

Consolidated Financial Statements of

**EGI FINANCIAL HOLDINGS INC.**

December 31, 2005

## **Management's Responsibility for Financial Reporting**

### **Role of Management, Board of Directors and Audit Committee**

Management is responsible for the preparation and fair presentation of the consolidated financial statements, management's discussion and analysis and other information in this annual report. The consolidated financial statements of EGI Financial Holdings Inc. (EGI) were prepared in accordance with Canadian generally accepted accounting principles, including the accounting requirements of the Superintendent of Financial Institutions Canada. Where necessary, these statements reflect amounts based upon the best estimates and judgement of management.

In meeting its responsibility for the reliability of the consolidated financial statements, management maintains the necessary system of internal controls. These controls are designed to provide management with reasonable assurance that the financial records are reliable for preparing financial statements and other financial information and assets are safeguarded against unauthorized use or disposition and liabilities are recognized. The Audit Committee, comprised of directors who are not officers or employees of the Company, meets, as required, with management, the appointed actuary and the external auditors to review actuarial, accounting, reporting and internal control matters. The Audit Committee is responsible for reviewing the consolidated financial statements and management's discussion and analysis and recommending them to the board of directors for approval.

### **Role of Appointed actuary**

The actuary is appointed by the Board of Directors pursuant to the Insurance Companies Act. The appointed actuary is responsible for ensuring that the assumptions and methods used in the valuation of policy liabilities are in accordance with accepted actuarial practice, applicable legislation and associated regulations or directives. The actuary is also required to provide an opinion regarding the appropriateness of the policy liabilities at the balance sheet date to meet all policyholder obligations of the Company. Examination of supporting data for accuracy and completeness and consideration of Company assets are important elements of the work required to form this opinion. The actuary uses the work of the external auditors in verifying data used for valuation purposes.

### **Role of External auditors**

PricewaterhouseCoopers LLP, external auditors, have been appointed by the shareholders to conduct an independent audit of the consolidated financial statements of EGI in accordance with Canadian generally accepted auditing standards and report to the shareholders regarding the fairness of the financial reporting. The external auditors use the work of the appointed actuary in respect of policy liabilities included in the consolidated financial statements on which the appointed actuary has rendered an opinion.

(signed) Douglas E. McIntyre,  
Chief Executive Officer

(signed) Hemraj Singh,  
Chief Financial Officer

## **APPOINTED ACTUARY'S REPORT**

To the Shareholders of EGI Financial Holdings Inc.:

J. S. Cheng & Partners Inc. has valued the policy liabilities of the subsidiary insurance operations of EGI Financial Holdings Inc. in its consolidated balance sheets as at December 31, 2005 and 2004, in accordance with accepted actuarial practice, including selection of appropriate assumptions and methods.

In my opinion, the amount of policy liabilities makes appropriate provision for all policyholder obligations and the consolidated balance sheets fairly present the results of the valuation.

Toronto, Ontario  
February 17, 2006

(signed) Joe S. Cheng, FCIA  
J. S. Cheng & Partners Inc.

Auditors Report

To the Shareholders of  
EGI Financial Holdings Inc.

We have audited the consolidated balance sheets of EGI Financial Holdings Inc. as at December 31, 2005 and 2004 and the consolidated statements of income, changes in shareholders' equity and cash flows for each of the years in the two year period ended December 31, 2005. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for each of the years in the two year period ended December 31, 2005 in accordance with Canadian generally accepted accounting principles.

**(signed) "PricewaterhouseCoopers LLP"**

Chartered Accountants  
Toronto, Canada

February 17, 2006

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Balance Sheets**  
**as at December 31, 2005**  
(in \$ thousands, except share amounts)

<b>Assets</b>	<b>2005</b>	<b>2004</b>
Cash and short-term deposits.....	15,899	7,327
Investments (note 4).....	152,736	57,098
Reinsurers' share - unearned premiums (note 5).....	2,761	6,871
- unpaid claims (note 6).....	54,043	24,978
Accounts receivable.....	22,271	10,219
Income taxes recoverable.....	273	-
Due from insurance companies.....	2,504	-
Deferred policy acquisition costs.....	6,289	2,733
Capital assets (note 8).....	560	267
Future income taxes(note 12).....	3,133	1,046
Prepaid expenses and other assets.....	262	198
	<u>260,731</u>	<u>110,737</u>

**Liabilities**

Provision for unpaid claims (note 6).....	129,173	54,149
Unearned premiums (note 5).....	39,973	17,933
Unearned commission.....	1,261	1,368
Accounts payable and accrued liabilities.....	4,503	1,592
Payable to insurance companies.....	7,340	8,833
Income taxes payable.....	5,708	893
Other liabilities.....	188	660
	<u>188,146</u>	<u>85,428</u>

**Shareholders' Equity**

Share capital (note 9).....	47,660	17,341
Contributed surplus (note 10).....	80	-
Retained earnings.....	24,845	7,968
	<u>72,585</u>	<u>25,309</u>
	<u>260,731</u>	<u>110,737</u>

On behalf of the Board:

(signed) Douglas E. McIntyre, Director

(signed) Mark Sylvia, Director

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Statements of Income**  
**for the Years Ended December 31**  
(in \$ thousands, except share amounts)

	<b>2005</b>	<b>2004</b>
Revenue:		
Direct written premiums .....	117,006	57,240
Net written premiums .....	<u>91,783</u>	<u>35,217</u>
Net earned premiums .....	76,344	33,615
Investment income .....	7,527	3,419
Other revenue .....	227	298
	<u>84,098</u>	<u>37,332</u>
Expenses		
Incurred claims .....	45,997	22,400
Acquisition costs .....	12,073	5,638
Operating expenses .....	9,083	4,506
	<u>67,153</u>	<u>32,544</u>
Income before income taxes .....	<u>16,945</u>	<u>4,788</u>
Income tax expense (recovery) (note 12)		
Current .....	7,505	1,155
Future .....	(1,768)	(1,085)
	<u>5,737</u>	<u>70</u>
Income from continuing operations .....	11,208	4,718
Income from discontinued operations, net of income taxes (note 2)	-	1,308
Extraordinary gain, net of income taxes (note 2) .....	5,669	-
Net income .....	<u>16,877</u>	<u>6,026</u>
Earnings per share (note 18):		
Net income per share from continuing operations	1.38	1.02
Net income per share from discontinued operations	-	0.29
Net income per share from extraordinary gain	0.71	-
Net income per share	2.09	1.31
Net income per diluted share from continuing operations	1.30	1.01
Net income per diluted share from discontinued operations	-	0.29
Net income per diluted share from extraordinary gain	0.66	-
Net income per diluted share	1.96	1.30

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**for the Years ended December 31**  
(in \$ thousands, except share amounts)

	<b>2005</b>	<b>2004</b>
Share capital		
Balance, beginning of year .....	17,341	15,186
Common shares issued .....	30,319	-
Stock dividend .....	-	2,155
	<u>47,660</u>	<u>17,341</u>
Contributed surplus		
Stock options granted .....	<u>80</u>	<u>-</u>
Retained earnings		
Balance, beginning of year .....	7,968	4,097
Net income .....	16,877	6,026
Stock dividend .....	-	<u>(2,155)</u>
Balance, end of year .....	<u>24,845</u>	<u>7,968</u>
Total, end of year .....	<u>72,585</u>	<u>25,309</u>

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Statements of Cash Flows**  
**for the Years Ended December 31**  
(in \$ thousands, except share amounts)

	<b>2005</b>	<b>2004</b>
Cash provided by (used in):		
Operating activities:		
Net income .....	16,877	6,026
Items not involving cash:		
Amortization of capital assets .....	448	187
Amortization of premium on bonds .....	177	(32)
Realized gains on investments .....	(1,221)	(907)
Extraordinary gain .....	(6,819)	-
Cash flow from change in:		
Reinsurers' share of unearned premiums .....	10,981	(4,081)
Reinsurers' share of unpaid claims .....	(4,087)	(3,622)
Accounts receivable .....	(2,190)	(4,348)
Income taxes recoverable .....	(273)	-
Due from insurance companies .....	(2,504)	-
Accounts payable and accrued liabilities .....	(15,564)	(2,259)
Provision for unpaid claims .....	21,426	11,259
Unearned premiums .....	4,445	1,719
Income taxes payable .....	3,749	747
Future income taxes .....	(1,267)	391
Deferred revenue .....	-	(714)
Other assets .....	(12)	294
Deferred acquisition cost .....	(884)	1,494
	<u>23,282</u>	<u>6,154</u>
Financing activities		
Issue of common shares .....	<u>16,096</u>	<u>-</u>
Investing activities:		
Acquisition of subsidiary, net of cash acquired .....	5,646	-
Purchase of capital assets .....	(564)	(91)
Purchase of investments .....	(75,508)	(33,081)
Sale/maturity of investments .....	39,620	26,633
	<u>(30,806)</u>	<u>(6,539)</u>
Increase (decrease) in cash and short-term deposits .....	8,572	(385)
Cash and short-term deposits, beginning of year .....	<u>7,327</u>	<u>7,712</u>
Cash and short-term deposits, end of year .....	<u>15,899</u>	<u>7,327</u>
Supplementary Information		
Income taxes paid .....	2,160	1,213

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements**  
(in \$ thousands, except share amounts)

**1 Organization**

EGI Financial Holdings Inc. (“the Company”) was incorporated on August 18, 1997 under the Business Corporations Act (Ontario). The Company is a holding company which, through its subsidiaries, is involved primarily in the underwriting of non-standard automobile and other niche and specialty general insurance products and the management of investment funds derived from its insurance operations.

The Company’s wholly owned subsidiaries are EGI Insurance Managers Inc., Echelon General Insurance Company (“Echelon”) and CIM Reinsurance Company Ltd.

**2 Acquisitions and divestitures**

- a) During January 2005, the Company issued shares to acquire an additional 50% ownership interest in the holding company that owned 100% of Echelon. The holding company, EGI Financial Holdings Inc. (“EGI Financial (2003)”), became a wholly owned subsidiary of the Company and amalgamated with the Company. The acquisition cost of \$14,222 was paid with the issuance of 1,682,768 common shares and 1,682,768 Series B special shares of the Company. The price of the common shares was determined and agreed using the fair value of the net assets acquired as at December 31, 2003.

The purchase transaction was accounted for as a step acquisition which resulted in negative goodwill of \$6,819 recognized in the consolidated statement of income. The Company’s consolidated statements of income reflect the results of 100% of the operations for the acquired entity from the date of acquisition. Prior to this date, 50% was proportionally consolidated.

Assets and liabilities acquired at fair values:

Cash and cash equivalents	5,646
Investments	58,625
Reinsurers’ share of	
- unpaid claims and adjustment expenses	24,978
- unearned premiums	6,871
Deferred policy acquisition costs	2,672
Other assets	10,911
Provision for unpaid claims and adjustment expenses	(53,598)
Unearned premiums	(17,595)
Other liabilities	(17,469)
Net assets acquired	<u>21,041</u>
Consideration given:	
Common and Series B special shares	<u>14,222</u>
Negative goodwill	<u>6,819</u>

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

The negative goodwill was recorded as an extraordinary gain in 2005, net of income tax of \$1,150.

The Company's 50% proportionate share in the assets, liabilities, revenues and expenses and cash flows of EGI Financial (2003) included by proportionate consolidation in 2004 is as follows:

Assets	106,831
Liabilities	88,663
Revenue	35,447
Expenses	30,125
Cash flows from:	
Operating activities	11,576
Investing activities	(12,984)
Financing activities	3,500

- b) During February 2004, the Company sold its 50% share in the Trent Health group of companies to Co-operators Life Insurance Company resulting in a gain of \$2,102 before income taxes which is recorded as income from discontinued operations. The net income for the period from January 1, 2004 to February 26, 2004, date of disposition, was approximately \$6 and was included in income from discontinued operations.

### **3 Summary of significant accounting policies**

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of income and expenses for the reporting period of the consolidated statement of income and retained earnings. Actual results could differ from those estimates.

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, except in 2004 a 50% proportionate share of the consolidated accounts of EGI Financial (2003) (note 2) is included. All significant intercompany balances and transactions have been eliminated upon consolidation.

#### **Cash and short-term deposits**

Cash and short-term deposits include cash on hand, cash balances with banks and investments in money market instruments maturing in 90 days or less from the date of acquisition.

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements**  
(in \$ thousands, except share amounts)

**Investments**

Bonds and debentures are stated at amortized cost. Premiums and discounts arising on the purchase of bonds and debentures are amortized to investment income on a yield-to-maturity basis. When the value of any bond, debenture or term deposit is identified as impaired, the carried amount is adjusted to an estimated realizable amount, and the adjustment is deducted from investment income.

Common shares are recorded at cost. Provision is made for any reductions in value of common shares that are considered other than temporary and any such amounts are deducted from investment income.

Investment income is recorded as it accrues. Dividend income on stocks is accrued on the ex-dividend date. Gains and losses on disposal of investments are determined and recorded as at the transaction date and are calculated on the basis of the average cost of the investments held.

**Provision for unpaid claims**

Provision for unpaid claims includes adjustment expenses which represent the estimated amounts required to settle all outstanding and unreported claims incurred to the end of the year. Unpaid claims liabilities are carried on a discounted basis. Expected reinsurance recoveries on unpaid claims and adjustment expenses, net of any required provision for doubtful amounts, are recognized as assets at the same time using principles consistent with the Company's method for establishing the related liability.

**Reinsurance**

The Company reflects third party reinsurance balances on the balance sheet on a gross basis to indicate the extent of credit risk related to third party reinsurance and its obligations to policyholders and on a net basis in the statement of income to indicate the results of the retention of premiums written.

**Revenue recognition**

*Premium income:*

Insurance premiums written are deferred as unearned premiums and taken into income pro rata over the terms of the underlying policies. The portion of the premium related to the unexpired term of the policy at the end of the fiscal year is reflected in unearned premiums.

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements**  
(in \$ thousands, except share amounts)

**Deferred policy acquisition costs**

Commissions and premium taxes incurred in the writing of premiums are deferred only to the extent that they are expected to be recovered from unearned premiums and are amortized to income over the terms of the related insurance policies. If unearned premiums are not sufficient to pay expected claims and expenses including policy maintenance expenses and unamortized policy acquisition costs, a premium deficiency is said to exist. Anticipated investment income is considered in determining whether a premium deficiency exists. Premium deficiencies are recognized initially by writing down deferred policy acquisition costs.

**Capital assets**

Capital assets are recorded at cost less accumulated amortization. Amortization is provided over the estimated useful lives of the assets using the straight-line method over the following terms:

Furniture and equipment	3 years
Computer hardware	3 years
Computer software	2 years

**Employee benefits**

The Company contributes to a Group Registered Savings Plan for employees as services are incurred. There are no other post-employment benefits.

**Income taxes**

The Company follows the asset and liability method of accounting for income taxes, whereby future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Future tax assets and liabilities are measured using enacted or substantively enacted income tax rates expected to apply to taxable income in the periods in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in income tax rates is recognized in income in the period that includes the date of enactment or substantive enactment.

**Foreign currency translation**

Foreign currency transactions are translated into Canadian dollars using the exchange rates in effect at the time the transactions occurred. Monetary assets and liabilities are translated into Canadian dollars using the exchange rates in effect at the balance sheet date. Exchange gains and losses are included in income.

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

**Stock based compensation**

The Company has a stock option plan that is described in Note 10. Stock options granted under the plan are accounted for using the fair value method. Under this method, the compensation cost of stock options granted is measured at estimated fair value at the grant date and recognized over the vesting period.

**4 Investments**

The Company utilizes the prudent person approach to asset management as required by the Insurance Companies Act (the "Act"). An investment policy is in place and its application is monitored by the Board of Directors. Diversification techniques are employed to minimize risk. Policies limit investments in any entity or group of related entities to a maximum of 5% of the Company's assets. Limitations are also placed on the quality of investments, particularly relating to investment grade bonds.

	2005				2004			
	Carrying amount	Fair value	Unrealized gain	Unrealized loss	Carrying amount	Fair value	Unrealized gain	Unrealized loss
Bonds								
Canadian								
Federal	61,405	61,267	97	(235)	22,137	22,458	324	(3)
Provincial	21,366	22,307	967	(26)	8,676	9,011	345	(10)
Municipal	1,529	1,617	88	-	769	798	29	-
Corporate	38,377	38,442	514	(449)	15,783	16,225	469	(27)
	122,677	123,633	1,666	(710)	47,365	48,492	1,167	(40)
Preferred shares	3,738	3,767	58	(29)	650	660	10	-
Common shares								
Canadian	22,802	28,934	6,185	(53)	7,960	9,670	1,730	(20)
United States	2,761	2,801	116	(76)	830	868	65	(27)
	25,563	31,735	6,301	(129)	8,790	10,538	1,795	(47)
Investment income due and accrued	758	758	-	-	293	293	-	-
	152,736	159,893	8,025	(868)	57,098	59,983	2,972	(87)

Fair values of bonds and stocks are determined based on quoted market prices. Bonds comprise Canadian government, provincial, municipal and corporate bonds.

The effective interest rate for bonds ranges from 3.8% to 4.5% in 2005 (2004 - 3.8% to 5.0%).

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

**Impaired assets and provisions for losses**

The Board of Directors has established a policy to write down or make provision for any investment with “other than temporary” impairment. There was no investment provision recorded in 2005 and 2004.

Management has reviewed currently available information regarding those investments whose estimated fair value is less than carrying value. Debt securities whose carrying value exceeds market value can be held until maturity. All investments have been reviewed to ensure that corporate performance expectations have not changed significantly to adversely affect the market value of these investments other than on a temporary basis.

**Securities lending**

Until April 2005 the Company participated in a securities lending program managed by a federally regulated financial institution whereby the Company lent securities it owned to other financial institutions to allow them to meet delivery commitments. The Company received securities of superior credit quality and value as collateral for securities loaned. As at December 31, 2004, securities with an estimated fair value of \$6,116 had been loaned, and securities with an estimated fair value of \$6,524 had been received as collateral.

**Interest rate and liquidity risk**

Historical data and current information are used to profile the ultimate claims settlement pattern by class of insurance, which is then used in a broad sense to develop an investment policy and strategy. Fluctuations in interest rates could have a significant impact on the market value of the bond portfolio. Stock market values can be volatile. This could result in realized gains or losses if actual claims payment patterns require liquidation of investments.

Liquidity risk is the risk that an entity will encounter difficulty in raising funds to meet cash flow commitments associated with financial instruments. To manage its cash flow requirements, the Company maintains a portion of its invested assets in liquid securities.

The maturity profile of bonds as at December 31, 2005 is as follows:

	<u>1 year</u>	<u>1 – 3 years</u>	<u>3 – 5 years</u>	<u>Over 5 years</u>	<u>Total</u>
Bonds	\$1,401	\$21,367	\$24,721	\$75,188	\$122,677
Percentage of total	1.1%	17.4%	20.2%	61.3%	100.0%

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

**Credit risk**

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the Company to incur a financial loss. Credit risk mostly arises from investments in bonds and preferred shares.

The Company's investment policy requires, at the time of the investment, that fixed income securities have a minimum credit rating of BBB and preferred shares have a minimum rating of P3. Management monitors subsequent rating changes on a regular basis.

**5 Unearned Premiums**

	<u>2005</u>		<u>2004</u>	
	<b>Gross</b>	<b>Ceded</b>	<b>Gross</b>	<b>Ceded</b>
Automobile:				
- accident benefits	14,210	1,025	6,525	2,576
- liability	15,160	1,079	7,129	2,790
- other	7,770	94	3,686	1,357
Total Automobile	<u>37,140</u>	<u>2,198</u>	<u>17,340</u>	<u>6,723</u>
Niche:				
Property				
- commercial	1,505	328	320	94
- personal	43	-	24	7
Liability	883	230	-	-
Accident and sickness	34	5	41	7
Other	368	-	208	40
Total Niche	<u>2,833</u>	<u>563</u>	<u>593</u>	<u>148</u>
	<u>39,973</u>	<u>2,761</u>	<u>17,933</u>	<u>6,871</u>

**6 Provision for unpaid claims**

The determination of the provision for unpaid claims and adjustment expenses and the related reinsurers' share requires the estimation of three major variables or quanta, being development of claims, reinsurance recoveries and the effects of discounting, to establish a best estimate of the value of the respective liability or asset.

The provision for unpaid claims and adjustment expenses is an estimate subject to variability and the variability could be material in the near term. The variability arises because all events affecting the ultimate settlement of claims have not taken place and may not take place for some time. Variability can be caused by receipt of additional claim information, changes in judicial interpretation of contracts, significant changes in the severity or frequency of claims for historical trends, the timing of claim payments, the recoverability of reinsurance and future rates of investment return. The estimates are principally based on the Company's historical

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

experience. Methods of estimation have been used, which the Company believes produce reasonable results given current information.

Unpaid claims, adjustment expenses and unreported losses consist of (i) case reserves based on reports and estimates prepared by claims adjusters, and (ii) a reserve for incurred but unreported losses based on past experience. The provision for adjustment expenses reflects the estimated costs of investigating, settling and processing these claims. An actuary has been appointed by the Board of Directors of Echelon pursuant to the Act. With respect to the preparation of Echelon's financial statements, the actuary is required to carry out a valuation of Echelon's policy liabilities. The adequacy of these estimates is evaluated by the actuary using appropriate actuarial techniques based on prior experience. The actuary is responsible for ensuring that the assumptions and methods used for the valuation of policy liabilities are in accordance with Canadian accepted actuarial practices, applicable legislation and associated regulations and directives. In performing the valuations of Echelon's liabilities, which are by their nature inherently variable, assumptions are made as to the future loss ratios, trends, rates of claims frequency and severity, inflation, reinsurance recoveries, investment rates of return and both internal and external adjustment expenses, taking into consideration the circumstances and the nature of the insurance policies in force.

All provisions are periodically reviewed and evaluated considering emerging claims experience and changing circumstances. The process of determining the provisions necessarily involves risks that actual results may differ, perhaps materially, from the best estimates made. The resulting changes in estimates of the ultimate liability are recorded as incurred claims in the current year.

The provision for unpaid claims includes a provision for adverse deviation, as required by Canadian accepted actuarial practices. The aggregate impact of the provision for adverse deviation is to increase the provision for unpaid claims on a gross basis by \$12,485 as at December 31, 2005 (2004 - \$4,318).

	<u>2005</u>		<u>2004</u>	
	<b>Gross</b>	<b>Ceded</b>	<b>Gross</b>	<b>Ceded</b>
Automobile:				
- accident benefits	47,571	21,668	17,251	8,028
- liability	75,631	30,647	34,673	16,214
- other	3,063	1,237	1,143	377
Total Automobile	<u>126,265</u>	<u>53,552</u>	<u>53,067</u>	<u>24,619</u>
Niche:				
Property				
- commercial	1,590	411	785	264
- personal	74	28	41	13
Liability	114	28	12	6
Accident and sickness	961	9	119	42
Other	169	15	125	34
Total Niche	<u>2,908</u>	<u>491</u>	<u>1,082</u>	<u>359</u>
	<u>129,173</u>	<u>54,043</u>	<u>54,149</u>	<u>24,978</u>

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

The Company discounts its best estimate of claim provisions at a rate of interest of 2.8% for 2005 (2004 – 3.5%) for all lines of business. The Company determines the discount rate based upon the expected return on its investment portfolio of assets with appropriate assumptions for interest rates relating to reinvestment of maturing investments.

**7 Underwriting policy and reinsurance ceded**

In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavourable underwriting results by purchasing reinsurance to share all or part of the insurance risks originally accepted by the Company in writing premiums. This reinsurance does not relieve the Company of its primary obligation to policyholders.

The Company has entered into quota share reinsurance contracts with third party reinsurers ceding 25% (2004 – 35%) of all risks written. There were other specific reinsurance placements for the specialty property and casualty program business. At the end of 2005 the Company arranged for a portfolio withdrawal of the unearned premiums from the 2005 quota share reinsurers. As a result of this withdrawal, the reinsurers' share of unearned premiums has been reduced by \$9,198 and unearned commission revenue has been reduced by \$2,115 as at December 31, 2005.

During 2005, the Company followed the policy of underwriting and reinsuring contracts of insurance, which limits the net exposure of the Company to a maximum amount on any one loss to \$450 (2004 - \$163). In addition, the Company obtained catastrophe reinsurance which limits the loss from a series of claims arising from a single occurrence to \$750 (2004 - \$325) to a maximum coverage of 75% of \$15,000 (2004 - 65% of \$7,500).

The Company places all its automobile reinsurance with Canadian registered reinsurers. There are non-registered reinsurers participating on the specialty property and casualty program business. The Company has access to trust funds that, in the Company's judgement, are adequate to secure the liabilities that the Company has ceded to non-registered reinsurers.

Failure of reinsurers to honour their obligations could result in losses to the Company. Consequently, the Company continually evaluates the financial condition of its reinsurers and monitors concentrations of credit risk to minimize its exposure to significant losses. There have been no defaults and no provision made in the accounts for defaults based on management's review of the creditworthiness of its reinsurers.

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

**8 Capital assets**

	2005			2004		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Furniture and equipment	425	371	54	314	232	82
Computer hardware	131	65	66	241	233	8
Computer software	1,020	580	440	625	448	177
	<u>1,576</u>	<u>1,016</u>	<u>560</u>	<u>1,180</u>	<u>913</u>	<u>267</u>

**9 Share capital**

	2005	2004
Authorized:		
Unlimited common shares		
Unlimited special shares issuable in Series		
Issued:		
9,583,152 common shares post split (2004 - 2,268,279)	45,505	15,186
2,268,279 Series F special shares	2,155	2,155
	<u>47,660</u>	<u>17,341</u>

Series A and Series B special shares were issued as part of the January 2005 acquisition by the Company of 50% of EGI Financial (2003) (note 2). Immediately prior to the acquisition, 2,268,279 Series A special shares were issued to the common shareholders of the Company and upon the acquisition, 1,682,768 Series B special shares were issued to the sellers of the 50% of EGI Financial (2003) as part of the purchase price along with 1,682,768 of common shares. The Series B special shares were issued to effect any necessary adjustments in the exchange ratio based on development of claims. At a future date, any adjustment required to the ratio was to be determined and either the Series A or the Series B shares would be converted into additional common shares, and the other series of special shares would be redeemed for nominal consideration; no change in the aggregate amount of share capital would result. On September 29, 2005, the outstanding Series B special shares were converted to 11,058 additional common shares and the Series A special shares were redeemed for nominal consideration.

During 2004 the number of common shares of the Company was increased by 50,121 upon conversion of 791,936 Series E special shares.

During 2004 a stock dividend was declared to shareholders of record on May 13, 2004. One special Series F special share with a nominal value of \$0.95 was issued for each common share. These Series F special shares are entitled to cumulative dividends at the rate of

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

\$0.06365 per share per annum. This transaction resulted in a reduction to retained earnings and an increase in share capital of \$2,155. As at December 31, 2005 there were unpaid cumulative dividends of \$217 on these shares (2004 - \$72). Subsequently, on January 31, 2006, the outstanding Series F special shares were redeemed for \$2,384, including cumulative dividends.

On June 7, 2005 the existing 3,951,047 common shares were split 2-for-1.

Upon the closing of an initial public offering on December 8, 2005, 1,670,000 common shares were issued at a price of \$10.50 per share. The net increase to share capital from this transaction was \$16,096 comprising gross proceeds of \$17,535 and expenses, net of taxes, of \$1,439.

**10 Employee stock option plan**

The Company sponsors a stock option plan. The stock option plan provides for the issuance of shares of the Company's common stock not exceeding 10% of the total issued and outstanding shares (on a non-diluted basis) and shares reserved for issuance under employee stock option plans, options for services and employee stock purchase plans. The Board of Directors determines the terms and conditions of the awards under the plan as well as any award allocations.

For the year ended December 31, 2005 the Company recorded a compensation expense of \$80 with an offsetting credit to contributed surplus. All stock options granted are for a term of five years. The stock options vest 20% on each anniversary of the grant date.

The following is a continuity schedule of stock options outstanding as at December 31, 2005 and 2004:

	Number of shares		Weighted average exercise price per share	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
			\$	\$
Outstanding, beginning of year	470,000	-	4.23	-
Granted	45,000	470,000	5.09	4.23
Outstanding, end of year	<u>515,000</u>	<u>470,000</u>	<u>4.30</u>	<u>4.23</u>

As at December 31, 2005, the outstanding stock options consist of the following:

<u>Option price per share</u>	<u>Number</u>	<u>Remaining contractual life</u>	<u>Number of options exercisable</u>
\$4.23	470,000	3.8 years	94,000
\$5.09	45,000	4.3 years	-

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

The fair value of the stock options issued was determined using the Black-Scholes option pricing model with the following assumptions: (i) risk-free rate of 3.75%, (ii) life expectancy of four years, (iii) estimated volatility of 0%, and (iv) dividend yield of 0%. The fair value of total options granted to date was estimated at \$398. The weighted average grant-date fair value of options granted to date is \$0.70.

**11 Related party transactions**

The Co-operators Group Limited and Co-operators General Insurance Company, significant shareholders of the Company, provide services to the Company including but not limited to product distribution and investment management services. Direct written premiums derived from Co-operator's agents in 2005 was \$27,217 (2004 - \$15,394) and commissions paid in 2005 were \$2,878 (2004 - \$1,627).

The Company holds deposits of \$5,996 at December 31, 2005 (2004 - \$5,825) under the terms of a 2001 100% Quota Share reinsurance treaty with Co-operators General Insurance with income resulting from the investment of these deposits for the account of the Company. Reinsurers' share of unpaid claims includes a recoverable of \$5,996 (2004 - \$5,826) from Co-operators General Insurance. The due to insurance companies balance includes amounts due to Co-operators General Insurance of \$7,024 (2004 - \$5,944).

Co-operators provided a loan of \$2,000 to the Company in 2001 bearing interest at 7% to be paid semi-annually. During 2004, the Company repaid \$945 to Co-operators. The balance of \$1,702, including interest, owing to Co-operators was repaid on December 16, 2005.

**12 Income taxes**

The provision for income taxes reflects an effective rate which differs from the corporate tax rate as follows:

	<u>2005</u>	<u>2004</u>
Income tax expense at statutory rates	6,100	1,723
Permanent differences	(314)	(330)
Future income tax rate changes	1	3
Large Corporations tax	-	8
Recognition of income tax losses from prior years	-	(1,380)
Other	(50)	46
	<u>5,737</u>	<u>70</u>

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

Future income taxes are comprised of the following:

	<u>2005</u>	<u>2004</u>
Income tax loss carry-forward amounts	-	226
Provision for unpaid claims	1,511	515
Investments	980	305
Deferred costs	647	-
Capital assets	(5)	-
	<u>3,133</u>	<u>1,046</u>

**13 Lease commitments**

The Company is committed under lease agreements for office premises and computer equipment with minimum lease payments of \$1,474 as follows:

2006	498
2007	469
2008	412
2009	95

**14 Structured settlements**

In the normal course of claims adjudication, the Company may settle certain long-term losses through the purchase of annuities (structured settlements) from life insurance companies. The fair value of these annuity contracts amounts to \$3,240 (2004 - \$1,543) using a discount rate of 5% (2004 – 5%). It is the policy of the Company to purchase annuities from life insurers with proven financial stability. The net risk to the Company is the credit risk related to the life insurance companies and this risk is reduced to the extent of coverage provided by the life insurance compensation insurance plan (Assuris, formerly Comp Corp). The Company has determined that no credit risk provision is required.

**15 Fair value disclosure**

Fair value is an amount that represents the estimated exchange value of a financial instrument between willing parties.

The fair value of the investments is considered to be the market value, less transaction costs. The majority of the investment portfolio is fully invested in well established, active, liquid markets. The fair value of investments is disclosed in note 4.

The fair value of outstanding claims is reasonably considered to be the carrying value, as stated. Many claims are of short duration and the Company already discounts claims. There is not an active market for policy liabilities stand-alone, so a market value is not readily available. An actuarial approach to determine value is to discount estimated future cash flows and includes a margin called the provision for adverse deviation. Both values are considered reasonable in the range of possible outcomes and the difference in the change year over year is not considered material.

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

The fair values of other financial assets and financial liabilities are considered to be the carrying values, as they are of short duration. The value of the Company as a whole on a going concern basis may be greater than the sum of the fair values of the individual assets and liabilities.

**16 Contingencies**

From time to time, in connection with its insurance operations, the Company is named a defendant in actions for damages and costs allegedly sustained by the plaintiffs. While it is not possible to estimate the outcome, such actions have generally been resolved with minimal damage or expense in excess of amounts provided as policy liabilities. The Company does not believe that it will incur any significant additional loss or expense in connection with such actions.

**17 Regulatory requirements**

At December 31, 2005 and 2004, Echelon met the minimum regulatory capital requirement. In addition, legislation applicable to insurance companies imposes certain restrictions on an insurance company's ability to pay dividends.

The Company writes business subject to rate regulation, including non-standard automobile insurance which comprises approximately 91% of net premiums written. The Company's automobile insurance premiums can be impacted by mandatory rate rollbacks and mandatory rate assessments as legislated by provincial law and by regulation in certain provinces. This could result in lower future premium rates or reductions to premium rates charged by the Company in prior periods. In addition, the Company is required, under certain provincial legislation, to participate in risk sharing pools, which may impact positively or negatively upon underwriting results. Certain benefit payments are also subject to provincial government regulation, including automobile accident benefits.

The Company currently has applications with Nova Scotia for an automobile premium rate increase of 10.6% in 2006. The Company is not aware of any proposed or pending rate rollbacks related to prior years.

**18 Earnings per share**

	<b>2005</b>	<b>2004</b>
Basic earnings per share:		
Net income from continuing operations	11,208	4,718
Dividends to Series F shareholders	<u>(144)</u>	<u>(72)</u>
Net income before discontinued operations and extraordinary items available to common shareholders	<u>11,064</u>	<u>4,646</u>
Average number of common shares (in thousands)	<u>8,018</u>	<u>4,537</u>
Diluted earnings per share:		
Average number of common shares (in thousands)	8,018	4,537
Common shares obligation under employee stock option plan	515	470
Average number of diluted common shares	8,517	4,595

Earnings per share amounts for 2004 reflect the common stock split completed on June 7, 2005.

**EGI FINANCIAL HOLDINGS INC.**  
**Notes to Consolidated Financial Statements (continued)**  
(in \$ thousands, except share amounts)

**19 Segmented information**

The Company operates through two divisions. Through its Automobile Division, the Company is engaged in the underwriting of high premium, non-standard automobile insurance. Through its recently established Niche Products Division, the Company designs and underwrites specialized non-auto insurance programs, such as higher premium property, primary and excess liability, legal expense, accident and health insurance and warranty coverage.

The effect of reinsurance is reflected in the revenue and results of the two divisions. The investment activities consist of managing the investment portfolio for the Company as a whole. Investment income is shown net of investment expenses. Non property and casualty insurance segments include the corporate and other activities, as well as realized investment gains. The corporate and other activities include sources of income and non-recurring items such as acquisitions, divestitures and discontinued operations.

	<b>2005</b>	<b>2004</b>
Revenue		
Earned premiums		
Property and casualty insurance		
Automobile	69,644	31,836
Niche	<u>6,927</u>	<u>2,077</u>
	76,571	33,913
Interest and dividends	6,306	2,500
Realized gains	<u>1,221</u>	<u>919</u>
Total revenue	<u>84,098</u>	<u>37,332</u>
Income (loss) before income taxes		
Property and casualty insurance		
Automobile	9,372	1,920
Niche	467	(139)
Corporate and other	<u>(421)</u>	<u>(412)</u>
Underwriting Income	9,418	1,369
Interest and dividends	6,306	2,500
Realized investment and other gains	<u>1,221</u>	<u>919</u>
Total income before income taxes	<u>16,945</u>	<u>4,788</u>

**20 Comparative figures**

Certain comparative figures have been reclassified to conform with the current financial statement presentation.