

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

FOR THE THREE MONTHS ENDED APRIL 30, 2013 and 2012

TERRACE ENERGY CORP.

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

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

The accompanying unaudited interim financial statements of the Company have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these interim financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

Vancouver, Canada

June 27, 2013

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

	April 30, 2013	January 31, 2013
ASSETS		
Current assets		
Cash	\$ 7,291,039	\$ 1,673,449
Accounts receivable (Note 11)	550,239	1,327,511
Prepays	167,546	50,029
Total current assets	8,008,824	3,050,989
Non-current assets		
Operators bond	25,000	25,000
Advances for future exploration (Note 5)	4,182,071	459,008
Exploration and evaluation assets (Note 6)	8,757,149	6,737,039
Property and equipment (Note 7)	5,810,585	6,047,528
Investment in Partnership (Note 4)	12,915,830	-
Total assets	39,699,459	\$ 16,319,564
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable and accrued liabilities (Note 11)	\$ 757,959	\$ 571,585
Non-current liabilities		
Decommissioning obligations (Note 9)	8,016	8,016
Convertible notes (Note 8)	22,027,096	-
Total liabilities	22,793,071	579,601
Shareholders' equity		
Capital stock (Note 10)	15,977,713	15,977,713
Convertible notes – equity component (Note 8)	1,860,852	
Stock options reserve (Note 10)	711,766	638,649
Warrants reserve (Note 10)	255,342	255,342
Translation reserve (Note 2)	166,433	396,149
Deficit	(2,065,718)	(1,527,890)
Total shareholders' equity	16,906,388	15,739,963
Total liabilities and shareholders' equity	\$ 39,699,459	\$ 16,319,564

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 INCOME
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in United States Dollars)
For the three months ended April 30

	2013	2012
		(Note 2)
REVENUE		
Oil and gas sales	\$ 856,011	\$557,090
DIRECT OPERATING EXPENSES		
Production and operating	148,449	31,299
Royalties	39,880	34,144
Depreciation, depletion and accretion (Notes 7 and 9)	272,758	5,519
Operating Income	<u>394,924</u>	<u>486,128</u>
GENERAL AND ADMINISTRATIVE EXPENSES		
Administrative	141,953	71,624
Consulting	-	42,923
Foreign exchange loss (gain)	33,792	(31,043)
Impairment of exploration and evaluation assets	104,150	-
Interest expense	199,187	-
Investor relations	142,128	54,977
Professional	72,269	41,458
Project investigation costs	12,570	5,094
Salaries and benefits	103,526	-
Share-based payments (Note 10)	73,117	75,730
Transfer agent and filing fees	29,018	12,612
Travel	21,042	-
	<u>932,752</u>	<u>273,375</u>
Net (loss) income for the period	<u>\$ (537,828)</u>	<u>212,753</u>
Basic and diluted (loss) earnings per share	<u>\$ (0.01)</u>	<u>\$ 0.00</u>
Weighted average number of common shares outstanding	63,069,321	52,919,321
Plus incremental shares from assumed conversions:		
Stock options	-	2,382,143
Warrants	-	5,969,420
Diluted potential common shares	<u>-</u>	<u>8,351,563</u>
Adjusted weighted average shares	<u>63,069,321</u>	<u>61,270,884</u>
Comprehensive loss		
Net loss for the period	\$ (537,828)	\$ 212,753
Cumulative translation adjustment	(229,716)	24,038
Comprehensive loss for the period	<u>\$ (767,544)</u>	<u>\$ 236,791</u>

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

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in United States Dollars)

	<u>Capital Stock</u>		Shares Subscriptions Received in Advance	Convertible Notes - Equity Component	Stock Options Reserve	Warrants Reserve	Translation Reserve	Deficit	Total Shareholders' Equity
	Shares	Amount							
Balance – January 31, 2012	52,919,321	\$ 5,970,906	\$ -	\$ -	\$ 259,081	\$ 255,342	\$ 299,995	\$ (1,406,168)	\$ 5,379,156
Shares subscriptions	-	-	3,613,659	-	-	-	-	-	3,613,659
Share-based payments	-	-	-	-	75,730	-	-	-	75,730
Cumulative translation adjustment	-	-	-	-	-	-	24,038	-	24,038
Net loss for the period	-	-	-	-	-	-	-	212,753	212,753
Balance – April 30, 2012	52,919,321	\$ 5,970,906	\$ 3,613,659	\$ -	\$ 334,811	\$ 255,342	\$ 324,033	\$ (1,193,415)	\$ 9,305,336
Balance – January 31, 2013	63,069,321	\$ 15,977,713	\$ -	\$ -	\$ 638,649	\$ 255,342	\$ 396,149	\$ (1,527,890)	\$ 15,739,963
Convertible notes - equity components	-	-	-	1,860,852	-	-	-	-	1,860,852
Share-based payments	-	-	-	-	73,117	-	-	-	73,117
Cumulative translation adjustment	-	-	-	-	-	-	(229,716)	-	(229,716)
Net loss for the period	-	-	-	-	-	-	-	(537,828)	(537,828)
Balance – April 30, 2013	63,069,321	\$ 15,977,713	\$ -	\$ 1,860,852	\$ 711,766	\$ 255,342	\$ 166,433	\$ (2,065,718)	\$ 16,906,388

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

TERRACE ENERGY CORP.
CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS
UNAUDITED – PREPARED BY MANAGEMENT
(Expressed in United States Dollars)
For the three months ended April 30

	2013	2012
		(Note 2)
CASH FLOWS FROM OPERATING ACTIVITIES		
Net (loss) income for the period	\$ (537,828)	\$ 212,753
Items not involving cash:		
Amortization of convertible notes	49,558	-
Depreciation, depletion and accretion	272,758	5,519
Share-based payments	73,117	75,730
Unrealized loss on foreign exchange	(263,927)	65,072
Changes in non-cash working capital items:		
Accounts receivable	777,272	(515,311)
Prepays	(117,517)	(2,741)
Accounts payable and accrued liabilities	186,374	(36,222)
Decommissioning obligations	-	(4,993)
Net cash provided by (used in) operating activities	<u>439,807</u>	<u>(200,193)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Exploration and evaluation expenditures	(2,020,110)	(2,360,618)
Advances for future exploration	(3,723,063)	-
Acquisition of property and equipment	(35,815)	(49,298)
Investment in partnership	(12,915,830)	-
Net cash used in investing activities	<u>(18,694,818)</u>	<u>(2,409,916)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Shares subscriptions received in advance	-	3,613,659
Proceed from issuance of convertible notes	23,838,390	-
Net cash provided by financing activities	<u>23,838,390</u>	<u>3,613,659</u>
Foreign exchange effect on cash	<u>34,211</u>	<u>17,362</u>
Change in cash for the period	5,617,590	1,020,912
Cash, beginning of the period	<u>1,673,449</u>	<u>2,559,228</u>
Cash, end of the period	<u>\$ 7,291,039</u>	<u>\$ 3,580,140</u>

Supplemental cash flow information (Note 16).

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

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2013 AND 2012
(Expressed in United States Dollars)

1. NATURE OF OPERATIONS

Terrace Energy Corp. (the “Company”) was incorporated on July 6, 2006 under the *Business Corporations Act* (British Columbia) and previously named Terrace Resources Inc.

The Company’s head office is located at 270 – 666 Burrard Street, Vancouver, British Columbia, Canada V6C 2X8.

The Company is classified as a “Tier 2 Oil and Gas Issuer”, as that term is defined in the TSX Venture Exchange (the “Exchange”) policies. Its common shares trade on the Exchange under the symbol “TZR”.

These condensed consolidated interim financial statements have been prepared on a going concern basis, which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business. The Company has a limited history of revenues and operating cash flows. The future development of the Company’s oil and gas interests are therefore dependent upon its ability to raise additional capital as required and future profitable operations, neither of which is assured. These condensed consolidated interim financial statements do not include adjustments to amounts and classifications of assets and liabilities that might be necessary should the Company be unable to continue operations.

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 Interpretations issued by the International Financial Reporting Interpretations Committee (“IFRIC”) and in accordance with International Accounting Standards (“IAS”) 34, Interim Financial Reporting. The policies applied in these condensed consolidated interim financial statements are based on IFRS issued and outstanding as of April 30, 2013. The Board of Directors approved the unaudited consolidated financial statements on June 27, 2013.

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 is the Canadian dollar (“CAD”). However, these consolidated financial statements are presented in United States dollars (“USD”) because 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 year, 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”.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2013 AND 2012
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3. NEW ACCOUNTING POLICIES

Convertible notes

The liability component of convertible debentures 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 debenture is measured at amortized cost using the effective interest method. The equity component is not re-measured subsequent to initial recognition.

New accounting standards and interpretation

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning after January 1, 2013, including IAS 19 *Employee Benefits*, IAS 27 *Separate Financial Statements*, IAS 28 *Investments in Associates and Joint Ventures*, IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interest of Other Entities*, and IFRS 13 *Fair Value Measurement*. The Company has adopted these policies and they do not have a significant effect on the condensed interim consolidated financial statements.

IFRS 9 *Financial Instruments* is effective for annual periods beginning after January 1, 2015. The extent of the effects of this new accounting standard on the condensed interim consolidated financial statements has not been determined.

4. INVESTMENT IN PARTNERSHIP

The Company entered into an agreement with BlackBrush Oil & Gas, LP (“BlackBrush”) to organize a special purpose limited partnership, the BlackBrush Terrace LP (the “SPLP”), to acquire a 50% working interest in certain oil and gas leases in Maverick County south Texas, USA (the “WI”) from SWEPI LP (“Shell Oil”).

The Company and BlackBrush have agreed that each party must fund its 50% share of the costs to drill and complete four Pearsall horizontal wells and one Eagle Ford horizontal well (the “Obligation Wells”) or forfeit their respective interest in the SPLP and each party’s interest in the SPLP may be adjusted, in defined circumstances, where one party finances a disproportionate share of costs to drill and complete additional wells.

The SPLP may secure the WI through a combination of cash payments, which have been made, and drilling obligations. The material terms of the agreement between the SPLP and Shell Oil are as follows:

1. the SPLP is obligated to commence drilling all of the remaining Obligation Wells on or before April 15, 2015;
2. the drilling of each Obligation Well must commence within 120 days of the completion of the previous well;
3. the SPLP is obligated to pay liquidated damages equal to \$2 million (\$1 million net to Terrace) for each Obligation Well that is not commenced on time;
4. upon completion of a well, the SPLP may request an assignment of 50% of Shell Oil’s interest in such well;
5. the SPLP has the option, but not the obligation, to earn the assignment of the WI in all of the leases by spending an aggregate of \$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, including those incurred in connection with the drilling and completion of the Obligation Wells;

TERRACE ENERGY CORP.**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2013 AND 2012**

(Expressed in United States Dollars)

4. INVESTMENT IN PARTNERSHIP (continued)

6. upon making the Carry Payment in full, the SPLP will pay 50% of all development costs for the right to participate in a 50% working interest in each subsequent well unless Shell Oil elects to convert its working interest in a producing formation into a net profits interest; and

7. 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 is made in full or (ii) establishment of production from a given

At April 30, 2013, the Company advanced the aggregate sum of \$12,915,830 representing its share of costs to organize, acquire and fund certain agreed upon exploration and evaluation activities to-date.

5. 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 \$4,182,071 at April 30, 2013 (January 31, 2013 - \$459,008), which consists of advances for future exploration on the Company's STS Olmos and Cutlass projects.

6. EXPLORATION AND EVALUATION ASSETS

	Los Patos	STS Olmos	Cutlass	Total
Balance - January 31, 2012	\$ 135,000	\$ 1,058,108	\$ 561,713	\$ 1,754,821
Acquisition costs	-	1,269	1,362,343	1,363,612
Exploration and evaluation	-	6,732,483	3,842,044	10,574,527
Transfer to property and equipment	-	(6,820,921)	-	(6,820,921)
Impairment charge	(135,000)	-	-	(135,000)
Expenditures during the year	(135,000)	(87,169)	5,204,387	4,982,218
Balance - January 31, 2013	\$ -	\$ 970,939	\$ 5,766,100	\$ 6,737,039
Exploration and evaluation	-	988,606	1,031,504	2,020,110
Expenditures during the period	-	988,606	1,031,504	2,020,110
Balance - April 30, 2013	\$ -	\$ 1,959,545	\$ 6,797,604	\$ 8,757,149

STS Olmos

In November 2011, the Company entered into an agreement, through a wholly-owned subsidiary, to acquire varying working and net revenue interests, which average 26.88% and 20.16%, respectively, in LaSalle and McMullen counties, Texas, and an evaluation well. The purchase price was \$1,000,000.

The Company's share of the aggregate costs, to drill, complete and place into production three wells was \$6,760,921. These costs and \$60,000 of the acreage lease acquisition cost were transferred from "exploration and evaluation assets" to "property and equipment" during the last fiscal year. The Company incurred additional costs of \$988,606 during the period in connection with the development of a fourth well.

The Company has secured its working and net revenue interests in all of the project acreage subject to participation in the development of additional wells proposed from time to time by the project's operator. The Company and the operator have formulated a project development plan for fiscal 2014.

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
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(Expressed in United States Dollars)

6. EXPLORATION AND EVALUATION ASSETS (continued)

Cutlass

In November 2011, the Company entered into an agreement, through a wholly-owned subsidiary, to earn a 25% working interest and an 18.75% net revenue interest in certain leases in Dimmit and LaSalle counties, Texas, for \$367,666 and a commitment to participate in a two-well drilling program. In February 2012, the Company acquired an additional 5% working interest and 3.75% net revenue interest for an additional \$234,097.

In order to earn the net revenue interests (22.5% in aggregate), the Company agreed to pay 33.33% of all costs, including acreage leases, prospect fees, site preparation and drilling, until the completion of two wells, and thereafter 30% of all costs relating to the lease payments, prospect fees and infrastructure costs (the "Dimmit County Acreage").

Drilling of the first well on the Dimmit County Acreage was substantially completed in June 2012. The results were subsequently analyzed and the well was fracture stimulated on March 28, 2013. It is now being flow back tested. The Company's share of well and infrastructure costs to April 30, 2013 was \$3,425,191 of which \$278,892 was allocated to acquisition costs.

The Company must participate in the development of a second well on the Dimmit County Acreage at an estimated cost of \$1,190,333 of which \$49,745 was incurred at April 30, 2013. Work on this well is currently scheduled for the second quarter of calendar 2013.

After the drilling and technical evaluation of the first well on the Dimmit County Acreage, the Company exercised its option to earn a 22.5% net revenue interest (the "LaSalle County Acreage") at a cost of \$570,462. The Company was obligated to fund 33.33% of the cost of an initial well on the La Salle County Acreage.

Drilling of the initial well on the La Salle County Acreage commenced in late June 2012. A vertical hole was drilled through several objective formations and is currently suspended for service as a monitor well. The timing and nature of the future development of the well will depend, in part, upon the results of additional drilling activity in the area. The Company's share of the initial well and infrastructure costs to April 30, 2013 was \$1,928,723 of which \$278,892 was allocated to acquisition costs. A second well designed to develop the Eagle Ford Shale was spudded on April 26, 2013. The estimated cost of this well is \$1,214,332 of which \$221,720 was incurred at April 30, 2013.

At April 30, 2013 the Company advanced the total sum of \$4,182,071 to cover planned exploration on the Cutlass project in 2013 (Note 5).

TERRACE ENERGY CORP.**NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2013 AND 2012**

(Expressed in United States Dollars)

7. PROPERTY AND EQUIPMENT

Cost	Other Equipment	Oil and Gas	Total
Balance – January 31, 2012	\$ -	\$ -	\$ -
Additions	63,597	-	63,597
Transfer from exploration and evaluation	-	6,820,921	6,820,921
Change in value of decommissioning obligations	-	7,294	7,294
Balance – January 31, 2013	\$ 63,597	\$ 6,828,215	\$ 6,891,812
Additions	35,815	-	35,815
Balance – April 30, 2013	\$ 99,412	\$ 6,828,215	\$ 6,927,627
Accumulated depreciation and depletion	Other Equipment	Oil and Gas	Total
Balance – January 31, 2012	\$ -	\$ -	\$ -
Charge for year	11,274	833,010	844,284
Balance – January 31, 2013	\$ 11,274	\$ 833,010	\$ 844,284
Charge for period	3,607	269,151	272,758
Balance – April 30, 2013	\$ 14,881	\$ 1,102,161	\$ 1,117,042
Net book value	Other Equipment	Oil and Gas	Total
Balance – January 31, 2013	\$ 52,323	\$ 5,995,205	\$ 6,047,528
Balance – April 30, 2013	\$ 84,531	\$ 5,726,054	\$ 5,810,585

8. CONVERTIBLE NOTES

During the period the Company completed a non-brokered private placement of convertible, unsecured promissory notes in the aggregate principal amount of CAD \$25,000,000. The convertible notes are due on April 2, 2018, pay interest of 8% per annum and are convertible into common shares of the Company at CAD \$2.00 per share.

The Company has the right to convert of all or part of the convertible 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 convertible 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.

Holders of the convertible 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 in certain circumstances.

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

FOR THE THREE MONTHS ENDED APRIL 30, 2013 AND 2012

(Expressed in United States Dollars)

8. CONVERTIBLE NOTES (continued)

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%. The difference between the CAD \$25 million 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 \$983,757 were allocated to the liability and equity components of the debentures proportionately at \$906,965 (\$857,759, net of \$49,206 amortization) and \$76,792, 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 April 30, 2013:

	Liability	Equity	Total
Subscription proceeds	\$ 22,884,856	\$ 1,937,644	\$ 24,822,500
Transaction costs	(906,965)	(76,792)	(983,757)
Accretion of discount	49,206	-	49,206
Balance, April 30, 2013	\$ 22,027,096	\$ 1,860,852	\$ 23,887,949

9. 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.

	2013
Balance - January 31, 2012	\$ -
Increase in estimated future obligations	7,294
Accretion expense	722
Balance - January 31, 2013 and April 30, 2013	\$ 8,016

TERRACE ENERGY CORP.
NOTES TO THE CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED APRIL 30, 2013 AND 2012
(Expressed in United States Dollars)

10. CAPITAL STOCK

On April 30, 2013 and January 31, 2013, the Company had unlimited authorized common shares, without par value and 63,069,321 shares outstanding.

Share issues

During the year ended January 31, 2013, the Company issued common shares as follows:

- a) In May 2012, the Company closed a private placement of 10,000,000 common shares at a purchase price of CAD \$1.00 per share for gross proceeds of CAD \$10,000,000. Share issue costs of CAD \$48,670 were paid in relation to the private placement.
- b) In July 2012, the Company issued 150,000 common shares on the exercise of stock options at an exercise price of CAD \$0.12 per share for gross proceeds of CAD \$18,000.

Restricted shares and warrants

Of the common shares issued, 11,184,345 are subject to an escrow agreement and may not be transferred without the consent of the Exchange. The escrow agreement provides, among other things, that a total of 3,827,115 common shares will be released from escrow on June 23, 2013 and the same amount will be released every six months thereafter, until such time all such shares are released from escrow.

Of the common shares underlying the outstanding warrants, 2,587,500 are subject to an escrow agreement and cannot be transferred without the consent of the Exchange. The escrow agreement provides that a total of 862,500 warrants will be released from escrow on June 23, 2013 and the same amount will be released every six months thereafter, until such time all such shares are released from escrow.

Included in the issued common shares and warrants are 2,250,000 common shares and 1,350,000 warrants that are subject to a voluntary pooling agreement. The agreement provides that 750,000 common shares and 450,000 warrants will be released from trading restrictions on June 23, 2013 and the same amount will be released every six months thereafter, until such time all such shares are free of trading restrictions.

Convertible Notes

As at April 30, 2013, the Company had issued and outstanding notes in the aggregate principal amount of CAD \$25,000,000 convertible into 12,500,000 common shares of the Company (see Note 8)

Stock options

The Company has an incentive stock option plan, which provides that the Board of Directors of the Company may from time to time, in its discretion, and in accordance with Exchange requirements, grant to directors, officers, employees and technical consultants to the Company, non-transferable options to purchase common shares, provided that the number of common shares reserved for issuance will not exceed 10% of the issued and outstanding common shares. The number of common share reserves for issuance pursuant to options granted to all technical consultants will not exceed 2% of the issued and outstanding common shares. The number of options granted to any one person cannot exceed 5% of the issued and outstanding common shares. Such options may be exercisable for a period of up to 10 years from the date of grant. Vesting terms will be determined at the time of grant by the Board of Directors.

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

FOR THE THREE MONTHS ENDED APRIL 30, 2013 AND 2012

(Expressed in United States Dollars)

10. CAPITAL STOCK (Continued)**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 \$73,117 for the period April 30, 2013 (2012 - \$75,730), with a corresponding credit to reserves.

Outstanding stock options and warrants

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

	Number of Stock Options	Weighted Average Exercise Price (CAD)
Balance - January 31, 2012	2,900,000	\$ 0.20
Granted	150,000	\$ 1.35
Exercised	(150,000)	\$ 0.12
Balance - January 31, 2013 and April 30, 2013	2,900,000	\$ 0.27

The following stock options were outstanding as at April 30, 2013:

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	3.15
250,000	137,500	\$ 0.19	July 15, 2016	3.21
250,000	100,000	\$ 0.21	September 16, 2016	3.35
250,000	100,000	\$ 0.19	October 18, 2016	3.47
100,000	60,000	\$ 0.53	November 25, 2016	3.57
250,000	100,000	\$ 0.67	December 16, 2016	3.63
150,000	37,500	\$ 1.35	July 8, 2017	4.19
2,900,000	2,185,000			3.31

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10. 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, 2012, 2013 and April 30, 2013	7,112,500	\$ 0.18	June 21, 2016

11. 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 – as other financial liabilities.

The Company's risk exposure and the impact on the Company's financial instruments are summarized below:

Fair value

The carrying values of cash, accounts receivable, and accounts payable and accrued liabilities approximate their fair values due to the short-term maturity of these financial instruments. The fair value of the 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.

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11. FINANCIAL INSTRUMENTS (continued)

Market risk

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

(i) Interest rate risk

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

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

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

(ii) Foreign currency risk

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 financing is raised in CAD, but a portion of the Company's operations is conducted 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:

	April 30, 2013 (USD)	January 31, 2013 (USD)
Cash	\$ 4,127,363	\$ 1,502,509
Accounts receivable	1,803,538	1,302,356
Operators bond	25,000	25,000
Accounts payable and accrued liabilities	(529,450)	(483,690)
Net	\$ 5,426,451	\$ 2,346,275
Canadian dollar equivalent	CAD\$ 5,465,521	CAD\$ 2,344,399

Based on the above net exposures as at April 30, 2013, a 5% change in the Canadian/US exchange rate would impact the Company's net loss and comprehensive loss by approximately \$271,300.

(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.

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11. FINANCIAL INSTRUMENTS (continued)

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 April 30, 2013, the Company had cash of \$7,291,039, accounts receivable of \$550,239, prepaid expenses of \$167,546 and accounts payable and accrued liabilities of \$757,959 due within three months of year-end.

Subsequent to April 30, 2013 the Company completed additional non-brokered private placements of convertible, unsecured promissory notes in the aggregate principal amount of CAD \$15,000,000 on substantially the same terms and conditions of the convertible notes described in Note 8.

Including the private placement completed subsequent to April 30, 2013, the Company has long term convertible notes in the aggregate principal amount of CAD \$40,000,000, which are due on April 2, 2018. These notes bear interest calculated at 8% per annum, which is payable quarterly, and may become immediately due in the event of default (see Note 8).

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.

12. CAPITAL DISCLOSURES

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

The Company's capital management strategy has not changed from January 31, 2013. As at April 30, 2013, the Company is not subject to any externally imposed capital requirements.

13. 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, 2014 and will require total payments in the remaining fiscal years of \$72,183 for January 31, 2014 and \$30,076 for January 31, 2015.

The Company subsequently entered into a new office lease in Vancouver, British Columbia, which commences on 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.

The Company is required to pay interest, calculated at 8% per annum, on outstanding convertible notes at the end of each fiscal quarter. The Company has estimated that it must pay CAD \$670,706 on July 31, 2013 and approximately CAD \$800,000 each quarter thereafter until the notes are converted or repaid.

The Company has interests in certain exploration and evaluation assets which are subject to certain expenditure commitments (Note 4 and Note 6).

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14. 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:

	2013	2012
Short-term compensation	\$ 98,321	\$ 54,400
Share-based payments	11,508	10,913
	\$ 109,829	\$ 65,313

As at April 30, 2013:

- (a) Included in accounts payable and accrued liabilities are amounts payable to key management personnel totalling \$Nil (January 31, 2013 - \$42,368).

15. SEGMENTED INFORMATION

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

April 30, 2013			
	USA	Canada	Total
Advances for future exploration	\$ 4,182,071	\$ -	\$ 4,182,071
Exploration and evaluation assets	8,757,149	-	8,757,149
Property and equipment	5,775,427	35,158	5,810,585
	\$ 18,714,647	\$ 35,158	\$ 18,749,805

January 31, 2013			
	USA	Canada	Total
Advances for future exploration	\$ 459,008	\$ -	\$ 459,008
Exploration and evaluation assets	6,737,039	-	6,737,039
Property and equipment	6,047,528	-	6,047,528
	\$ 13,243,575	\$ -	\$ 13,243,575

The Company's operating expenses are incurred evenly between the US and Canada. Exploration and development activities are located in the US and oil and gas revenues are in the US.

16. SUPPLEMENTAL CASH FLOW INFORMATION

There were no significant non-cash transactions during the period ended April 30, 2013.

During the three months ended April 30 2012, the Company transferred \$1,261,670 from exploration and evaluation assets to property and equipment.

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17. EVENTS AFTER THE REPORTING PERIOD

Subsequent April 30, 2013, the Company completed an additional private placement of convertible notes in the aggregate principle amount of CAD \$15,000,000. These notes have substantially the same terms and conditions of the convertible notes described in Note 8.