



## Financial Statements

### Prince Edward Island Mutual Insurance Company

December 31, 2012



# Contents

<b>Independent Auditor's Report</b>	<b>1 - 2</b>
<b>Statement of Financial Position</b>	<b>3</b>
<b>Statement of Comprehensive Income</b>	<b>4</b>
<b>Statement of Members' Surplus</b>	<b>5</b>
<b>Statement of Cash Flows</b>	<b>6</b>
<b>Notes to the Financial Statement</b>	
1. Nature of operations and summary of significant accounting policies	7 - 12
2. Critical accounting estimates and judgments	12 - 13
3. Financial instrument classification	14
4. Receivables	14
5. Investments	15 - 17
6. Property, plant & equipment	18
7. Insurance contracts	18 - 21
8. Pension plan	21
9. Income taxes	22 - 24
10. Gross claims and adjustment expenses	24
11. Fees, commissions and other acquisition expenses	25
12. Other operating and administrative expenses	25
13. Salaries, benefits and directors fees	25
14. Investment and other income	26
15. Change in non-cash operating working capital	26
16. Related party transactions	27
17. Capital management	27
18. Financial instrument and Insurance risk management	27 - 31

# Independent auditor's report

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To the policyholders of  
Prince Edward Island Mutual Insurance Company

We have audited the accompanying financial statements of Prince Edward Island Mutual Insurance Company, which comprise the statement of financial position as at December 31, 2012, and the statement of comprehensive income, statement of members' surplus and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

## Management's responsibility for the financial statements

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

## Auditor's responsibility

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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

#### Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Prince Edward Island Mutual Insurance Company as at December 31, 2012, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

*Grant Thornton LLP*

Summerside, Canada

February 12, 2013

Chartered accountants

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# Prince Edward Island Mutual Insurance Company

## Statement of Financial Position

December 31

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	2012	2011
<b>Assets</b>		
Current		
Cash and cash equivalents	\$ 2,233,781	\$ 1,209,841
Receivables (Note 4)	1,879,390	1,746,695
Income taxes receivable	-	111,519
Prepaid items	25,981	34,777
Deferred policy acquisition expenses (Note 7)	1,283,701	1,166,832
Reinsurers' share of provision for unpaid claims (Note 7)	2,349,886	2,169,035
	<u>7,772,739</u>	<u>6,438,699</u>
Investments (Note 5)	50,234,143	48,837,628
Property, plant and equipment (Note 6)	1,110,223	563,893
Deferred income taxes (Note 9)	18,916	11,398
	<u>\$ 59,136,021</u>	<u>\$ 55,851,618</u>

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### Liabilities

#### Current

Accounts payables and accrued liabilities	\$ 543,472	\$ 516,493
Income taxes payable	473,262	-
Provision for unpaid claims (Note 7)	7,329,430	8,522,587
Unearned premium reserve (Note 7)	10,321,714	9,653,300
	<u>18,667,878</u>	<u>18,692,380</u>

#### Members' surplus

Unappropriated members' surplus	38,951,611	36,232,575
Accumulated other comprehensive income	1,516,532	926,663
	<u>40,468,143</u>	<u>37,159,238</u>
	<u>\$ 59,136,021</u>	<u>\$ 55,851,618</u>

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On behalf of the Board

\_\_\_\_\_  
Director

*The accompanying notes are an integral part of these financial statements*

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# Prince Edward Island Mutual Insurance Company

## Statement of Comprehensive Income

Year ended December 31

	2012	2011
<b>Underwriting Income</b>		
Gross premiums written	\$ 17,960,865	\$ 16,845,195
Add: reinsurance premiums assumed	6,041	5,576
Less: reinsurance premiums ceded	<u>(2,346,289)</u>	<u>(2,031,312)</u>
Net premiums written	15,620,617	14,819,459
Less: increase in unearned premiums	<u>(668,414)</u>	<u>(590,425)</u>
<b>Net premiums earned</b>	<u>14,952,203</u>	<u>14,229,034</u>
<b>Direct losses incurred</b>		
Gross claims and adjustment expenses (Note 10)	9,602,127	10,375,814
Less: reinsurance recoveries	<u>(733,138)</u>	<u>(505,447)</u>
Net losses incurred	<u>8,868,989</u>	<u>9,870,367</u>
<b>Underwriting income</b>	<u>6,083,214</u>	<u>4,358,667</u>
<b>Expenses</b>		
Fees, commissions and other acquisition expenses (Note 11)	2,116,905	1,986,825
Other operating and administrative expenses (Note 12)	<u>3,358,373</u>	<u>3,175,815</u>
	<u>5,475,278</u>	<u>5,162,640</u>
<b>Net underwriting income (loss)</b>	607,936	(803,973)
<b>Investment and other income (Note 14)</b>	<u>2,684,109</u>	<u>2,587,724</u>
<b>Income before income taxes</b>	3,292,045	1,783,751
<b>Provision for income taxes (Note 9)</b>	<u>573,009</u>	<u>258,537</u>
<b>Net income</b>	2,719,036	1,525,214
<b>Other comprehensive income (loss)</b>		
Change in unrealized gain (loss) on available for sale investments, net of income taxes	<u>589,869</u>	<u>(30,980)</u>
<b>Total comprehensive income for the year</b>	<u>\$ 3,308,905</u>	<u>\$ 1,494,234</u>

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*The accompanying notes are an integral part of these financial statements*

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**Prince Edward Island Mutual Insurance Company**  
**Statement of Members' Surplus**  
December 31

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	<b>Unappropriated Members' Surplus</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Total</b>
<b>Balance at January 1, 2011</b>	\$ 34,707,361	\$ 957,643	\$ 35,665,004
Net income	1,525,214	-	1,525,214
Change in unrealized gain/losses on available-for-sale investments, net of income taxes	-	(30,980)	(30,980)
<b>Balance at December 31, 2011</b>	<b>36,232,575</b>	<b>926,663</b>	<b>37,159,238</b>
Net income	2,719,036	-	2,719,036
Change in unrealized gain/losses on available-for-sale investments, net of income taxes	-	589,869	589,869
<b>Balance at December 31, 2012</b>	<b>\$ 38,951,611</b>	<b>\$ 1,516,532</b>	<b>\$ 40,468,143</b>

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*The accompanying notes are an integral part of these financial statements*

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# Prince Edward Island Mutual Insurance Company

## Statement of Cash Flows

Year ended December 31

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	2012	2011
Increase (decrease) in cash equivalents		
<b>Operating</b>		
Net income	\$ 2,719,036	\$ 1,525,214
Depreciation	85,309	85,269
Bond premium amortized	183,805	187,852
Gain on sale of investments	(209,538)	(102,543)
Loss on sale of equipment	1,009	3,217
Deferred income taxes	(7,518)	85
	<u>2,772,103</u>	<u>1,699,094</u>
Change in non-cash operating working capital (Note 15)	(334,602)	(252,566)
Income tax provision - comprehensive income (loss)	(145,995)	6,068
	<u>2,291,506</u>	<u>1,452,596</u>
<b>Investing</b>		
Purchase of property, plant and equipment	(632,648)	(66,483)
Proceeds on disposal of investments	3,829,816	3,133,276
Purchase of investments	(4,464,734)	(5,376,306)
Proceeds on disposal of property, plant and equipment	-	6,965
	<u>(1,267,566)</u>	<u>(2,302,548)</u>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>1,023,940</b>	<b>(849,952)</b>
<b>Cash and cash equivalents, beginning of year</b>	<u><b>1,209,841</b></u>	<u><b>2,059,793</b></u>
<b>Cash and cash equivalents, end of year</b>	<u><b>\$ 2,233,781</b></u>	<u><b>\$ 1,209,841</b></u>

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*The accompanying notes are an integral part of these financial statements*



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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 1. Nature of operations and summary of significant accounting policies

#### Reporting entity

The Company is incorporated without share capital under the laws of Prince Edward Island and is subject to the Prince Edward Island Insurance Act. It is licensed to write property and casualty insurance in Prince Edward Island. The Company's head office is located at 201 Water Street, Summerside, Prince Edward Island.

These financial statements have been authorized for issue by the Board of Directors on February 12, 2013.

#### Basis of presentation

These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (the IASB).

These financial statements were prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets.

The Company's functional and presentation currency is the Canadian dollar.

The preparation of financial statements in compliance with IFRS requires management to make certain critical accounting estimates. It also requires management to exercise judgment in applying the Company's accounting policies. The areas involving a higher degree of judgment of complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 2.

#### Significant accounting policies:

##### Insurance contracts

In accordance with IFRS 4, Insurance Contracts, the Company has continued to apply the accounting policies it applied in accordance with pre-changeover Canadian GAAP.

Balances arising from insurance contracts primarily include unearned premiums, provisions for unpaid claims and adjustment expenses, the reinsurer's share of provisions for unearned premiums and unpaid claims and adjustment expenses, deferred policy acquisition expenses, and salvage and subrogation recoverable.

##### (a) Premiums and unearned premiums

Premiums written comprise the premiums on contracts incepting in the financial year. Premiums written are stated gross of commissions' payable to agents.

The Company earns premium income evenly over the term of the insurance policy generally using the pro rata method. The portion of the premium related to the unexpired portion of the policy at the end of the fiscal year is reflected in unearned premiums.

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 1. Nature of operations and summary of significant accounting policies (cont'd)

- (b) Deferred policy acquisition expenses  
Acquisition costs are those expenses such as agents' commissions, which relate directly to the acquisition of premiums. These costs are deferred and amortized over the terms of the related policies to the extent that they are considered to be recoverable from unearned premiums.

- (c) Provisions for unpaid claims and adjustment expenses  
Individual loss estimates are provided on each claim reported. In addition, provisions are made for adjustment expenses, changes in reported claims and for claims incurred but not reported, based on past experience and business in force. The estimates are regularly reviewed and updated, and any resulting adjustments are included in current income.

Claim liabilities are carried on an undiscounted basis.

- (d) Liability adequacy test  
At each reporting date the Company performs a liability adequacy test on its insurance liabilities less deferred policy acquisition expenses to ensure the carrying value is adequate. If that assessment shows that the carrying amount of the liabilities is inadequate, any deficiency is recognized as an expense to the income statement initially by writing off the deferred policy acquisition expense and subsequently by recognizing an additional claims liability for claims provisions.

- (e) Reinsurers' share of provisions for unpaid claims and adjustment expenses  
The Company enters into reinsurance contracts in the normal course of business in order to limit potential losses arising from certain exposures. Reinsurance premiums are accounted for in the same period as the related premiums for the direct insurance business being reinsured. Reinsurance liabilities, comprised of premiums payable for the purchase of reinsurance contracts, are included in accounts payable and accrued liabilities and are recognized as an expense when due.

Expected reinsurance recoveries on unpaid claims and adjustment expenses are recognized as assets at the same time and using principles consistent with the Company's method for establishing the related liability.

- (f) Salvage and subrogation recoverable  
In the normal course of business, the Company obtains the ownership of damaged property, which they resell to various salvage operations. Unsold property is valued at its estimated net realizable value.

Where the Company indemnifies policyholders against a liability claim, it acquires rights to subrogate its claim against other parties. These claims are reflected at amounts expected to be received from the subrogated parties net of related costs.

- (g) Refund from premium  
Under the discretion of the board of directors the Company may declare a refund to its policyholders based on the premiums paid in the fiscal period. This refund is recognized as a reduction of revenue in the period for which it is declared.

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 1. Nature of operations and summary of significant accounting policies (cont'd)

#### Financial instruments

The Company's financial assets are classified as held for trading, held to maturity, available for sale, or loans and receivables. Financial liabilities are classified as held for trading or other financial liabilities. Financial assets and liabilities are initially recognized at fair value with subsequent measurement based on classification. The classification depends on the purpose for which the financial instruments were acquired, their characteristics and choice where applicable.

All financial instruments are measured at fair value except for loans & receivable, held to maturity and other financial liabilities, which are measured at amortized cost using the effective interest method. Unrealized gains and losses on available for sale investments are recognized in other comprehensive income until the financial asset is derecognized or other than temporarily impaired, at which time any unrealized gains or losses are recorded in net income.

Accumulated other comprehensive income is included in the balance sheet as a separate component of equity (net of income tax) and includes net unrealized gains or losses on available for sale assets.

Fair values are based on quoted market values where available from active markets, otherwise fair values are estimated using a variety of valuation techniques and models.

#### Fair values

The estimated fair values of financial instruments are intended to approximate values at which these instruments could be exchanged in a current market.

No fair values have been determined for property and equipment, or any other asset or liability that is not a financial instrument. The fair values of cash and cash equivalents, receivables, and payables and accruals are assumed to approximate their carrying values due to the short term nature of these financial instruments.

#### Transaction costs

Transaction costs relating to the purchase of available for sale assets are capitalized to the cost.

#### Property, plant and equipment

Property, plant and equipment is initially recorded at cost and subsequently measured at cost less accumulated depreciation and accumulated impairment losses, with the exception of land which is not depreciated. Depreciation is recognized in net income and is recorded using the diminishing balance method over the estimated useful life of the assets at the following rates:

Building structure	5%
Building components	8%
Office equipment	20%
Computer equipment	30%, 45%
Vehicles	30%
Parking lots	8%

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 1. Nature of operations and summary of significant accounting policies (cont'd)

Depreciation methods, useful lives and residual values are reviewed annually and adjusted if necessary.

#### **Impairment of non-financial assets**

Non-financial assets are subject to impairment tests whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. Where the carrying value of an asset exceeds its recoverable amount, which is the higher of value in use and fair value less costs to sell, the asset is written down accordingly.

Where it is not possible to estimate the recoverable amount of an individual asset, the impairment test is carried out on the asset's cash-generating unit, which is the lowest group of assets in which the asset belongs for which there are separately identifiable cash flows. The Company has one cash-generating unit for which impairment testing is performed.

Impairment charges are included in net income, except to the extent they reverse gains previously recognized in other comprehensive income.

#### **Income taxes**

Income tax expense comprises of current and deferred tax. Current tax and deferred tax are recognized in net income except to the extent that it relates to a business combination, or items recognized directly in equity or in other comprehensive income.

Current income taxes are recognized for the estimated income taxes payable or receivable on taxable income or loss for the current year and any adjustment to income taxes payable in respect of previous years. Current income taxes are determined using tax rates and tax laws that have been enacted or substantively enacted by the year-end date.

Deferred tax assets and liabilities are recognized where the carrying amount of an asset or liability differs from its tax base, except for taxable temporary differences arising on the initial recognition of goodwill and temporary differences arising on the initial recognition of an asset of liability in a transaction which is not a business combination and at the time of the transaction affects neither accounting or taxable profit or loss.

Recognition of deferred tax assets for unused tax losses, tax credits and deductible temporary differences is restricted to those instances where it is probable that future taxable profit will be available against which the deferred tax asset can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

The amount of the deferred tax asset or liability is measured at the amount expected to be recovered from or paid to the taxation authorities. This amount is determined using tax rates and tax laws that have been enacted or substantively enacted by the year-end date and are expected to apply when the liabilities / (assets) are settled / (recovered).

#### **Provisions**

Provisions are recognized for liabilities of uncertain timing or amount that have arisen as a result of past transaction, including legal, equitable or constructive obligations. The provision is measured at the best estimate of the expenditure required to settle at the reporting date.

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 1. Nature of operations and summary of significant accounting policies (cont'd)

#### Foreign currency translation

Foreign currency accounts are translated into Canadian dollars as follows:

At the transaction date, each asset, liability, revenue and expense denominated in a foreign currency is translated into Canadian dollars by the use of the exchange rate in effect at that date. At the year-end date, unsettled monetary assets and liabilities are translated into Canadian dollars by using the exchange rate in effect at the year-end date and the related translation differences are recognized in net income. Exchange gains and losses arising on the retranslation of monetary available-for-sale financial assets are treated as a change in fair value and recognized in net income or other comprehensive income.

#### Leased assets

Where substantially all of the risks and rewards incidental to ownership of a leased asset have been transferred to the Company (a "finance lease"), the asset is treated as if it had been purchased outright. The amount initially recognized as an asset is the lower of the fair value of the leased property and the present value of the minimum lease payments payable over the term of the lease. The corresponding lease commitment is shown as a liability. Lease payments are analyzed between capital and interest. The interest element is charged to the statement of comprehensive income over the period of the lease and is calculated so that it represents a constant proportion of the lease liability. The capital element reduces the balance owed to the lessor.

Where substantially all of the risks and rewards incidental to ownership are not transferred to the Company (an "operating lease"), the total rentals payable under the lease are charged to the statement of comprehensive income on a straight-line basis over the lease term. The aggregate benefit of lease incentives is recognized as a reduction of the rental expense over the lease term on a straight-line basis.

#### Cash and cash equivalents

Cash and cash equivalents comprise cash on hand together with other short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

#### Standards, amendments and interpretations not yet effective

Certain new standards, amendments and interpretations have been published that are mandatory for the Company's accounting periods beginning on or after January 1, 2012 or later periods that the Company has decided not to early adopt. The standards, amendments and interpretations that will be relevant to the Company are:

- IFRS 9 Financial Instruments is part of the IASB's wider project to replace IAS 39 'Financial Instruments: Recognition and Measurement'. IFRS 9 retains but simplifies the mixed measurement model and establishes two primary measurement categories for financial assets; amortized cost and fair value. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset. The standard is effective for annual periods beginning on or after January 1, 2015. The Company is in the process of evaluating the impact of the new standards.

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 1. Nature of operations and summary of significant accounting policies (cont'd)

- IFRS 13 Fair Value Measurement (IFRS 13) does not affect which items are required to be fair-valued, but clarifies the definition of fair value and provides related guidance and enhanced disclosures about fair value measurements. It is applicable for annual periods beginning on or after 1 January 2013. The Company's management has yet to assess the impact of this new standard on the Company's financial statements.
- Amendments to IAS 1 Presentation of Financial Statements (IAS 1 Amendments) require an entity to group items presented in other comprehensive income into those that, in accordance with other IFRSs: a) will not be reclassified subsequently to profit or loss and b) will be reclassified subsequently to profit or loss when specific conditions are met. It is applicable for annual periods beginning on or after 1 July 2012. The Company's management expects this will change the current presentation of items in other comprehensive income; however, it will not affect the measurement of such items.

None of the other new standards, interpretations and amendments, which are effective for the Company's accounting periods beginning after January 1, 2012 and which have not been adopted early, are expected to have a material effect on the Company's future financial statements.

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### 2. Critical accounting estimates and judgments

The Company makes estimates and assumptions about the future that affect the reported amounts of assets and liabilities. Estimates and judgments are continually evaluated and based on historical experience and other IAS factors, including expectations of future events that are believed to be reasonable under the circumstances. In the future, actual experience may differ from these estimates and assumptions.

The effect of a change in an accounting estimate is recognized prospectively by including it in comprehensive income in the period of the change, if the change affects that period only; or in the period of the change and future periods, if the change affects both.

The estimates and assumptions that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

#### **Deferred policy acquisition expenses**

Deferred policy acquisition expenses are those expenses such as agents' commissions, which relate directly to the acquisition of policies. These expenses, to the extent that they are considered recoverable, are estimated, deferred and amortized over the terms of the related policies.

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 2. Critical accounting estimates and judgments (cont'd)

#### **Provision for unpaid claims**

The estimation of the provision for unpaid claims and the related reinsurers' share are the Company's most critical accounting estimates. There are several sources of uncertainty that need to be considered by the Company in estimating the amount that will ultimately be paid on these claims. The uncertainty arises because all events affecting the ultimate settlement of claims have not taken place and may not take place for some time. Changes in the estimate of the provisions can be caused by receipt of additional claim information, changes in judicial interpretation of contracts, or significant changes in severity or frequency of claims from historical trends. The estimates are based on the Company's historical experience and industry experience. More details are included in Note 7.

#### **Unearned premium reserve**

The unearned premium reserve is calculated based on the estimated unexpired term of all policies of the Company in force as at December 31. The factor used to estimate the unexpired term is based on the Company's historical experience.

#### **Impairment of available-for-sale investments**

The Company determines that available-for-sale investments are impaired when there has been a significant or prolonged decline in fair value below its cost. The determination of what is significant or prolonged requires judgment. In making this judgment the Company considers among other factors, the normal volatility in market price, the financial health of the investee and industry and sector performance. Had the Company considered all declines in fair value to be significant or prolonged, the Company would have suffered an additional loss of \$108,803 in its 2012 financial statements, being the transfer of the entire amount in accumulated other comprehensive income related to available-for-sale investments to net income.

#### **Income taxes**

The Company periodically assesses its liabilities and contingencies related to income taxes for all years open to audit based on the latest information available. For matters where it is probable that an adjustment will be made, the Company records its best estimate of the tax liability including the related interest and penalties in the current tax provision. Management believes they have adequately provided for the probable outcome of these matters; however, the final outcome may result in a materially different outcome than the amount included in the tax liabilities.

# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

### 3. Financial instrument classification

The carrying amount of the Company's financial instruments by classification is as follows:

	Available for sale	Held to maturity	Loans and receivables	Other financial liabilities	Total
<b>December 31, 2012</b>					
Cash and cash equivalents	\$ -	\$ -	\$ 2,233,781	\$ -	\$ 2,233,781
Receivables (Note 4)	-	-	1,879,390	-	1,879,390
Investments (Note 5)	10,678,352	39,555,791	-	-	50,234,143
Accounts payable and accrued liabilities	-	-	-	(543,472)	(543,472)
	<b>\$10,678,352</b>	<b>\$ 39,555,791</b>	<b>\$ 4,113,171</b>	<b>\$(543,472)</b>	<b>\$53,803,842</b>
<b>December 31, 2011</b>					
Cash and cash equivalents	\$ -	\$ -	\$ 1,209,841	\$ -	\$ 1,209,841
Receivables (Note 4)	-	-	1,746,695	-	1,746,695
Investments (Note 5)	9,342,510	39,495,118	-	-	48,837,628
Accounts payable and accrued liabilities	-	-	-	(516,493)	(516,493)
	<b>\$ 9,342,510</b>	<b>\$ 39,495,118</b>	<b>\$ 2,956,536</b>	<b>\$(516,493)</b>	<b>\$51,277,671</b>

### 4. Receivables

	2012	2011
Policyholders for premiums	\$ 1,404,758	\$ 1,249,855
Accrued interest	472,937	485,476
Other	1,695	11,364
	<b>\$ 1,879,390</b>	<b>\$ 1,746,695</b>



**Prince Edward Island Mutual Insurance Company**  
**Notes to the Financial Statements**  
December 31, 2012

**5. Investments**

The following table provides cost and fair value information of investments by type of security and issuer. The maximum exposure to credit risk would be the carrying value as shown below.

<b>Carrying value</b>	<b>2012</b>	<b>2011</b>
Held to maturity investments, at amortized cost	<b>\$ 39,555,791</b>	\$ 39,495,118
Available for sale investments, at fair value	<b>10,678,352</b>	9,342,510
	<b>\$ 50,234,143</b>	\$ 48,837,628

	<b>Monday, December 31, 2012</b>		<b>Saturday, December 31, 2011</b>	
	<b>Cost</b>	<b>Fair Value</b>	<b>Cost</b>	<b>Fair Value</b>
<b>Held to maturity investments</b>				
Term deposits and GIC's	<b>\$ 2,156,673</b>	<b>\$ 2,160,000</b>	\$ 1,300,000	\$ 1,300,000
Bonds, at par less unamortized purchase discounts and premiums				
- Federal	<b>388,557</b>	<b>448,446</b>	387,838	450,740
- Provincial	<b>12,103,643</b>	<b>13,973,627</b>	14,386,766	16,673,679
- Municipal	<b>10,918,087</b>	<b>12,477,578</b>	11,360,988	12,991,423
- Corporate	<b>13,988,831</b>	<b>15,321,086</b>	12,059,526	12,972,163
Total bonds	<b>37,399,118</b>	<b>42,220,737</b>	38,195,118	43,088,005
	<b>\$ 39,555,791</b>	<b>\$ 44,380,737</b>	\$ 39,495,118	\$ 44,388,005
<b>Available for sale investments</b>				
Equities - Canadian				
Common Stock	<b>\$ 6,421,135</b>	<b>\$ 8,026,699</b>	\$ 5,952,233	\$ 6,938,537
Equities - US				
Common Stock	<b>2,046,723</b>	<b>2,276,950</b>	1,921,495	2,048,556
Farm Mutual Pooled Funds	<b>402,702</b>	<b>374,703</b>	396,854	355,417
	<b>\$ 8,870,560</b>	<b>\$ 10,678,352</b>	\$ 8,270,582	\$ 9,342,510

# Prince Edward Island Mutual Insurance Company Notes to the Financial Statements

December 31, 2012

## 5. Investments (cont'd)

The following table provides an analysis of investments that are measured subsequent to initial recognition at fair value, grouped into levels 1 to 3 based on the degree to which the fair value is observable:

- Level 1 fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities using the last bid price;

- Level 2 fair value measurements are those derived from inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

- Level 3 fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

	Level 1	Level 2	Level 3	Total
<b>December 31, 2012</b>				
Farm Mutual pooled funds	\$ -	\$ 374,703	\$ -	\$ 374,703
Equity investments				
- Canadian	8,026,699	-	-	8,026,699
- US	2,276,950	-	-	2,276,950
<b>Total</b>	<b>\$10,303,649</b>	<b>\$ 374,703</b>	<b>\$ -</b>	<b>\$10,678,352</b>
<b>December 31, 2011</b>				
Farm Mutual pooled funds	\$ -	\$ 355,417	\$ -	\$ 355,417
Equity investments				
- Canadian	6,938,537	-	-	6,938,537
- US	2,048,556	-	-	2,048,556
<b>Total</b>	<b>\$ 8,987,093</b>	<b>\$ 355,417</b>	<b>\$ -</b>	<b>\$ 9,342,510</b>

There were no transfers between Level 1 and Level 2 for the years ended December 31, 2011 and 2012.

The company has determined that certain investments have incurred a significant or prolonged decline in their fair value, which constitutes objective evidence of impairment. As a result, an impairment loss of \$56,239 and \$83,266 has been recognized in net income for the years ended December 31, 2012 and 2011 respectively.

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**Prince Edward Island Mutual Insurance Company**  
**Notes to the Financial Statements**  
December 31, 2012

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**5. Investments (cont'd)**

Maturity profile of held to maturity investments is as follows:

	<b>Within 1 Year</b>	<b>2 to 5 Years</b>	<b>6 to 10 Years</b>	<b>Over 10 Years</b>	<b>Total</b>
<hr/>					
<b>December 31, 2012</b>					
Bonds	\$ 2,486,000	\$ 10,409,371	\$ 12,727,696	\$ 11,776,051	\$ 37,399,118
Term Deposits	200,000	1,956,673	-	-	2,156,673
	<hr/>				
<b>Total</b>	<b>\$ 2,686,000</b>	<b>\$ 12,366,044</b>	<b>\$ 12,727,696</b>	<b>\$ 11,776,051</b>	<b>\$ 39,555,791</b>
<b>Percent of total</b>	<b>7%</b>	<b>31%</b>	<b>32%</b>	<b>30%</b>	<b>100%</b>
<hr/>					
<b>December 31, 2011</b>					
Bonds	\$ 2,385,000	\$ 10,301,525	\$ 12,534,238	\$ 12,974,355	\$ 38,195,118
Term Deposits	460,000	840,000	-	-	1,300,000
	<hr/>				
<b>Total</b>	<b>\$ 2,845,000</b>	<b>\$ 11,141,525</b>	<b>\$ 12,534,238</b>	<b>\$ 12,974,355</b>	<b>\$ 39,495,118</b>
<b>Percent of total</b>	<b>7%</b>	<b>28%</b>	<b>32%</b>	<b>33%</b>	<b>100%</b>
<hr/>					

The effective interest rate of the held to maturity investments is 5.17% and 5.35% at December 31, 2012 and December 31, 2011 respectively.

# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

### 6. Property, plant and equipment

	Land	Building	Office equipment	Computer equipment	Vehicles	Parking lots	Total
<b>Cost</b>							
Balance on January 1, 2011	\$ 132,097	\$ 579,549	\$ 228,771	\$ 172,242	\$ 196,711	\$ 25,711	\$ 1,335,081
Additions	-	3,363	22,847	5,616	34,657	-	66,483
Disposals	-	-	(42,004)	(33,040)	(28,619)	-	(103,663)
Balance on December 31, 2011	132,097	582,912	209,614	144,818	202,749	25,711	1,297,901
Additions	563,571	5,256	6,581	27,352	29,887	-	632,647
Disposals	-	-	(631)	(24,175)	-	-	(24,806)
<b>Balance on December 31, 2012</b>	<b>\$ 695,668</b>	<b>\$ 588,168</b>	<b>\$ 215,564</b>	<b>\$ 147,995</b>	<b>\$ 232,636</b>	<b>\$ 25,711</b>	<b>\$ 1,905,742</b>
<b>Accumulated depreciation</b>							
Balance on January 1, 2011	\$ -	\$ 311,785	\$ 173,624	\$ 137,687	\$ 106,690	\$ 12,434	\$ 742,220
Depreciation expense	-	16,394	14,881	16,970	35,962	1,062	85,269
Disposals	-	-	(38,416)	(31,256)	(23,809)	-	(93,481)
Balance on December 31, 2011	-	328,179	150,089	123,401	118,843	13,496	734,008
Depreciation expense	-	15,611	13,193	21,392	34,136	977	85,309
Disposals	-	-	(487)	(23,311)	-	-	(23,798)
<b>Balance on December 31, 2012</b>	<b>\$ -</b>	<b>\$ 343,790</b>	<b>\$ 162,795</b>	<b>\$ 121,482</b>	<b>\$ 152,979</b>	<b>\$ 14,473</b>	<b>\$ 795,519</b>
<b>Net book value</b>							
December 31, 2011	\$ 132,097	\$ 254,733	\$ 59,525	\$ 21,417	\$ 83,906	\$ 12,215	\$ 563,893
<b>December 31, 2012</b>	<b>\$ 695,668</b>	<b>\$ 244,378</b>	<b>\$ 52,769</b>	<b>\$ 26,513</b>	<b>\$ 79,657</b>	<b>\$ 11,238</b>	<b>\$ 1,110,223</b>

### 7. Insurance contracts

*Reinsurers share of provision for unpaid claims*

	2012	2011
<b>Balance, beginning of the year</b>	<b>\$ 2,169,035</b>	<b>\$ 1,756,503</b>
New claims reserve	493,894	297,616
Change in prior years reserve	239,245	207,831
Submitted to reinsurer	(552,288)	(92,915)
<b>Balance, end of the year</b>	<b>\$ 2,349,886</b>	<b>\$ 2,169,035</b>
<b>Expected settlement</b>		
Within one year	\$ 559,488	\$ 114,029
More than one year	\$ 1,790,398	\$ 2,055,006

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 7. Insurance contracts (cont'd)

*Deferred policy acquisition expenses*

	2012	2011
<b>Balance, beginning of the year</b>	<b>\$ 1,166,832</b>	\$ 1,117,512
Acquisition costs incurred	2,233,774	2,036,145
Expensed during the year	<u>(2,116,905)</u>	<u>(1,986,825)</u>
<b>Balance, end of the year</b>	<b><u>\$ 1,283,701</u></b>	<b><u>\$ 1,166,832</u></b>

Deferred policy acquisition expenses will be recognized as an expense within one year.

*Unearned premium reserve*

	2012	2011
<b>Balance, beginning of the year</b>	<b>\$ 9,653,300</b>	\$ 9,062,875
Premiums written	17,960,865	16,845,195
Premiums earned during year	<u>(17,292,451)</u>	<u>(16,254,770)</u>
<b>Balance, end of the year</b>	<b><u>\$10,321,714</u></b>	<b><u>\$ 9,653,300</u></b>

The following is a summary of the insurance contract provisions and related reinsurance assets at December 31.

	December 31, 2012			December 31, 2011		
	Gross	Reinsurance	Net	Gross	Reinsurance	Net
Outstanding claims provision						
Long settlement term	\$4,303,736	\$ 1,893,792	\$2,409,944	\$4,248,003	\$2,100,105	\$2,147,898
Short settlement term	1,904,988	456,094	1,448,894	2,937,876	68,930	2,868,946
	<u>6,208,724</u>	<u>2,349,886</u>	<u>3,858,838</u>	7,185,879	2,169,035	5,016,844
Provision for claims incurred but not reported	1,120,706	-	1,120,706	1,336,708	-	1,336,708
	<u>\$7,329,430</u>	<u>\$ 2,349,886</u>	<u>\$4,979,544</u>	<u>\$8,522,587</u>	<u>\$2,169,035</u>	<u>\$6,353,552</u>

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 7. Insurance contracts (cont'd)

#### Comments and assumptions for specific claims categories

The ultimate cost of long settlement general liability claims are difficult to predict for several reasons. Claims may not be reported until many years after a policy expires. Changes in the legal environment have created further complications. Court decisions and federal and provincial legislation may dramatically increase the liability between the time a policy is written and associated claims are ultimately resolved. For example, liability for exposure to toxic substances and environmental impairment, which did not appear likely or even exist when the policies were written, has been imposed by legislators and judicial interpretation. Tort liability has been expanded by some jurisdictions to cover defective workmanship. Provisions for such difficult-to-estimate liabilities are established by examining the facts of tendered claims and adjusted in the aggregate for ultimate loss expectations based upon historical experience patterns and current socioeconomic trends.

#### Claims and adjustment expenses

Changes in claim liabilities recorded in the balance sheet for the years-ended December 31, 2012 and 2011 and their impact on claims and adjustment expenses for the two years follow:

#### *Claims and adjustment expenses*

	<u>2012</u>	<u>2011</u>
Unpaid claim - beginning of year – net of reinsurance	\$ 5,016,844	\$ 5,704,247
Increase (decrease) in estimated losses and expenses, for losses occurring in prior years	80,310	(235,784)
Provision for losses and expenses on claims occurring in the current year	9,004,680	9,888,555
Payment on claims:		
Current year	(6,922,611)	(6,309,291)
Prior years	(3,320,385)	(4,030,883)
	<u>\$ 3,858,838</u>	<u>\$ 5,016,844</u>
Unpaid claims – end of year - net of reinsurance		

The change in estimate of losses occurring in prior years is due to changes arising from new information received.

#### Provision for unpaid claims and adjustment expenses

The determination of the provision for unpaid claims and adjustment expenses and the related reinsurers' share requires the estimation of three major variables which are the development of claims, reinsurance recoveries, and future investment income. As the Company does not sell auto insurance, future investment income has been disregarded for this purpose.

# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

### 7. Insurance contracts (cont'd)

#### Claim development

The estimation of claim development involves assessing the future behavior of claims, taking into consideration the consistency of the Company's claim handling procedures, the amount of information available, the characteristics of the line of business from which the claim arises and historical delays in reporting claims. In general, the longer the term required for the settlement of a group of claims the more variable the estimates. Short settlement term claims are those which are expected to be substantially paid within a year of being reported.

The tables that follow present the development of claims payments and the estimated ultimate cost of claims for the claim year 2007 to 2012. The upper half of the tables shows the cumulative amounts paid or estimated to be paid during successive years related to each claim year. The original estimates will be increased or decreased, as more information becomes known about the original claims and overall claim frequency and severity.

In 2011, the year of adoption of IFRS, only information from periods beginning on or after January 1, 2007 is required to be disclosed. This is being increased in each succeeding additional year, until ten years of information is included.

<i>Net Claims</i>	(\$'000)						
	2007	2008	2009	2010	2011	2012	Total
<b>Net estimate of cumulative claims cost</b>							
At the end year of claim	7,764	8,746	8,098	8,890	9,885	9,012	
One year later	7,592	8,133	8,347	8,797	9,966		
Two years later	7,602	8,110	8,296	8,774			
Three years later	7,595	8,127	8,326				
Four years later	7,516	8,121					
Five years later	7,536						
Current estimate of cumulative claims cost	7,536	8,121	8,326	8,774	9,966	9,012	
Cumulative payments	7,489	7,983	7,953	8,504	9,223	6,923	
Outstanding claims	47	138	373	270	743	2,089	3,660
Outstanding claims 2006 and prior							199
Claims handling expense							(246)
<b>Total net outstanding claims net of claims handling expense</b>							<b>3,613</b>

### 8. Pension plan

The Company has a defined contribution plan providing pension benefits to eligible employees. The total plan expense for the Company's defined contribution plan for 2012 was \$168,106 (2011 - \$154,714).

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**Prince Edward Island Mutual Insurance Company**  
**Notes to the Financial Statements**  
December 31, 2012

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**9. Income taxes**

The Company is subject to income taxes on that portion of its income derived from insuring other than fishing and farming related risks.

The significant components of tax expense included in net income are composed of:

	<u>2012</u>	<u>2011</u>
<b>Current tax expense</b>		
Based on current year taxable income	\$ 580,527	\$ 257,881
Adjustments for over / under provision in prior periods	-	571
	<u>\$ 580,527</u>	<u>\$ 258,452</u>
<b>Deferred tax expense</b>		
Origination and reversal of temporary differences	(2,647)	(590)
(Increase) reduction in tax rate	(4,871)	675
	<u>(7,518)</u>	<u>85</u>
<b>Total income tax expense</b>	<u>\$ 573,009</u>	<u>\$ 258,537</u>

The significant components of the tax affect of the amounts recognized in other comprehensive income are composed of:

	<u>2012</u>	<u>2011</u>
<b>Current tax</b>		
Change in unrealized gain / losses on available-for-sale investments	\$ 145,995	\$ (6,068)



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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 9. Income taxes (cont'd)

Reasons for the difference between tax expense for the year and the expected income taxes based on the statutory tax rates are as follows:

	2012	2011
Income before income taxes	<b>\$ 3,292,045</b>	<b>\$ 1,783,751</b>
Combined basic Canadian Federal and provincial income tax rate	<b>31%</b>	<b>25%</b>
Income taxes at statutory rates	<b>1,007,886</b>	447,296
Income from insuring farming & fishing related risks	<b>(403,429)</b>	(141,185)
Non deductible portion of claims liabilities	<b>(36,530)</b>	(1,436)
Depreciation in excess of capital cost allowance	<b>3,183</b>	3,483
Other non deductible expenses	<b>6,526</b>	5,141
Market to market and other adjustments related to investments	<b>225,291</b>	(9,290)
Deduction for CCPC dividends	<b>(85,411)</b>	(59,759)
Change in tax rates	<b>(4,871)</b>	675
Origination and reversal of temporary timing differences	<b>(2,647)</b>	(590)
Over (under) provision in prior years	<b>-</b>	571
Provision for tax on foreign investment income	<b>9,004</b>	7,563
Total income tax expense	<b>\$ 719,003</b>	<b>\$ 252,469</b>

Changes to the federal and provincial tax rates were announced in 2011 which resulted in an adjustment to the opening carrying value of temporary differences. The reduction in deferred income tax payable is reflected in deferred income taxes.

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**Prince Edward Island Mutual Insurance Company**  
**Notes to the Financial Statements**  
December 31, 2012

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**9. Income taxes (cont'd)**

The movement in 2012 deferred tax liabilities and assets are:

<u>2012</u>	Opening balance at Jan 1, 2012	Recognize in net income	Closing Balance at Dec 31, 2012
<i>Deferred tax assets</i>			
Pension obligation	\$ 5,919	\$ 3,332	\$ 9,251
Property, plant & equipment	5,479	4,186	9,665
	<u>\$ 11,398</u>	<u>\$ 7,518</u>	<u>\$ 18,916</u>
Deferred tax asset			
	<u>\$ 11,398</u>	<u>\$ 7,518</u>	<u>\$ 18,916</u>
2011 net deferred tax asset movement			

The movement in 2011 deferred tax liabilities and assets are:

<u>2011</u>	Opening balance at Jan 1, 2011	Recognize in net income	Closing Balance at Dec 31, 2011
<i>Deferred tax assets</i>			
Pension obligation	\$ 5,417	\$ 502	\$ 5,919
Property, plant & equipment	6,066	(587)	5,479
	<u>\$ 11,483</u>	<u>\$ (85)</u>	<u>\$ 11,398</u>
Deferred tax asset			
	<u>\$ 11,483</u>	<u>\$ (85)</u>	<u>\$ 11,398</u>
2011 net deferred tax asset movement			

	<u>2012</u>	<u>2011</u>
<i>Deferred tax assets</i>		
Deferred tax assets to be recovered within 12 months	\$ -	\$ -
Deferred tax assets to be recovered after more than 12 months	18,916	11,398
	<u>\$ 18,916</u>	<u>\$ 11,398</u>
Net Deferred tax asset		

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**10. Gross claims and adjustment expenses**

Included in claims expenses were wage costs of \$299,121 (2011 - \$348,420).

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**Prince Edward Island Mutual Insurance Company**  
**Notes to the Financial Statements**  
December 31, 2012

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**11. Fees, commissions and other acquisition expenses**

	<u>2012</u>	<u>2011</u>
Commissions	\$ 1,734,434	\$ 1,581,522
Sales salaries	280,327	301,194
Other	102,144	104,109
	<u>\$ 2,116,905</u>	<u>\$ 1,986,825</u>

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**12. Other operating and administrative expenses**

	<u>2012</u>	<u>2011</u>
Advertising	\$ 109,336	\$ 108,414
Conventions, courses and travel	86,197	78,798
Depreciation	58,483	55,842
Directors fees	220,153	209,173
Donations	93,562	77,367
Fire prevention tax	179,609	168,452
Loss Prevention	132,124	99,922
Office supplies	115,066	125,542
Other administration costs	249,025	251,351
Postage	137,922	137,444
Professional fees	64,585	30,586
Salaries and benefits	1,816,871	1,739,732
Taxes, dues and licences	39,493	37,663
Telephone	55,947	55,529
	<u>\$ 3,358,373</u>	<u>\$ 3,175,815</u>

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**13. Salaries, benefits and directors fees**

	<u>2012</u>	<u>2011</u>
Claims handling - Salaries, adjusting fees & benefits (Note 10)	\$ 299,121	\$ 348,420
Sales salaries, commissions and benefits (Note11)	2,014,761	1,882,716
Director fees (Note 12)	220,153	209,173
Other salaries and benefits (Note 12)	1,816,871	1,739,732
	<u>\$ 4,350,906</u>	<u>\$ 4,180,041</u>

**Prince Edward Island Mutual Insurance Company**  
**Notes to the Financial Statements**  
December 31, 2012

**14. Investment and other income**

2012	AFS	FVTPL	HTM	Other	Total
Interest Income	\$ 5,848	\$ 11,669	\$ 2,041,882	\$ -	\$ 2,059,399
Interest Expense				(1,548)	(1,548)
Dividend Income	339,000				339,000
Net realized gains	265,777				265,777
Impairment Losses	(56,239)				(56,239)
Gain (loss) on disposal of PPE				(1,009)	(1,009)
Other income				78,729	78,729
<b>Investment and Other Income</b>	<b>\$ 554,386</b>	<b>\$ 11,669</b>	<b>\$ 2,041,882</b>	<b>\$ 76,172</b>	<b>\$ 2,684,109</b>
2011	AFS	FVTPL	HTM	Other	Total
Interest Income	\$ 14,095	\$ 14,490	\$ 2,080,531	\$ -	\$ 2,109,116
Interest Expense				(1,193)	(1,193)
Dividend Income	288,729				288,729
Net realized gains	185,809				185,809
Impairment Losses	(83,266)				(83,266)
Gain (loss) on disposal of PPE				(3,217)	(3,217)
Other income				91,746	91,746
<b>Investment and Other Income</b>	<b>\$ 405,367</b>	<b>\$ 14,490</b>	<b>\$ 2,080,531</b>	<b>\$ 87,336</b>	<b>\$ 2,587,724</b>

**15. Change in non-cash operating working capital**

	2012	2011
Receivables	\$ (132,695)	\$ (210,240)
Prepaid expenses	8,796	11,852
Deferred premium acquisition expenses	(116,869)	(49,320)
Reinsurers' share of provision for unpaid claims	(180,851)	(412,532)
Payables and accruals	26,979	(98,359)
Income tax payable/receivable	584,781	(27,117)
Unpaid claims	(1,193,157)	(57,275)
Unearned premiums	668,414	590,425
	<b>\$ (334,602)</b>	<b>\$ (252,566)</b>
Income taxes paid, net	<b>\$ 141,741</b>	<b>\$ 279,501</b>

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 16. Related party transactions

The Company entered into the following transactions with key management personnel, which are defined by IAS 24, Related Party-Disclosures, as those persons having authority and responsibility for planning, directing and controlling the activities of the Company, including directors and management:

	2012	2011
Compensation		
Short term employee benefits and director's fees	\$ 899,934	\$ 960,128
Total pension and other post-employment benefits	62,173	62,556
	<u>\$ 962,107</u>	<u>\$ 1,022,684</u>
Premiums	<u>\$ 45,265</u>	<u>\$ 43,727</u>
Claims paid	<u>\$ 4,830</u>	<u>\$ 9,933</u>
Amounts owing to	<u>\$ 105</u>	<u>\$ -</u>
Amounts owing from	<u>\$ 3,826</u>	<u>\$ 3,418</u>

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### 17. Capital management

The Company's objectives with respect to capital management are to maintain a capital base that is structured to exceed regulatory requirements and to best utilize capital allocations. Reinsurance is utilized to protect capital from catastrophic losses as the frequency and severity of these losses are inherently unpredictable. To limit their potential impact, catastrophe coverage limits the Company's exposure to \$1.35 million plus 5% of the remaining loss. The \$1.35 million net retained amount represents approximately 3.5% of Company's capital. For the purpose of capital management, the Company has defined capital as policyholders' security fund, excluding accumulated other comprehensive income (loss).

Section 317.(1) of the Insurance Act of Prince Edward Island requires insurers to maintain a reserve fund equal to the sum of \$500 for every \$100,000 of the first \$1 million of insurance in force, and \$3,000 for each additional \$1 million or part thereof insurance in force. The Company's reserve fund as at December 31, 2012 was 1.67 times that which is required by S317.(1) of the Insurance Act.

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### 18. Financial instrument and Insurance risk management

#### Insurance risk management

The principal risk the Company faces under insurance contracts is that the actual claims and benefit payments or the timing thereof, differ from expectations. This is influenced by the frequency of claims, severity of claims, actual benefits paid and subsequent development of long-term claims. Therefore, the objective of the Company is to ensure that sufficient reserves are available to cover these liabilities.

The above risk exposure is mitigated by diversification across a large portfolio of insurance. The variability of risks is also improved by careful selection and implementation of underwriting strategy guidelines, as well as the use of reinsurance arrangements.

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 18. Financial instrument and Insurance risk management (cont'd)

The Company purchases reinsurance as part of its risk mitigation program. Retention limits for the excess-of-loss reinsurance vary by product line.

Amounts recoverable from reinsurers are estimated in a manner consistent with the outstanding claims provision and are in accordance with the reinsurance contracts. Although the Company has reinsurance arrangements, it is not relieved of its direct obligations to its policyholders and thus a credit exposure exists with respect to ceded insurance, to the extent that any reinsurer is unable to meet its obligations assumed under such reinsurance agreements.

The Company writes insurance primarily over a twelve month duration. The most significant risks arise through high severity, low frequency events such as natural disasters or catastrophes. A concentration of risk may arise from insurance contracts issued in a specific geographic location since all insurance contracts are written in Prince Edward Island.

The Company manages this risk via its underwriting and reinsurance strategy within an overall risk management framework. Exposures are limited by having documented underwriting limits and criteria. Pricing of property and liability policies are based on assumptions in regard to trends and past experience, in an attempt to correctly match policy revenue with exposed risk.

Reinsurance is purchased to mitigate the effect of the potential loss to the company. Reinsurance is placed with Farm Mutual Reinsurance Plan Inc. (FMRP), a Canadian registered reinsurer.

The Company follows a policy of underwriting and reinsuring contracts of insurance which, in the main, limit the liability of the Company to an amount on any one claim of \$450,000 in the event of a property claim, and \$200,000 in the event of a liability claim. For amounts over the respective limits there is a 10% retention to a specified maximum. The Company also obtained reinsurance which limits the Company's liability to \$1.35 million in the event of a series of claims arising out of a single occurrence. In addition, the Company has obtained stop loss reinsurance which limits the liability of all claims in a specific year to 80% of gross net earned premiums for property.

The Company is exposed to a pricing risk to the extent that unearned premiums are insufficient to meet the related future policy costs. Evaluation is performed regularly to estimate future claims costs, related expenses, and expected profit in relation to unearned premiums. There was no premium deficiency at December 31, 2012 and 2011.

The risks associated with insurance contracts are complex and subject to a number of variables which complicate quantitative sensitivity analysis. The company uses various techniques based on past claims development experience to quantify these sensitivities. This includes indicators such as average claim cost, amount of claims occurrence, expected loss ratios and claims development as described in Note 7.

# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

### 18. Financial instrument and Insurance risk management (cont'd)

Results of sensitivity testing based on expected loss ratios are as follows, shown gross and net of reinsurance as impact on pre-tax income.

	Property claims		Liability claims	
	2012	2011	2012	2011
5% increase in loss ratios				
Gross	<b>750,893</b>	708,462	<b>147,150</b>	133,798
Net	<b>706,366</b>	667,699	<b>74,362</b>	72,996
5% decrease in loss ratios				
Gross	<b>(750,893)</b>	(708,462)	<b>(147,150)</b>	(133,798)
Net	<b>(706,366)</b>	(667,699)	<b>(74,362)</b>	(72,996)

There have been no significant changes from the previous year in the exposure to risk or policies, procedures and methods used to measure the risk.

#### Credit Risk

Credit risk is the risk of financial loss to the Company if a debtor fails to make payments of interest and principal when due. The Company is exposed to this risk relating to its debt holdings in its investment portfolio and the reliance on reinsurers to make payment when certain loss conditions are met.

The Company's investment policy includes guidelines on the bond portfolio relating to portfolio composition, issuer type, bond quality ratings (at time of acquisition – rated as "A" or better) and general guidelines for geographic exposure. All fixed income portfolios are monitored by management on a monthly basis.

Reinsurance is placed with Farm Mutual Reinsurance Plan Inc. (FMRP), a Canadian registered reinsurer. Management monitors the creditworthiness of FMRP by reviewing their annual financial statements and through ongoing communications. Reinsurance treaties are reviewed annually by management prior to renewal of the reinsurance contract.

Accounts receivable are short-term in nature consisting of a large number of policyholders, and are not subject to material credit risk. Regular review of outstanding receivables is performed to ensure credit worthiness.

The maximum exposure to investment credit risk is outlined in Note 5.

There have been no significant changes from the previous year in the exposure to risk or policies, procedures and methods used to measure the risk.

#### Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate as a result of market factors. Market factors include three types of risk: currency risk, interest rate risk and equity risk.

The Company's investment policy operates within the guidelines of the Insurance Act. An investment policy is in place and its application is monitored by the Investment Committee and the Board of Directors. Diversification techniques are utilized to minimize risk.

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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 18. Financial instrument and Insurance risk management (cont'd)

#### Currency risk

Currency risk relates to the Company operating in different currencies and converting non-Canadian earnings at different points in time at different foreign exchange levels when adverse changes in foreign currency exchange rates occur.

The Company's foreign exchange risk is related to stock holdings which are limited to United States equities in sectors which are not readily available in Canada. The Company limits its holdings in foreign equity to 25% of the total investment portfolio in accordance with its investment policy. Foreign currency changes are monitored by the investment committee and holdings are adjusted when offside of the investment policy. A 1% change in the value of the United States dollar would affect the fair value of stocks by \$22,770 which would be reflected in net income or OCI.

There have been no significant changes from the previous year in the exposure to risk or policies, procedures and methods used to measure the risk.

#### Interest rate risk

Interest rate risk is the potential for financial loss caused by fluctuations in fair value or future cash flows of financial instruments because of changes in market interest rates.

The Company is not exposed to this risk as its interest bearing investments are being held to maturity.

There have been no significant changes from the previous year in the exposure to risk or policies, procedures and methods used to measure the risk.

#### Equity risk

Equity risk is the uncertainty associated with the valuation of assets arising from changes in equity markets. The Company is exposed to this risk through its equity holdings within its investment portfolio.

The Company's portfolio includes Canadian stocks with fair values that move with the Toronto Stock Exchange Composite Index and United States stocks with fair values that move with the S&P 500 Index. A 10% movement in the stock markets with all other variables held constant would have an estimated effect on the fair values of the Company's Canadian common stock and United States common stock of \$1.03 million (2011 - \$898,000). For stocks that the Company did not sell during the period, the change would be recognized in the asset value and in other comprehensive income. For stocks that the Company did sell during the period, the change during the period and changes prior to the period would be recognized as net realized gains (losses) in income during the period.

The Company's investment policy limits investment in common shares to a maximum of 25% of the adjusted cost base of the portfolio.

Equities are monitored by the board of directors on a semi-annual basis. Holdings are adjusted by the Investment Committee, as required.



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# Prince Edward Island Mutual Insurance Company

## Notes to the Financial Statements

December 31, 2012

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### 18. Financial instrument and Insurance risk management

#### **Liquidity Risk**

Liquidity risk is the risk that the Company will not be able to meet all cash outflow obligations as they come due. The Company mitigates this risk by monitoring cash activities and expected outflows. The Company's current liabilities arise as claims are made. The Company does not have material liabilities that can be called unexpectedly at the demand of a lender or client. The Company has no material commitments for capital expenditures and there is no need for such expenditures in the normal course of business. Claim payments are funded by current operating cash flow including investment income.

There have been no significant changes from the previous year in the exposure to risk or policies, procedures and methods used to measure the risk.