are allocated first to reduce the carrying amount of goodwill, if any, allocated to the units and then to reduce carrying amounts of other assets in the unit (group of units) on a pro rata basis.

Fair value less costs to sell is determined to be the amount for which the asset could be sold in an arm's length transaction. Fair value less costs to sell can be determined by using an observable market or by using discounted future net cash flows of proved and probable reserves using forecasted prices and costs. Value in use is determined by estimating the present value of the future net cash flows expected to be derived from the continued use of the asset or CGU.

Impairment losses recognized in prior years are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of accumulated depletion and depreciation or amortization, if no impairment loss had been recognized.

Investment in partnership

The Company considers the investment in the partnership a joint venture, and accordingly accounts its investment using the equity method. Under the equity method, the investment is initially recorded at cost and the carrying value is adjusted thereafter to reflect the Company’s pro rata share of income or loss of the equity accounted investment. The Company’s share of net income or loss is included in the consolidated statements of operations and comprehensive loss as equity income (loss) in partnership.

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Decommissioning obligations

Decommissioning costs will be incurred by the Company many years into the future. Amounts recorded for decommissioning obligations require the use of management's best estimates of future decommissioning expenditures, expected timing of expenditures and future inflation rates. The estimates are based on internal and third party information and calculations are subject to changes in laws and regulations, public expectations, prices, discovery and analysis of site conditions, and changes in clean-up technology. Actual costs and outflows can differ from estimates and may have a material impact on earnings or financial position.

Convertible notes

The liability component of convertible notes is recognized initially at the fair value of a similar liability that does not have a conversion option. The equity component is recognized initially as the difference between the fair value of the convertible debenture as a whole and the fair value of the liability component. Transaction costs are allocated to the liability and equity components in proportion to their initial carrying amounts. Subsequent to initial recognition, the liability component of the convertible note is measured at amortized cost using the effective interest method. The equity component is not re-measured subsequent to initial recognition.

Share-based payments

Stock options and restricted share units ("RSUs") granted to employees are measured at the fair value of the instruments issued and recognized over the vesting periods. Share-based payments to non-employees are measured at the fair value of the goods or services received or the fair value of the equity instruments issued, if it is determined the fair value of the goods or services cannot be reliably measured, and are recorded at the date the goods or services are received. The offset to the recorded cost is to stock options reserve. Consideration received on the exercise of stock options is recorded as capital stock and the related amount originally recorded in stock options reserve is transferred to capital stock. Upon expiry, related fair value calculated is transferred from stock options reserve to deficit.

Income taxes

The Company uses the liability method for accounting for income taxes. Under this method of tax allocation, deferred income tax assets and liabilities are determined based on differences between the financial statement carrying values and their respective income tax basis (temporary differences). Deferred income tax assets and liabilities are measured using the tax rates expected to be in effect when the temporary differences are likely to reverse. The effect on deferred income tax assets and liabilities of a change in tax rates is included in the statement of operations in the year in which the change is enacted or substantively enacted. Deferred income tax assets are recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred income tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

Capital stock

Proceeds from the issue of units is allocated between common shares and share purchase warrants on a relative fair value basis, based on the fair value of common shares being the market value on the date of announcement of the placement and the value of share purchase warrants, as determined using the Black-Scholes option pricing model.

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basic and diluted loss per share

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

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

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

Revenue recognition

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 costs 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.

Joint interest operations

Some of the Company's oil and gas exploration and production activities are conducted jointly with others, and accordingly, the consolidated financial statements reflect only the Company's proportionate interest in such activities.

New accounting standards

Effective February 1, 2014, the Company adopted the following:

(i) Amendment to IAS 36 *Impairment of Assets*, requires additional disclosure on the recoverable amounts of an impaired CGU. The adoption of this amendment had no impact on the amounts recorded in the consolidated financial statements for the year ended January 31, 2015 or on the comparative periods

(ii) IFRIC 21 *Levies*, clarifies the requirements for recognizing a liability for a levy imposed by a government. The adoption of this standard had no impact on the amounts recorded in the financial statements for the year ended January 31, 2015 or on the comparative periods.

3. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Accounting standards that will become effective in future periods

The IASB or IFRIC have issued pronouncements effective for accounting periods beginning on or after January 1, 2015. Only those that may significantly impact the Company are discussed below:

IFRS 9 *Financial Instruments* (2014)

IFRS 9 contains accounting requirements for financial instruments and replacing IAS 39 *Financial Instruments: Recognition and Measurement*. The standard contains requirements in the following areas:

- Classification and measurement. Financial assets are classified by reference to the business model within which they are held and their contractual cash flow characteristics. The 2014 chapter of IFRS 9 introduces a "fair value through other comprehensive income" category for certain debt instruments. Financial liabilities are classified in a similar manner to under IAS 39; however, there are differences in the requirements applying to the measurement of an entity's own credit risk.
- Impairment. The 2014 chapter of IFRS 9 introduces an "expected credit loss" model for the measurement of the impairment of financial assets, so it is no longer necessary for a credit event to have occurred before a credit loss is recognized.
- Hedge accounting. Introduces a new hedge accounting model that is designed to be more closely aligned with how entities undertake risk management activities when hedging financial and non-financial risk exposures.
- Derecognition. The requirements for the derecognition of financial assets and liabilities are carried forward from IAS 39.

Applicable to annual periods beginning on or after January 1, 2018. The Company has not assessed the impact of this pronouncement.

IFRS 15 *Revenue from Contracts with Customers*

IFRS 15 provides a single, principles based five-step model to be applied to all contracts with customers.

The five steps in the model are as follows:

- Identify the contract with the customer
- Identify the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contracts
- Recognize revenue when (or as) the entity satisfies a performance obligation.

Guidance is provided on topics such as the point in which revenue is recognized, accounting for variable consideration, costs of fulfilling and obtaining a contract and various related matters. New disclosures about revenue are also introduced.

IFRS 15 is effective for annual periods beginning January 1, 2017, however on May 19, 2015 the IASB released an exposure draft for comment suggesting deferral of this effective date by one year to January 1, 2018. The Company has not assessed the impact of this pronouncement.

(Expressed in United States Dollars)

4. ASSETS HELD FOR SALE

During the year ended January 31, 2014, the Company funded all of the costs necessary and was assigned its working interests in the properties that comprise the Cutlass Eagle Ford Development Project. Upon completing a project review, management determined that the project was no longer a core asset and decided to solicit bids from prospective purchasers.

As the proposed sale met the definition of "assets held for sale" under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, as of January 31, 2014 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" and "liabilities associated with assets held for sale". The Company is required to recognize assets held for resale at the lower of their carrying value and fair value less costs to sell. Management has determined that the carrying value of the project exceeded its fair value, and therefore recognized an impairment charge of $3,747,259 in the year ended January 31, 2014.

Balance, January 31, 2013		
Assets reclassified from		
Exploration and evaluation assets (Note 7)	$	4,513,121
Property and equipment (Note 8)		8,974,564
Less: Accumulated depreciation and depletion(Note 8)		(81,833)
Advances for future exploration (Note 6)		341,407
Impairment		(3,747,259)
Balance, January 31, 2014	$	10,000,000

In August, 2014, the project operator made a claim that the Company did not meet its obligations and demanded it reassign its interests in the leases. The Company denied the claim as unfounded and without merit. This matter was not resolved and the property had not been sold as of the end of the third fiscal quarter and, accordingly, at October 31, 2014, the Company reclassified the assets back to the appropriate financial position classifications due to the difficulty the Company experienced in marketing the sale of its interest in the project. As of October 31, 2014, the Company recorded additional depletion expense of $1,372,906 to reflect the depletion that would have been recorded had the Cutlass assets not been classified as assets held for sale.

Balance January 31, 2014	$	10,000,000
Changes during the year		
Recovery of advances, net		341,407
Effect of foreign exchange		384,877
Assets held for sale prior to reclassification		10,726,284
Depreciation and depletion (November 1, 2013 to October 31, 2014)		(1,372,906)
Impairment as of October 31, 2014		(1,559,054)
Reclassified to		
Exploration and evaluation assets (Note 7)		(3,094,834)
Property and equipment (Note 8)		(6,154,229)
Accumulated depreciation and depletion (Note 8)		1,454,739
Balance October 31, 2014	$	-

(Expressed in United States Dollars)

4. ASSETS HELD FOR SALE (Continued)

In April 2015, the litigation was settled and the Company's interest in the acreage was affirmed. As a condition of settlement, the Company agreed to use its best efforts to sell the project. Accordingly, the Company has reclassified the assets and liabilities associated with the Company's interests in the project from their respective financial position classifications to "assets held for sale". Management has evaluated the expected fair value less costs to sell and determined that it is lower than the carrying value and therefore recognized a further impairment charge of $7,710,967 during the year ended January 31, 2015. The fair value less costs to sell was based on an offer to purchase the asset and categorized in Level 3 of the fair value hierarchy. Based on these factors, assets held for sale have been remeasured at $1,762,845 as of January 31, 2015, being the lower of carrying value and fair value less costs to sell.

In accordance with IFRS 5, the assets and liabilities associated with the Company’s interests in Cutlass have been reclassified from their respective financial position classifications to “assets held for sale” as follows:

Assets reclassified 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 January 31, 2015	$	1,762,845

During the year ended January 31, 2015, the project generated operating income of $615,069 (2014 - $451,102), comprising revenues and expenses of $1,432,061 and $816,992 (2014 - $650,055 and $198,953), respectively.

5. INVESTMENT IN PARTNERSHIP

The Company and its partner, BlackBrush Oil & Gas, LP ("BlackBrush") organized a special purpose limited partnership, the BlackBrush Terrace LP (the "BTLP"), to acquire a 50% 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

(Expressed in United States Dollars)

5. INVESTMENT IN PARTNERSHIP (Continued)

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.

During the year ended January 31, 2015, the BTLP successfully renegotiated the drilling obligations under the farm-out agreement predominantly to amend the required targets and timing of future wells necessary to fulfill the remaining earning requirements. Under the revised agreement, the BTLP has the flexibility to choose locations, set objectives and govern timing of operations under a blanket requirement to spend $25 million per year ($12.5 million net to Terrace) commencing January 1, 2015 until the total required drilling carry of $104 million has been spent. Prior to January 1, 2015, the BTLP has spent approximately $32 million towards this obligation. The BTLP is obligated to pay liquidated damages equal to $2 million ($1 million net to Terrace) in the event that the minimum expenditure is not met in any given year. The BTLP is currently in discussions with Shell Oil to reduce the amount required to be funded during 2015. There can be no assurances that the BTLP will be successful in negotiating the reduction of such 2015 expenditure requirements.

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. 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 $16,622,882 at January 31, 2015 (2014 - $16,966,553), which includes $22,179,357 (2014 - $16,914,500) 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 $5,556,475 (2014 - $52,053 net income) of which approximately $4,631,405 of the loss was attributable to impairment.

Summary of financial information of the BTLP

As at January 31,		**2015**		**2014**
Assets				
Cash	$	2,271,756	$	35,393
Other current assets		91,034		104,390
Property and equipment		38,600,324		35,127,396
	$	40,963,114	$	35,267,179
Liabilities				
Current liabilities	$	6,990,747	$	1,306,171
Decommissioning obligations		538,327		27,902
Deferred income tax liability		188,276		-
	$	7,717,350	$	1,334,073

(Expressed in United States Dollars)

5. INVESTMENT IN PARTNERSHIP (Continued)

Summary of financial information of the BTLP (Continued)

For the year ended January 31	**2015**	**2014**
Revenue	$ 299,626	$ 480,081
Direct operating costs		
Production and operating	242,012	138,506
Depreciation and depletion	1,555,017	181,118
Operating income (loss)	(1,497,403)	160,457
Other expenses	220,037	56,400
Accretion	48,814	-
Impairment	9,262,810	-
Income (loss) before income taxes	(11,029,064)	104,057
Deferred income tax expense	188,276	-
Net income (loss) and comprehensive income (loss) for the year	$(11,217,340)	$ 104,057

The BTLP has a fiscal year-end of December 31. Adjustments for material transactions between December 31, 2014 and January 31, 2015 have been made to adjust for the non-coterminous year-ends.

The Company has recasted comparative information as at January 31, 2014 for the investment in partnership, to present the functional currency of BTLP as USD. As a result, the investment in partnership and translation reserve increased by $1,284,633. The recast of comparative information had no impact on cash flows and net loss, except for comprehensive loss. The investment arose during the year ended January 31, 2014; accordingly there was no impact to the consolidated financial statements for the year ended January 31, 2013.

6. 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 $475,797 at January 31, 2015 (2014 - $428,559 of which $341,407 was reclassified to assets held for sale).

(Expressed in United States Dollars)

7. EXPLORATION AND EVALUATION ASSETS

	Big Wells	STS Olmos	Cutlass	Total
Balance -January 31, 2013	**$ -**	**$ 970,939**	**$ 5,766,100**	**$ 6,737,039**
Acquisition costs	-	497,430	1,670,281	2,167,711
Exploration and evaluation	-	10,302,922	7,269,863	17,572,785
Transfer to property and equipment	-	(10,353,308)	(9,784,136)	(20,137,444)
Expenditures during the year	-	447,044	(843,992)	(396,948)
Effect of changes in foreign exchange rates	-	(186,096)	(408,987)	(595,083)
Reclassified to assets held for sale (Note 4)	-	-	(4,513,121)	(4,513,121)
	-	(186,096)	(4,922,108)	(5,108,204)
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
Reclassified from assets held for sale (Note 4)	-	-	3,094,834	3,094,834
Impairment charge	(6,656,569)	(492,135)	-	(7,148,704)
Reclassified to assets held for sale (Note 4)	-	-	(3,094,834)	(3,094,834)
Effect of changes in foreign exchange rates	(1,075,654)	(18,494)	-	(1,094,148)
	(7,732,223)	(510,629)	-	(8,242,852)
Balance - January 31, 2015	**$ 1,361,439**	**$ 2,874,461**	**$ -**	**$ 4,235,900**

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 year ended January 31, 2015, $10,216,633 (2014 - $20,137,444) 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.

(Expressed in United States Dollars)

8. PROPERTY AND EQUIPMENT

Cost	**Other Equipment**	**Leaseholds**	**Oil and Gas**	**Total**
Balance – January 31, 2013	**$ 63,597**	**$ -**	**$ 6,828,215**	**$ 6,891,812**
Additions	121,725	138,038	-	259,763
Transfer from exploration and evaluation	-	-	20,137,444	20,137,444
Change in value of decommissioning obligations	-	-	99,605	99,605
Expenditures during the year	121,725	138,038	20,237,049	20,496,812
Effect of changes in foreign exchange rates	(21,415)	(8,932)	(2,178,940)	(2,209,287)
Reclassified to assets held for sale (Note 4)	-	-	(8,974,564)	(8,974,564)
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)	-	52,484	12,351
Reclassified to assets held for sale (Note 4)	-	-	(6,154,229)	(6,154,229)
Balance – January 31, 2015	**$ 151,750**	**$ 129,106**	**$ 26,518,411**	**$26,799,267**
Accumulated depreciation and depletion				
Balance – January 31, 2013	**$ 11,274**	**$ -**	**$ 833,010**	**$ 844,284**
Charge for year	25,390	14,336	1,926,852	1,966,578
Effect of changes in foreign exchange rates	(4,676)	(536)	(184,699)	(189,911)
Reclassified to assets held for sale (Note 4)	-	-	(81,833)	(81,833)
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)	(1,998,414)	(2,013,348)
Balance – January 31, 2015	**$ 73,085**	**$ 33,842**	**$ 4,424,101**	**$ 4,531,028**
Net book value				
Balance – January 31, 2014	**$ 131,919**	**$ 115,306**	**$ 13,418,430**	**$13,665,655**
Balance – January 31, 2015	**$ 78,665**	**$ 95,264**	**$ 22,094,310**	**$22,268,239**

9. 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 STS, 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 is $75 million, of which $50 million was available to be drawn at the Company’s discretion. The 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)

9. 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

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 January 31, 2015, the Company had $14,392,294 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. Finally, the Company has agreed to advance to Terrace STS any proceeds received from the sale of the Cutlass oil and gas assets. The following assets of Terrace STS were pledged at January 31, 2015:

Cash	$	14,392,294
Accounts receivable		944,912
Advances for future exploration		475,797
Property and equipment		22,094,310
Exploration and evaluation assets		2,874,461
	$	40,781,774

10. 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.

(Expressed in United States Dollars)

10. CONVERTIBLE NOTES (Continued)

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, 2014 by offering cash equal to 1.08 multiplied by the principal amount that is called for redemption, and 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 January 31, 2015, CAD $38,590,000 (2014 - CAD $38,825,000) of the New Notes were outstanding and convertible into 19,295,000 (2014 - 19,412,500) common shares.

The liability component of the convertible debentures was recognized initially at the fair value of a similar liability that does not have an equity conversion option, which was calculated based on the application of a market interest rate of 10% and an effective rate of 11%. The difference between the CAD $40,000,000 face value of the debentures and the fair value of the liability component was recognized in equity. Transaction costs directly attributable to the offering of $1,625,283 were allocated to the liability and equity components of the debentures proportionately at $1,498,118 and $127,165, respectively. The discount on the debentures is being accreted such that the liability component will equal the face value of the debentures at maturity.

The following table reconciles the fair value of the convertible debentures on initial recognition to the carrying amount at January 31, 2015 and 2014:

	Liability	Equity	Total
Subscription proceeds	$ 35,355,642	$ 3,039,844	$ 38,395,486
Transaction costs	(1,498,118)	(127,165)	(1,625,283)
Net accretion of discount	530,462	-	530,462
Conversion to common shares	(945,573)	(82,703)	(1,028,276)
Effect of changes in foreign exchange rates	(2,157,361)	-	(2,157,361)
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**

(Expressed in United States Dollars)

11. 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.

	2015	2014
Balance, beginning of the year	$ 102,008	$ 8,016
Change in value of decommissioning obligations	337,534	92,247
Accretion expense	14,296	1,745
Effect of changes in foreign exchange rates	20,419	-
Balance, end of the year	$ 474,257	$ 102,008

12. CAPITAL STOCK

The Company has unlimited authorized common shares without par value. At January 31, 2015, the Company has 87,844,321 (2014 - 74,434,321) shares outstanding.

Share issues

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.

During the year ended January 31, 2014, the Company issued:

d) 80,000 common shares with a fair value of $140,000 as partial compensation to the Chief Executive Officer ("CEO") and President of the Company.

e) 587,500 common shares on the conversion of CAD $1,175,000 convertible notes.

f) 5,762,500 common shares for proceeds of CAD $1,037,250 on the exercise of 5,762,500 warrants at an exercise price of CAD $0.18 per warrant.

g) 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.

12. CAPITAL STOCK (Continued)

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 issued 1,200,000 RSUs with a grant date fair value of CAD $2,991,500 based on the stock price at the time of the grant. Each RSU, upon vesting, gives the holder the right to receive one common share. Unless otherwise approved by the Company's Board of Directors, all of the RSUs will vest upon the occurrence of a "change of control transaction", as such term is defined in the RSU award agreements. In the absence of a change of control transaction or other acceleration of vesting by the Company’s Board of Directors, unvested RSUs will expire 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 January 31, 2015, there are no contemplated transactions that would give rise to vesting; therefore, no compensation expense has been recognized.

Convertible notes

As at January 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 January 31, 2014, the Company had issued and outstanding convertible notes with a face value of CAD $38,825,000 convertible into 19,412,500 common shares (Note 10).

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 $136,727 for the year ended January 31, 2015 (2014 - $286,293) with a corresponding credit to reserves. These amounts represent the value of options vested during the years.

(Expressed in United States Dollars)

12. CAPITAL STOCK (Continued)

Outstanding stock options and warrants

Stock option transactions and the number of stock options outstanding as at January 31, 2015 are summarized as follows:

Number of Options	Number of Options Exercisable	Exercise Price (CAD)	Expiry Date	Weighted Average Remaining Contractual Life (Years)
100,000	100,000	$ 0.53	June 30, 2015	0.41
1,650,000	1,650,000	$ 0.12	June 22, 2016	1.39
250,000	250,000	$ 0.19	July 15, 2016	1.45
250,000	250,000	$ 0.21	September 16, 2016	1.60
250,000	250,000	$ 0.19	October 18, 2016	1.71
250,000	250,000	$ 0.67	December 16, 2016	1.88
150,000	127,500	$ 1.35	July 8, 2017	2.44
2,900,000	2,877,500			1.50

The weighted average exercise price of the outstanding stock options at January 31, 2015 is CAD $0.27 (2014 - CAD $0.27). There have been no stock options granted, expired, forfeited during year ended January 31, 2014 and 2015.

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, 2013	7,112,500	$ 0.18	June 21, 2016
Exercised	(5,762,500)	$ 0.18	
Balance – January 31, 2014	1,350,000	$ 0.18	June 21, 2016
Exercised	(850,000)	$ 0.18	
Balance – January 31, 2015	500,000	$ 0.18	June 21, 2016

13. FINANCING EXPENSES

	2015	2014
Interest expense	$ 3,927,879	$ 2,394,752
Accretion of convertible notes	537,672	510,623
Accretion of decommissioning obligations	14,296	1,745
Amortization of financing costs	280,006	-
PIK interest	609,955	-
Total	$ 5,369,808	$ 2,907,120

14. 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 consists primarily of trade receivables outstanding from operators of its oil and gas interests. To mitigate this risk, the Company regularly reviews the collectability of accounts receivable to ensure there is no indication that these amounts will not be fully recoverable. The Company has no balances past due or impaired.

Market risk

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

(i) Interest rate risk

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

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

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

(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 and its subsidiaries functional currency is CAD and transaction 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.

(Expressed in United States Dollars)

14. FINANCIAL INSTRUMENTS (Continued)

Market risk (Continued)

(ii) Foreign currency risk (Continued)

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

	2015 (USD)	2014 (USD)
Cash	$ 25,251,968	$ 8,595,184
Accounts receivable	1,439,871	1,856,863
Operators bond	25,000	25,000
Accounts payable and accrued liabilities	(4,530,587)	(223,073)
Liabilities associated with assets held for sale		(56,151)
Credit facility	(25,609,954)	
Net	$ (3,423,702)	$ 10,197,823

Based on the above net exposure as at January 31, 2015, a 5% change in the Canadian/US exchange rate would impact the Company's net loss and comprehensive loss by approximately $171,185 (2014 - $509,891).

(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 January 31, 2015, the Company had cash of $26,494,024, accounts receivable of $1,482,629, current liabilities of $4,566,006, amounts outstanding under the Credit Facility of $25,609,954 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.

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.

(Expressed in United States Dollars)

14. FINANCIAL INSTRUMENTS (Continued)

Classification of financial instruments

The following table sets forth the Company's financial assets and financial liabilities measured at fair value by level within the fair value hierarchy as at January 31, 2015.

	Level 1	Level 2	Level 3
Cash	$ 26,494,024	$ -	$ -
Credit facility	(25,609,954)	-	-
Convertible notes	-	-	(30,358,753)
	$ 884,070	$ -	$ (30,358,753)

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, 2014.

	Level 1	Level 2	Level 3
Cash	$ 11,097,174	$ -	$ -
Convertible notes	-	-	(34,857,085)
	$ 11,097,174	$ -	$ (34,857,085)

15. 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, 2014. As at January 31, 2015, the Company is not subject to any externally imposed capital requirements; however, the Credit Facility is subject to certain restrictions (see Note 9).

16. COMMITMENTS

The Company has a commitment to make monthly rental payments pursuant to an office rental agreement in Houston, Texas. The agreement expires June 30, 2015 and will require total payments of $89,337 until the expiry date.

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 $68,824 in years one and two; CAD $72,511 in years three, four and five; and CAD $76,198 in years six and seven.

Total rent expense included in the consolidated statements of operations and comprehensive loss for the year ended January 31, 2015 amounted to $161,652 (2014 - $141,142).

The Company is required to pay interest, calculated at 8% per annum, on outstanding convertible notes at the end of each fiscal quarter (Note 10). The Company has estimated that it must pay approximately CAD $800,000 each quarter subsequent to January 31, 2015 until the notes are converted or repaid.

(Expressed in United States Dollars)

16. COMMITMENTS (Continued)

The Company has interests in certain exploration and evaluation assets, which are subject to certain expenditure commitments (Notes 5 and 7).

During the year, 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. 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.

17. 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:

	2015	2014
Short-term compensation	$ 1,344,253	$ 902,920
Share-based payments	136,717	214,705
	$ 1,480,970	$ 1,117,625

During the year ended January 31, 2014, the Company paid a bonus of $300,000 to its CEO in respect of activities carried out in the Company's previous fiscal year. Included in the $300,000 is 80,000 (2013 - nil) common shares with a fair value at the date of grant of $140,000 as partial payment of the bonus, included in share-based payments, and the balance of $160,000 was paid in cash, included in short-term compensation above.

a) Included in accounts receivable as at January 31, 2015 are advances to key management personnel totalling $47,562 (2014 - $47,562) for expenses incurred by the Company on their behalf.

b) Included in accounts payable and accrued liabilities as at January 31, 2015 are amounts payable to key management personnel totalling $13,602 (2014 - $7,870).

c) At January 31, 2015, convertible notes held by key management personnel and their close family members totalled CAD $3,230,000 (2014 - CAD $3,090,000). Interest paid these convertible notes totalled $248,717.

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

(Expressed in United States Dollars)

18. 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:

	2015		
	USA	**Canada**	**Total**
Advances for future exploration	$ 475,797	$ -	$ 475,797
Exploration and evaluation assets	6,674,276	-	6,674,276
Property and equipment	19,694,633	135,230	19,829,863
Investment in partnership	13,302,094	-	13,302,094
	$ 40,146,800	$ 135,230	$ 40,282,030

	2014		
	USA	**Canada**	**Total**
Advances for future exploration	$ 87,152	$ -	$ 87,152
Exploration and evaluation assets	1,231,887	-	1,231,887
Property and equipment	13,418,400	247,255	13,665,655
Investment in partnership	15,681,920	-	15,681,920
	$ 30,419,359	$ 247,255	$ 30,666,614

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

19. SUPPLEMENTAL CASH FLOW INFORMATION

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

a) transferred $10,216,633 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 $168,272 from the liability component of convertible notes and $15,803 from the equity component of convertible notes to capital stock on the conversion of convertible notes;

d) had accounts payable and accrued liabilities of $1,862,626 related to exploration and evaluation expenditures; and

e) paid $3,902,879 of interest, received $10,337 of interest and paid $nil income taxes.

(Expressed in United States Dollars)

19. SUPPLEMENTAL CASH FLOW INFORMATION (Continued)

During the year ended January 31, 2014, the Company:

f) transferred $20,137,444 from exploration and evaluation assets to property and equipment;

g) transferred $238,103 from equity reserves to capital stock on the exercise of warrants;

h) transferred $945,573 from the liability component of convertible notes and $82,703 from the equity component of convertible notes to capital stock on the conversion of convertible notes;

i) had accounts payable and accrued liabilities of $133,288 related to exploration and evaluation expenditures; and

j) paid $2,394,752 of interest, received $nil of interest and paid $nil income taxes.

20. INCOME TAXES

a) Income tax expense differs from the amount that would be computed by applying the Canadian statutory income tax rate of 26.00% (2014 - 25.83%) to loss before income taxes. The reasons for the differences are as follows:

	2015	2014
Loss before income taxes	$ (24,514,426)	$ (6,575,492)
Statutory income tax rate	26.00%	25.83%
Expected income tax	(6,373,751)	(1,698,449)
Items not deductible for tax purposes	678,989	71,936
Differences between Canadian and foreign tax rates	(2,312,042)	-
Temporary differences	171,798	(661,166)
Effect of change in tax rates	(352,169)	(34,239)
Impact of foreign exchange on tax assets and liabilities	591,335	(784,338)
Over-provided in prior years	(1,995,191)	-
Changes in unrecognized deferred income tax assets	9,591,031	3,106,256
	$ -	$ -

b) The Company recognizes tax benefits on losses or other deductible amounts generated in countries where the probable criteria for the recognition of deferred tax assets has been met.

The Company's unrecognized deductible temporary differences and unused tax losses for which no deferred tax asset is recognized consist of the following amounts:

	2015	2014
Non-capital losses	$ 35,502,197	$ -
Property and equipment	-	9,773,996
Share issue costs	2,388,900	1,968,040
Other	539,611	182,204
	$ 38,430,708	$ 11,924,240

(Expressed in United States Dollars)

20. INCOME TAXES (Continued)

As at January 31, 2015, the Company's unused tax losses have the following expiry years:

2027	$	7,999
2028		23,451
2029		59,142
2030		94,911
2031		105,156
2032		906,896
2033		7,323,520
2034		17,278,840
2035		25,021,529
	$	50,821,444

21. EVENTS AFTER THE REPORTING PERIOD

Subsequent to January 31, 2015, the Company agreed to modify the terms of its Credit Facility, which is fully described in Note 9.