

Consolidated Financial Statements of

**EGI FINANCIAL HOLDINGS INC.**

December 31, 2006

## **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. ("the Company") were prepared in accordance with Canadian generally accepted accounting principles. Where necessary, these consolidated financial 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 consolidated financial statements and other financial information, 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 appointed actuary is also required to provide an opinion regarding the appropriateness of the policy liabilities at the consolidated 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 appointed 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, 2006 and 2005, 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 22, 2007

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

**February 22, 2007**

**Auditors' Report**

**To the Shareholders of  
EGI Financial Holdings Inc.**

We have audited the consolidated balance sheet of **EGI Financial Holdings Inc.** as at December 31, 2006 and 2005 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, 2006. 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 audit.

We conducted our audit 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, 2006 and 2005 and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2006 in accordance with Canadian generally accepted accounting principles.

**(signed) "PricewaterhouseCoopers LLP"**

**Chartered Accountants**

**EGI FINANCIAL HOLDINGS INC.**  
**Consolidated Balance Sheets**  
**as at December 31**

(in \$ thousands, except share amounts)

<b>Assets</b>	<b>2006</b>	<b>2005</b>
Cash and short-term deposits.....	17,153	15,899
Investments (note 4).....	179,383	152,736
Reinsurers' share - unearned premiums (note 5).....	3,831	2,761
- unpaid claims (note 6).....	48,385	54,043
Accounts receivable.....	22,182	22,271
Income taxes recoverable.....	572	273
Due from insurance companies.....	3,996	2,504
Deferred policy acquisition costs.....	7,465	6,289
Capital assets (note 8).....	799	560
Future income taxes (note 12).....	4,403	3,133
Prepaid expenses and other assets.....	270	262
	<u>288,439</u>	<u>260,731</u>
<b>Liabilities</b>		
Provision for unpaid claims (note 6).....	146,101	129,173
Unearned premiums (note 5).....	43,154	39,973
Unearned commission.....	733	1,261
Accounts payable and accrued liabilities.....	4,746	4,503
Payable to insurance companies.....	4,428	7,340
Income taxes payable.....	3,151	5,708
Other liabilities.....	85	188
	<u>202,398</u>	<u>188,146</u>
<b>Shareholders' Equity</b>		
Share capital (note 9).....	45,833	47,660
Contributed surplus (note 10).....	149	80
Retained earnings.....	40,059	24,845
	<u>86,041</u>	<u>72,585</u>
	<u>288,439</u>	<u>260,731</u>

On Behalf of the Board of Directors:

(signed) Douglas E. McIntyre, Director

(signed) Kevin Daniel, Director

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

	<b>2006</b>	<b>2005</b>
Revenue		
Direct written premiums.....	117,834	117,006
Net written premiums.....	106,047	91,783
Net earned premiums.....	103,942	76,344
Investment income.....	11,033	7,527
Other revenue.....	1	227
	<u>114,976</u>	<u>84,098</u>
Expenses		
Incurred claims.....	59,503	45,997
Acquisition costs.....	19,499	12,073
Operating.....	10,431	9,083
	<u>89,433</u>	<u>67,153</u>
Income before income taxes.....	<u>25,543</u>	<u>16,945</u>
Income tax expense (recovery) (note 12)		
Current.....	9,832	7,505
Future.....	(1,270)	(1,768)
	<u>8,562</u>	<u>5,737</u>
Income from operations	16,981	11,208
Extraordinary gain, net of income taxes (note 2).....	-	5,669
Net income.....	<u>16,981</u>	<u>16,877</u>
Earnings per share (note 18)		
Net income per share before extraordinary gain	1.76	1.38
Net income per share from extraordinary gain	-	0.71
Net income per share	<u>1.76</u>	<u>2.09</u>
Net income per diluted share before extraordinary gain	1.67	1.30
Net income per diluted share from extraordinary gain	-	0.66
Net income per diluted share	<u>1.67</u>	<u>1.96</u>

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

	<b>2006</b>	<b>2005</b>
<b>Share capital</b>		
Balance, beginning of year.....	47,660	17,341
Common shares issued.....	328	30,319
Redemption of Series F special shares.....	(2,155)	-
Balance, end of year.....	<u>45,833</u>	<u>47,660</u>
<b>Contributed surplus</b>		
Balance, beginning of year.....	80	-
Stock options – granted.....	97	80
– exercised.....	(28)	-
Balance, end of year.....	<u>149</u>	<u>80</u>
<b>Retained earnings</b>		
Balance, beginning of year.....	24,845	7,968
Net income.....	16,981	16,877
Dividends – Series F special shares.....	(229)	-
– Common shares.....	(1,538)	-
Balance, end of year.....	<u>40,059</u>	<u>24,845</u>
<b>Total, end of year.....</b>	<b><u>86,041</u></b>	<b><u>72,585</u></b>

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

	<b>2006</b>	<b>2005</b>
Cash provided by (used in)		
Operating activities		
Net income	16,981	16,877
Items not involving cash		
Amortization of capital assets	433	448
Amortization of premium on bonds	386	177
Realized gains on investments	(3,489)	(1,221)
Extraordinary gain	-	(6,819)
Other	97	-
	<u>14,408</u>	<u>9,462</u>
Cash flow from changes in		
Reinsurers' share of unearned premiums	(1,070)	10,981
Reinsurers' share of unpaid claims	5,658	(4,087)
Accounts receivable	89	(2,190)
Income taxes recoverable	(299)	(273)
Due from insurance companies	(1,492)	(2,504)
Accounts payable and accrued liabilities	(3,300)	(15,564)
Provision for unpaid claims	16,928	21,426
Unearned premiums	3,181	4,445
Income taxes payable	(2,557)	3,749
Future income taxes	(1,270)	(1,267)
Other assets	(8)	(12)
Deferred policy acquisition costs	(1,176)	(884)
	<u>29,092</u>	<u>23,282</u>
Financing activities		
Issue of common shares	300	16,096
Series F special shares dividends	(229)	-
Redemption of Series F special shares	(2,155)	-
Common share dividends	(1,538)	-
	<u>(3,622)</u>	<u>16,096</u>
Investing activities		
Acquisition of subsidiary, net of cash acquired	-	5,646
Purchase of capital assets	(672)	(564)
Purchase of investments	(193,256)	(75,508)
Sale/maturity of investments	169,712	39,620
	<u>(24,216)</u>	<u>(30,806)</u>
Increase in cash and short-term deposits	1,254	8,572
Cash and short-term deposits, beginning of year	15,899	7,327
Cash and short-term deposits, end of year	<u>17,153</u>	<u>15,899</u>
Supplementary information		
Income taxes paid	12,713	4,195

**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 Acquisition**

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 statements 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	<u>(17,469)</u>
Net assets acquired	21,041
Consideration given:	
Common and Series B special shares	<u>14,222</u>
Negative goodwill	<u>6,819</u>

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

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

**3 Summary of significant accounting policies**

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of consolidated 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 the revenue and expenses for the reporting period of the consolidated statements of income. Actual results could differ from those estimates.

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. 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.

**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 and preferred shares are recorded at cost. Provision is made for any reductions in value of common and preferred 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 shares 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.

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

**Reinsurance**

The Company reflects third party reinsurance balances on the consolidated balance sheets 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 consolidated statements of income to indicate the results of the retention of premiums written.

**Revenue recognition**

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.

**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. 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 income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases and operating loss and tax credit carry forwards. Future income tax assets and liabilities are measured using enacted or substantively enacted income tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in income tax rates is recognized in income in the year that includes the date of enactment or substantive enactment.

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

**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 consolidated balance sheet dates. Exchange gains and losses are included in income.

**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.

	2006				2005			
	Carrying amount	Fair value	Unrealized gain	Unrealized loss	Carrying amount	Fair value	Unrealized gain	Unrealized loss
Bonds								
Canadian								
Federal	65,918	65,928	187	(177)	61,405	61,267	97	(235)
Provincial	27,249	27,883	655	(21)	21,366	22,307	967	(26)
Municipal	3,914	3,954	71	(31)	1,529	1,617	88	-
Corporate	49,236	49,525	369	(80)	38,377	38,442	514	(449)
	146,317	147,290	1,282	(309)	122,677	123,633	1,666	(710)
Preferred shares	6,277	6,369	141	(49)	3,738	3,767	58	(29)
Common shares								
Canadian	21,574	28,374	7,222	(422)	22,802	28,934	6,185	(53)
United States	3,883	4,183	356	(56)	2,761	2,801	116	(76)
	25,457	32,557	7,578	(478)	25,563	31,735	6,301	(129)
Investment income due and accrued	1,332	1,332	-	-	758	758	-	-
	179,383	187,548	9,001	(836)	152,736	159,893	8,025	(868)

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 4.0% to 4.6% in 2006 (2005 - 3.8% to 4.5%).

**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 an “other than temporary” impairment. There was no investment provision recorded in 2006 and 2005.

Management has reviewed currently available information regarding those investments whose 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.

**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, 2006 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	\$9,916	\$18,762	\$27,379	\$90,260	\$146,317
Percentage of total	6.8%	12.8%	18.7%	61.7%	100.0%

**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.

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

**5 Unearned Premiums**

	<u>2006</u>		<u>2005</u>	
	<b>Gross</b>	<b>Ceded</b>	<b>Gross</b>	<b>Ceded</b>
Automobile:				
- accident benefits	14,267	1,280	14,210	1,025
- liability	15,392	1,374	15,160	1,079
- other	7,591	139	7,770	94
Total Automobile	<u>37,250</u>	<u>2,793</u>	<u>37,140</u>	<u>2,198</u>
Niche:				
Property				
- commercial	3,660	403	1,505	328
- personal	61	30	43	-
Liability	1,883	601	883	230
Accident and sickness	34	4	34	5
Other	266	-	368	-
Total Niche	<u>5,904</u>	<u>1,038</u>	<u>2,833</u>	<u>563</u>
	<u>43,154</u>	<u>3,831</u>	<u>39,973</u>	<u>2,761</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: 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 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 appointed actuary using appropriate actuarial techniques based on prior experience. The appointed 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

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

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 \$14,794 as at December 31, 2006 (2005 - \$12,485).

	<u>2006</u>		<u>2005</u>	
	<b>Gross</b>	<b>Ceded</b>	<b>Gross</b>	<b>Ceded</b>
Automobile:				
- accident benefits	50,750	19,473	47,571	21,668
- liability	86,473	27,226	75,631	30,647
- other	2,592	367	3,063	1,237
Total Automobile	<u>139,815</u>	<u>47,066</u>	<u>126,265</u>	<u>53,552</u>
Niche:				
Property				
- commercial	2,940	392	1,590	411
- personal	106	52	74	28
Liability	2,280	872	114	28
Accident and sickness	702	3	961	9
Other	258	-	169	15
Total Niche	<u>6,286</u>	<u>1,319</u>	<u>2,908</u>	<u>491</u>
	<u>146,101</u>	<u>48,385</u>	<u>129,173</u>	<u>54,043</u>

The Company discounts its best estimate of claim provisions at a rate of interest of 2.8% for 2006 (2005 – 2.8%) 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.

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

In 2005, the Company had entered into quota share reinsurance contracts with third party reinsurers ceding 25% of all risks written. There were other specific reinsurance placements for the specialty property and casualty program business. However, 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 2006, 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 \$950 (2005 - \$450). In addition, the Company obtained catastrophe reinsurance which limits the loss from a series of claims arising from a single occurrence to \$950 (2005 - \$750) to a maximum coverage of \$19,100 (2005 - \$14,425).

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.

**8 Capital assets**

	2006			2005		
	Cost	Accumulated amortization	Net book value	Cost	Accumulated amortization	Net book value
Furniture and equipment	435	423	12	425	371	54
Computer hardware	171	100	71	131	65	66
Computer software	<u>1,640</u>	<u>924</u>	<u>716</u>	<u>1,020</u>	<u>580</u>	<u>440</u>
	<u>2,246</u>	<u>1,447</u>	<u>799</u>	<u>1,576</u>	<u>1,016</u>	<u>560</u>

**9 Share capital**

Authorized:

- Unlimited common shares
- Unlimited special shares issuable in series

Issued:

	<b>2006</b>	<b>2005</b>
9,639,152 common shares (2005 - 9,583,152)	45,833	45,505
2,268,279 Series F special shares (2006 – Nil)	-	2,155
	<u>45,833</u>	<u>47,660</u>

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

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 A and 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 would 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 January 31, 2006, the outstanding Series F special shares were redeemed for cash of \$2,384, including cumulative dividends.

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

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.

On 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.

During 2006, 46,000 common shares were issued pursuant to the exercise of employee stock options, with an issue cost of \$4.82 per share, and 10,000 common shares were issued to a new director, at a price of \$10.61 per share, to comply with the Company's requirements.

## **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, 2006, the Company recorded a compensation expense of \$97 (2005 - \$80) with an offsetting credit to contributed surplus. During 2006, 46,000 stock options were exercised. All stock options granted are for a term of five years with varying vesting periods.

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

The following is a continuity schedule of stock options outstanding as at December 31, 2006 and 2005:

	Number of shares		Weighted average exercise price per share	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Outstanding, beginning of year	515,000	470,000	4.30	4.23
Granted during year	212,750	45,000	9.95	5.09
Exercised during year	(46,000)	-	4.23	-
Outstanding, end of year	<u>681,750</u>	<u>515,000</u>	6.07	4.30

As at December 31, 2006, the outstanding stock options consist of the following:

<u>Option price per share</u>	Number	Remaining contractual life	Number of options exercisable
\$4.23	424,000	2.8 years	142,000
\$5.09	45,000	3.3 years	4,500
\$10.61	90,500	3.8 years	-
\$10.31	6,750	4.3 years	-
\$9.26	70,500	4.8 years	-
\$9.65	45,000	5.0 years	-

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 1%; and (iv) dividend yield of 1.7%. The grant date fair value of total options granted is estimated at \$565. The weighted average grant-date fair value of stock options granted to date is \$0.77.

## 11 Related party transactions

The Co-operators Group Limited and Co-operators General Insurance Company (collectively Co-operators), 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-operators' agents in 2006 was \$20,866 (2005 - \$27,217) and commissions paid in 2006 were \$2,223 (2005 - \$2,858).

The Company holds deposits of \$3,378 as at December 31, 2006 (2005 - \$5,996) under the terms of a 2001, 100% Quota Share reinsurance treaty with Co-operators General Insurance Company with income resulting from the investment of these deposits for the account of the Company. Reinsurers' share of unpaid claims includes a recoverable of \$3,371 (2005 - \$5,996) from Co-operators General Insurance Company. The due to insurance companies balance includes amounts due to Co-operators General Insurance Company of \$3,766 (2005 - \$7,024).

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

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>2006</u>	<u>2005</u>
Income tax expense at statutory rates	9,363	6,100
Permanent differences	(685)	(314)
Future income tax rate changes	(5)	1
Other	(111)	(50)
	<u>8,562</u>	<u>5,737</u>

Future income taxes are comprised of the following:

	<u>2006</u>	<u>2005</u>
Provision for unpaid claims	2,095	1,511
Investments	1,741	980
Deferred costs	487	647
Capital assets	80	(5)
	<u>4,403</u>	<u>3,133</u>

**13 Lease commitments**

The Company is committed under lease agreements for office premises and computer equipment with minimum lease payments of \$962 as follows:

2007	464
2008	407
2009	91
	<u>962</u>

**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 \$3,914 (2005 - \$3,240) using a discount rate of 5% (2005 - 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 Assuris, the life insurance compensation insurance plan. The Company has determined that no credit risk provision is required.

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

**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 stand-alone policy liabilities, 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.

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**

As at December 31, 2006 and 2005, 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 and motorcycle insurance, which comprises approximately 83% 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 years. 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 Ontario for an automobile premium rate decrease of 3.6%, and with Alberta for the introduction of motorcycle business, both to be effective in 2007. The Company is not aware of any proposed or pending rate rollbacks related to prior years.

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

**18 Earnings per share**

	<b>2006</b>	<b>2005</b>
Basic earnings per share:		
Income from operations	16,981	11,208
Extraordinary gain, net of income taxes	<u>-</u>	<u>5,669</u>
Net income	16,981	16,877
Dividends to Series F shareholders	<u>(12)</u>	<u>(144)</u>
Net income available to common shareholders	<u>16,969</u>	<u>16,733</u>
Average number of common shares (in thousands)	<u>9,603</u>	<u>8,018</u>
Basic earnings per share		
Operations	1.76	1.38
Extraordinary gain	<u>-</u>	<u>0.71</u>
Total	<u>1.76</u>	<u>2.09</u>
Diluted earnings per share:		
Net income available to common shareholders	<u>16,969</u>	<u>16,733</u>
Average number of common shares (in thousands)	9,603	8,018
Average number of common shares obligation under employee stock option plan (in thousands)	<u>597</u>	<u>499</u>
Average number of diluted shares (in thousands)	<u>10,200</u>	<u>8,517</u>
Diluted earnings per share		
Operations	1.67	1.30
Extraordinary gain	<u>-</u>	<u>0.66</u>
Total	<u>1.67</u>	<u>1.96</u>

**19 Segmented information**

The Company operates through two divisions. Through its Personal Lines (formerly the Automobile) Division, the Company is engaged in the underwriting of high premium, non-standard automobile insurance and other specialty individual personal lines of business. Through its 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 expenses of the parent company.

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

	<b>2006</b>	<b>2005</b>
Revenue		
Earned premiums		
Property and casualty insurance		
Personal Lines (formerly Automobile)	91,016	69,644
Niche	<u>12,927</u>	<u>6,927</u>
	103,943	76,571
Interest and dividends	8,410	6,306
Realized gains	<u>2,623</u>	<u>1,221</u>
Total revenue	<u>114,976</u>	<u>84,098</u>
Income (loss) before income taxes		
Property and casualty insurance		
Personal Lines (formerly Automobile)	15,141	9,372
Niche	248	467
Corporate and other	<u>(879)</u>	<u>(421)</u>
Underwriting income	14,510	9,418
Interest and dividends	8,410	6,306
Realized investment and other gains	<u>2,623</u>	<u>1,221</u>
Total income before income taxes	<u>25,543</u>	<u>16,945</u>

**20 Subsequent event**

Echelon has entered into two related reinsurance treaties effective January 1, 2007, to assume premiums from two insurance companies incorporated in the United States. One of the insurers manages the business to be reinsured on behalf of both insurers.

Under the treaties, the Company will assume 17.6% and 12.3%, respectively, of the United States companies' 2007 quota share reinsurance treaties. The Company has agreed to accept a maximum aggregate of \$17.1 million of non-standard automobile premiums in 2007, the first year of the treaties. The arrangement has an initial term of two years and renews annually thereafter, unless terminated by either party.

**21 Comparative figures**

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