IROBOT CORP
Form 8-K
June 15, 2015

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT
Pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934

Date of report (Date of earliest event reported): June 12, 2015

iROBOT CORPORATION

(Exact Name of Registrant as Specified in its Charter)

	Delaware (State or other jurisdiction of incorporation or organization)	
001-36414 (Commission File Number)		77-0259 335 (I.R.S. Employer Identification No.)
8 Crosby Drive, Bedford, MA (Address of principal executive offices)		01730 (Zip Code)

Registrant's telephone number, including area code: (781) 430-3000

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

¨ Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

¨ Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

¨ Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

¨ Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Item 5.02 Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers.

On June 12, 2015, Paul Sagan informed the Board of Directors (the “Board of Directors”) of iRobot Corporation (the “Company”) of his resignation from the Board of Directors, effective immediately. Mr. Sagan’s decision to resign from the Board of Directors did not result from any disagreement with the Company on any matter relating to the Company’s operations, policies or practices. In connection with Mr. Sagan’s resignation, the Board of Directors will reduce the number of directors constituting the Board of Directors to seven.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

iRobot Corporation

June 15, 2015

By: /s/ Glen D. Weinstein
Name: Glen D. Weinstein
Title: Chief Legal Officer and Secretary

GHT: 0pt" align="center">**Segment**

Segment

Corporate

Consolidated

(in thousands)

Produced premium

90,985

151,003

55,916

-

297,904

Gross premiums written

90,868

102,688

55,916

-

249,472

Ceded premiums written

(6,646
)

(4,683
)

-

-

(11,329
)
Net premiums written

84,222

98,005

55,916

-

238,143

Change in unearned premiums

(840
)

(9,589
)

(2,411
)

(12,840
)
Net premiums earned

83,382

88,416

53,505

-

225,303

Total revenues

86,139

126,255

58,268

3,836

274,498

Losses and loss adjustment expenses

48,480

48,484

35,969

(15
)

132,918

Pre-tax income (loss)

12,042

28,043

7,523

(6,507
)

41,101

Net loss ratio (1)	58.1 %	54.8 %	67.2 %	59.0 %
Net expense ratio (2)	28.9 %	31.2 %	23.2 %	28.4 %
Net combined ratio (3)	87.0 %	86.0 %	90.4 %	87.4 %

	Year Ended December 31, 2006				
	Standard Commercial Segment	**Specialty Commercial Segment**	**Personal Segment**	**Corporate**	**Consolidated**
			(in thousands)		
Produced premium	91,679	156,490	45,135	-	293,304
Gross premiums written	91,070	77,740	45,135	-	213,945
Ceded premiums written	(8,850)	(2,167)	-	-	(11,017)

Net premiums written	82,220	75,573	45,135	-	202,928
Change in unearned premiums	(12,146)	(35,903)	(2,818)	-	(50,867)
Net premiums earned	70,074	39,670	42,317	-	152,061
Total revenues	75,325	80,689	46,998	(271)	202,741
Losses and loss adjustment expenses	38,799	21,908	26,443	(33)	87,117
Pre-tax income (loss)	11,757	14,309	8,760	(20,501)	14,325
Net loss ratio (1)	55.4%	55.2%	62.5%		57.3%
Net expense ratio (2)	29.4%	30.5%	24.9%		28.4%
Net combined ratio (3)	84.8%	85.7%	87.4%		85.7%

[1] Net loss ratio is calculated as total net losses and loss adjustment expenses divided by net premiums earned, each determined in accordance with GAAP.

[2] Net expense ratio is calculated as total underwriting expenses of our insurance company subsidiaries, including allocated overhead expenses and offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP.

[3] Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

38

Standard Commercial Segment. Gross premiums written for the Standard Commercial Segment were $90.9 million for the year ended December 31, 2007, which was slightly less than the $91.1 million reported for the same period in 2006. Net premiums written were $84.2 million for the year ended December 31, 2007 as compared to $82.2 million reported for the same period in 2006. Increased competition and rate pressure challenged premium volume growth by the Standard Commercial Segment throughout 2007.

Total revenue for the Standard Commercial Segment of $86.1 million for the year ended December 31, 2007 was $10.8 million more than the $75.3 million reported during the year ended December 31, 2006. This approximately 14% increase in total revenue was primarily due to increased net premiums earned of $13.3 million and increased net investment income of $1.6 million. These increases in revenue were partially offset by lower ceding commission revenue of $2.3 million and lower processing and service fees of $1.5 million, in both cases due to the shift from a third party agency structure to an insurance underwriting structure. Increased contingent commission adjustments related to adverse development on prior accident years of $0.3 million also partially offset the increases in revenue.

Pre-tax income for our Standard Commercial Segment of $12.0 million for the year ended December 31, 2007 increased $0.3 million, or approximately 2%, from the $11.8 million reported for the same period of 2006. Increased revenue as discussed above was the primary reason for the increase in pre-tax income, partially offset by increased losses and loss adjustment expenses of $9.7 million and additional operating expenses of $0.8 million, mostly due to the earning of increased premium retention.

The net loss ratio for the year ended December 31, 2007 was 58.1% as compared to the 55.4% reported for the same period of 2006. The net loss ratio was unfavorably impacted by lower ceded losses of $2.8 million for the year ended December 31, 2007 as compared to $4.4 million for the same period in 2006. The gross loss ratio before reinsurance was 56.0% for the year ended December 31, 2007 as compared to 55.4% for the same period the prior year. The gross loss results for the year ended December 31, 2007 included $1.7 million of favorable prior year development as compared to $0.2 million of favorable prior year development for the year ended December 31, 2006. Absent prior year development, the gross incurred losses and loss adjustment expense before reinsurance for the Standard Commercial Segment were higher by $2.2 million primarily due to competitive market conditions in the current accident year.

The Standard Commercial Segment reported net expense ratios of 28.9% and 29.4% for the year ended December 31, 2007 and 2006, respectively. The net expense ratio for 2006 was slightly higher primarily due to costs to assume from Clarendon National Insurance Company the unearned premium previously produced by the Standard Commercial Segment.

Specialty Commercial Segment. The $126.3 million of total revenue for the year ended December 31, 2007 was $45.6 million over the $80.7 million reported for 2006. This approximately 56% increase in revenue was largely due to increased net premiums earned of $48.7 million as a result of the increased retention of business. The Specialty Commercial Segment recognized $5.6 million of contingent ceding commission under quota share agreements for treaty effective 2006, due to improved underwriting results. Increased net investment income contributed an additional $1.7 million to the increase in revenue. These increases in revenue were partially offset by lower ceding commission revenue of $10.3 million due to the shift from a third party agency structure to an insurance underwriting structure, as well as a decrease in finance charges of $0.2 million.

Pre-tax income for the Specialty Commercial Segment of $28.0 million was $13.7 million higher than the $14.3 million reported in 2006. Increased revenue, discussed above, was the primary reason for the increase in pre-tax income, partially offset by increased losses and loss adjustment expenses of $26.6 million and increased operating expenses of $5.4 million due mostly to production related expenses that are directly related to increased earned premium. The Specialty Commercial Segment reported a net loss ratio of 54.8% for 2007 as compared to 55.2% for 2006. Favorable prior year development of $3.8 million for the year ended December 31, 2007 was the primary cause

for the decrease in the net loss ratio. The Specialty Commercial Segment reported a net expense ratio of 31.2% for 2007 as compared to 30.5% for 2006.

Personal Segment. Net premium written for our Personal Segment increased $10.8 million during the year ended December 31, 2007 to $55.9 million compared to $45.1 million in the year ended December 31, 2006. The increase in premium was due mostly to continued geographic expansion that began in 2006.

Total revenue for the Personal Segment increased approximately 24% to $58.3 million for the year ended December 31, 2007 from $47.0 million the prior year. Higher earned premium of $11.2 million was the primary reason for the increase in revenue for the period. Increased finance charges of $0.9 million were offset by lower investment income of $0.6 million due to the reallocation of capital to other segments for their increased retention of premium and lower third party commission and processing fee revenue of $0.2 million.

39

Pre-tax income for the Personal Segment was $7.5 million for the year ended December 31, 2007 as compared to $8.8 million the prior year. The increased revenue, as discussed above, was offset by increased losses and loss adjustment expenses of $9.5 million and increased operating expenses of $3.0 million due mostly to production related expenses attributable to the increased earned premium. The Personal Segment reported a net loss ratio of 67.2% for the year ended December 31, 2007 as compared to 62.5% for the prior year. A competitive pricing environment and the new business impact associated with geographic expansion were the primary reasons for the increase in the net loss ratio. We recognized $0.9 million of favorable prior accident year development during the year ended December 31, 2007 and 2006. The Personal Segment reported a net expense ratio of 23.2% for the year ended December 31, 2007 as compared to 24.9% for the prior year. The decrease in the net expense ratio was mainly due to increased finance charges in relation to earned premium, as well as fixed overhead allocations to PIIC in each period.

Corporate. Total revenue for corporate increased by $4.1 million for the year ended December 31, 2007 as compared to the prior year. The increase was due to $2.6 million of net gains on our investment portfolio during 2007 as compared to $1.5 million of net losses recognized during 2006.

Corporate pre-tax loss was $6.5 million for the year ended December 31, 2007 as compared to $20.5 million for the prior year. The decreased loss was mostly due to the absence of the $9.6 million of interest expense incurred in 2006 from amortization attributable to the deemed discount on convertible promissory notes issued in January, 2006. These notes were converted to common stock during the second quarter of 2006. Also contributing to the decreased loss was the net gain on investments of $2.6 million in 2007 compared to a net loss on investments of $1.5 million in 2006. Interest expense was also $1.8 million lower due to the permanent financing of debt used to acquire the subsidiaries comprising the Specialty Commercial Segment in 2006. Most of this debt was either converted to equity in the second quarter of 2006 or repaid with proceeds from our public equity offering in the fourth quarter of 2006. Partially offsetting these improvements were increased operating expenses of $1.5 million for 2007 due mostly to increased consulting costs related to compliance with Sarbanes-Oxley Section 404 requirements and new employees.

Comparison of Years ended December 31, 2006 and December 31, 2005

Management overview. During fiscal 2006, our total revenues were $202.7 million, representing a 132.9% increase over the $87.0 million in total revenues for fiscal 2005. The acquisition of the subsidiaries included in the Specialty Commercial Segment in the first quarter of 2006 contributed $80.7 million to the increase in total revenues for the year ended December 31, 2006 as compared to the year ended December 31, 2005. The following table provides additional information concerning the increases in revenue contributed by these acquisitions.

		Year Ended December 31, 2006 (in thousands)
Earned premium on retained business	$	39,670
Third party commission revenue		36,111
Investment income, finance charges and other revenue items		4,908
Revenue contributions from acquisitions	$	80,689

The retention of business produced in the Standard Commercial Segment that was previously retained by third parties also contributed $48.3 million to the increase in revenue, but was partially offset by lower ceding commission revenue of $15.7 million and lower processing and service fees of $2.7 million primarily attributable to the shift from a third-party agency structure to an insurance underwriting structure. Earned premium from the Personal Segment contributed $4.9 million and additional finance charges contributed $0.4 million to the increase in revenue, but were partially offset by lower ceding commission revenue of $1.8 million and lower processing and service fees of $0.3

million attributable to increased retention of the policies produced. The investment of funds derived from the implementation of our 2005 capital plan and a trust account to secure the future guaranteed payments to the sellers of acquired subsidiaries contributed another $3.4 million to revenue for fiscal 2006 as compared to fiscal 2005. These increases were partially offset by realized losses on our investment portfolio of $1.5 million in 2006.

We reported net income of $9.2 million for the year ended December 31, 2006, which is the same as the year ended December 31, 2005. On a diluted per share basis, net income was $0.53 for fiscal 2006 as compared to $0.76 for fiscal 2005. The decrease in diluted earnings per share was partially due to issuing an additional 6.3 million shares during fiscal 2006. In addition, during fiscal 2006 we recorded $9.6 million of interest expense from amortization attributable to the deemed discount on convertible promissory notes issued in January, 2006 and converted to common stock during the second quarter of 2006. In the absence of this non-cash expense, our net income for the year ended December 31, 2006 would have been $15.3 million representing an approximately 66% increase over the year ended December 31, 2005.

The following is a reconciliation of our net income without such interest expense to our reported results. Management believes this reconciliation provides useful supplemental information in evaluating the operating results of our business. This disclosure should not be viewed as a substitute for net income determined in accordance with GAAP.

		Year Ended December 31, 2006 (in thousands)
Income excluding interest expense from amortization of discount, net of tax	$	15,257
Interest expense from amortization of discount		9,625
Less related tax effect		(3,559)
		6,066
Net income	$	9,191

Excluding the interest expense from amortization of discount, the increase in net income for the year ended December 31, 2006 versus the year ended December 31, 2005 was primarily attributable to the results of the newly acquired subsidiaries of the Specialty Commercial Segment, additional investment income and the retention of business produced by the Standard Commercial Segment beginning in the third quarter of 2005. These increases were partially offset by (i) additional interest expense on borrowings to finance the acquisitions of the subsidiaries in the Specialty Commercial Segment, (ii) lower results from the Personal Segment due primarily to favorable prior accident year loss development recognized in 2005 and the runoff of third party revenue recognized in 2005 from assuming 100% of the Texas non-standard auto business beginning in the fourth quarter of 2004, (iii) increased corporate operating expenses, (iv) realized losses on our investment portfolio and (v) additional income tax due to an increase in our federal statutory rate from 34% to 35% in 2006 attributable to higher taxable income.

Segment information. The following is additional business segment information for the year ended December 31, 2006 and 2005:

	Year Ended December 31, 2006				
	Standard Commercial Insurance	**Specialty Commercial Insurance**	**Personal Insurance**	**Corporate**	**Consolidated**
Produced premium	91,679	156,490	45,135	-	293,304
Gross premiums written	91,070	77,740	45,135	-	213,945
Ceded premiums written	(8,850)	(2,167)	-	-	(11,017)
Net premiums written	82,220	75,573	45,135	-	202,928
Change in unearned premiums	(12,146)	(35,903)	(2,818)		(50,867)
Net premiums earned	70,074	39,670	42,317	-	152,061
Total revenues	75,325	80,689	46,998	(271)	202,741
Loss and loss adjustment expenses	38,799	21,908	26,443	(33)	87,117
Pre-tax income	11,757	14,309	8,760	(20,501)	14,325
Loss ratio (1)	55.4%	55.2%	62.5%		57.3%
Expense ratio (2)	29.4%	30.5%	24.9%		28.4%
Combined ratio (3)	84.8%	85.7%	87.4%		85.7%

	Year Ended December 31, 2005				
	Standard Commercial Segment	**Specialty Commercial Segment**	**Personal Segment**	**Corporate**	**Consolidated**
			(in thousands)		
Produced premium	81,721	-	36,345	-	118,066
Gross premiums written	52,952	-	36,515	-	89,467
Ceded premiums written	(1,703)	-	488	-	(1,215)
Net premiums written	51,249	-	37,003	-	88,252
Change in unearned premiums	(29,498)	-	430	-	(29,068)
Net premiums earned	21,751	-	37,433	-	59,184
Total revenues	43,067	-	43,907	61	87,035
Losses and loss adjustment expenses	12,610	-	21,239	(65)	33,784
Pre-tax income (loss)	6,651	-	11,647	(4,830)	13,468
Net loss ratio (1)	58.0%		56.7%		57.1%
Net expense ratio (2)	34.4%		28.8%		30.8%
Net combined ratio (3)	92.4%		85.5%		87.9%

[1] Net loss ratio is calculated as total net losses and loss adjustment expenses divided by net premiums earned, each determined in accordance with GAAP.

[2] Net expense ratio is calculated as total underwriting expenses of our insurance company subsidiaries, including allocated overhead expenses and offset by agency fee income, divided by net premiums earned, each determined in accordance with GAAP. During the fourth quarter of fiscal 2006, we adopted the widely used industry calculation that offsets expenses with agency fee income. Prior period comparative expense ratios have been restated.

[3] Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

Standard Commercial Segment. Net written premium for the Standard Commercial Segment was $82.2 million for the year ended December 31, 2006, or approximately 60% more than the $51.2 million for the year ended December 31, 2005. Beginning in the third quarter of fiscal 2005, the Standard Commercial Segment began retaining written premium through AHIC that was previously retained by third parties. On July 1, 2005, the Standard Commercial Segment assumed $20.1 million of in-force policies previously produced for Clarendon.

The total revenue for the Standard Commercial Segment of $75.3 million for the year ended December 31, 2006 was $32.3 million more than the $43.1 million reported the prior year. This approximately 75% increase in total revenue was primarily due to an increase of $48.3 million in net premiums earned. Increased net investment income contributed an additional $2.2 million to the increase in total revenue. These increases were partially offset by lower ceding commission revenue of $15.6 million primarily due to the shift from a third party agency structure to an insurance underwriting structure and also affected by lower than expected profit sharing commission. The increase in total revenue was also partially offset by lower processing and service fees of $2.7 million attributable to the change to an insurance underwriting structure.

Pre-tax income for the Standard Commercial Segment of $11.8 million for the year ended December 31, 2006 increased $5.1 million, or approximately 77%, over the $6.7 million reported for the prior year. Increased revenue, as discussed above, was the primary reason for the increase in pre-tax income, partially offset by increased losses and loss adjustment expenses of $26.2 million and additional operating expenses of $1.0 million, mostly due to increased premium production. The Standard Commercial Segment reported a net loss ratio of 55.4% for the year ended December 31, 2006 as compared to a net loss ratio of 58.0% for the prior year. The loss ratios gross of reinsurance were 55.4% and 55.7% for the years ended December 31, 2006 and 2005, respectively. The slight decrease in the gross loss ratio was partially impacted by $0.2 million of favorable reserve development from prior accident years recognized during 2006. There was no prior year reserve development recognized during the year ended December 31, 2005 as we began retaining this business during the third quarter of 2005. The Standard Commercial Segment reported net expense ratios of 29.4% and 34.4% for the years ended December 31, 2006 and 2005, respectively. The net expense ratio for 2005 was higher primarily due to costs to assume from Clarendon the unearned premium previously produced by the Standard Commercial Segment.

Specialty Commercial Segment. All of the subsidiaries included in the Specialty Commercial Segment were acquired effective January 1, 2006. The $80.7 million of total revenue was derived mostly from $39.7 million of earned premium on produced business that was assumed by our insurance company subsidiaries and third party commission revenue of $36.1 million on the portion of business produced by the Specialty Commercial Segment that was retained by third parties. The remaining $4.9 million of revenue was primarily derived from investment income and finance charges.

Pre-tax income for the Specialty Commercial Segment of $14.3 million was primarily due to revenue as discussed above less (i) $42.0 million in operating expenses, comprised mostly of commission expense and salary related expenses, (ii) incurred losses and loss adjustment expenses of $21.9 million on the portion of business assumed by our insurance company subsidiaries, (iii) $2.3 million of amortization of intangible assets related to the acquisitions of the subsidiaries included in the Specialty Commercial Segment, and (iv) $0.2 million in interest expense

Personal Segment. Net premium written in the Personal Segment increased $8.1 million during the year ended December 31, 2006 to $45.1 million compared to $37.0 million for the year ended December 31, 2005. The increase in premium was due mostly to new state expansion during 2006.

Total revenue for the Personal Segment increased approximately 7% to $47.0 million for the year ended December 31, 2006 from $43.9 million the prior year. Higher earned premium of $4.9 million and higher finance charges of $0.4 million was partially offset by lower ceding commission revenue of $1.8 million and lower processing and service fees of $0.3 million due to the 100% assumption of the Texas non-standard automobile premium beginning late in

2004.

Pre-tax income for the Personal Segment decreased $2.9 million, or approximately 25%, for the year ended December 31, 2006 compared to the prior year. The primary reason for the decline in pre-tax income for the year ended December 31, 2006 was increased losses and loss adjustment expenses of $5.2 million as evidenced by an increase in the net loss ratio to 62.5% versus 56.7% reported in 2005. The increase in the net loss ratio was primarily attributable to a competitive pricing environment and favorable reserve development of $2.4 million recognized during 2005 as compared to $0.9 million recognized during 2006. In addition, new business written as a result of new programs and expansion into new states had not yet benefited from the reduced loss ratios typically associated with renewals of seasoned business. The increase in losses and loss adjustment expenses was partially offset by the increase in revenue discussed above. The Personal Segment reported net expense ratios of 24.9% and 28.8% for the years ended December 31, 2006 and 2005, respectively. The decrease in the net expense ratio was primarily a function of increased earned premium and policy fees income in 2006 without corresponding increases in expenses.

Corporate. Total revenue for corporate decreased by $0.3 million for the year ended December 31, 2006 as compared to the prior year. The decrease was primarily due to $1.5 million in realized losses on our investment portfolio in 2006. This was partially offset by $1.0 million in interest earned on a trust account established in the first quarter of 2006 securing the guaranteed future payments to the sellers of acquired subsidiaries. (See Note 1, "Accounting Policies" and Note 7, "Structured Settlements.")

Corporate pre-tax loss was $20.5 million for the year ended December 31, 2006 as compared to $4.8 million for the prior year. The increased pre-tax loss was primarily due to $9.6 million in interest expense from amortization attributable to the deemed discount on convertible promissory notes issued in January, 2006. This interest expense had no impact on our cash flow or book value. Also contributing to the increased corporate pre-tax loss was additional interest expense of $4.3 million comprised of: (i) $1.1 million from the trust preferred securities issued in the second quarter of 2005 (see Note 6, "Notes Payable"); (ii) $1.1 million of amortization of the discount on the future guaranteed payments to the sellers of acquired subsidiaries (see Note 7, "Structured Settlements"); (iii) $1.0 million from a related party promissory note issued in January 2006; (iv) $0.8 million from borrowings under our revolving credit facility in January 2006 (see Note 6, "Notes Payable" and Note 8, "Credit Facilities"); and (v) $0.3 million from the convertible notes issued in January 2006. Also contributing to the increase in pre-tax loss was increased salary and related expenses of $0.9 million, professional services of $0.4 million, decreased revenue discussed above and travel expenses of $0.2 million.

Liquidity and Capital Resources

Sources and Uses of Funds

Our sources of funds are from insurance-related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions and processing and service fees. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of December 31, 2007, Hallmark had $25.7 million in unrestricted cash and invested assets. Unrestricted cash and invested assets of our non-insurance subsidiaries were $5.4 million as of December 31, 2007.

AHIC, domiciled in Texas, is limited in the payment of dividends to their stockholders in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. PIIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholders surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. HSIC, domiciled in Oklahoma, is limited in the payment of dividends to the greater of 10% of prior year policyholders surplus or prior year's statutory net income, without prior written approval from the Oklahoma Insurance Department. During 2008, our insurance company subsidiaries' ordinary dividend capacity is $16.3 million. None of our insurance company subsidiaries paid a dividend to Hallmark during the year ended December 31, 2007 or 2006.

The state insurance departments also regulate financial transactions between our insurance subsidiaries and their affiliated companies. Applicable regulations require approval of management fees, expense sharing contracts and similar transactions. Phoenix General Agency paid $1.9 million, $1.3 million and $1.8 million in management fees to Hallmark during 2007, 2006 and 2005, respectively. PIIC paid $1.2 million in management fees to Phoenix General Agency during each of 2007, 2006 and 2005. AHIC did not pay any management fees during 2007, 2006 or 2005. HSIC did not pay any management fees during 2007 or 2006.

Statutory capital and surplus is calculated as statutory assets less statutory liabilities. The various state insurance departments that regulate our insurance company subsidiaries require us to maintain a minimum statutory capital and

surplus. As of December 31, 2007, our insurance company subsidiaries reported statutory capital and surplus of $132.0 million, substantially greater than the minimum requirements for each state. Each of our insurance company subsidiaries is also required to satisfy certain risk-based capital requirements. (See, “Item 1. Business - Insurance Regulation - Risk-based Capital Requirements.”) As of December 31, 2007, the adjusted capital under the risk-based capital calculation of each of our insurance company subsidiaries substantially exceeded the minimum requirements. Our total statutory premium-to-surplus percentage was 151% for each of the years ended December 31, 2007 and 2006.

Comparison of December 31, 2007 to December 31, 2006

On a consolidated basis, our cash and investments, excluding restricted cash and investments, at December 31, 2007 were $413.4 million compared to $244.4 million at December 31, 2006. Net cash provided by our operating activities and the issuance of trust preferred securities during the third quarter of 2007 contributed to this increase in our cash and investments as of December 31, 2007.

Comparison of Years Ended December 31, 2007 and December 31, 2006

Net cash provided by our consolidated operating activities was $80.3 million for the year ended December 31, 2007 compared to $76.0 million for the year ended December 31, 2006. The increase in operating cash flow was primarily due to increased collected premiums resulting from increased retained premium volume, partially offset by additional retained paid losses and loss adjustment expenses and additional paid operating expenses.

Cash used by investing activities during the year ended December 31, 2007 was $26.0 million as compared to $91.6 million for the prior year. The higher cash used in investing activities during 2006 was mostly due to the acquisitions of the subsidiaries comprising our Specialty Commercial Segment which used $26.0 million, net of cash acquired. The withdrawal of $15.0 million from a trust account securing the future guaranteed payments to the sellers of the subsidiaries comprising our TGA Operating Unit to make the first installment payment in the first quarter of 2007 contributed to the reduction in cash used by investing activities during 2007. Also contributing to the reduction in cash used by investing activities was an increase of $128.3 million from maturities and redemptions of investment securities, a $35.7 million decrease in net purchase of short-term investments and a $9.4 million decrease in transfers to other restricted cash. Net premium finance notes repaid were $0.7 million during 2007 versus net premium finance notes repaid of $2.8 million during 2006. Partially offsetting these reductions was a $151.0 million increase in purchases of debt and equity securities.

Cash provided in financing activities during 2007 was $10.1 million as compared to $52.6 million provided by financing activities for the same period of 2006. The cash provided in 2007 was from the issuance of trust preferred securities of $25.1 million partially offset by the payment of a portion of the structured settlement to the sellers of the subsidiaries comprising our TGA Operating Unit of $15.0 million. The cash provided in 2006 was primarily from the issuance of three debt instruments in January. The first was a promissory note payable to Newcastle Partners, L.P. ("Newcastle Partners") in the amount of $12.5 million to fund the cash required to close the acquisition of the subsidiaries now comprising our Aerospace Operating Unit. The second debt instrument was $25.0 million in subordinated convertible promissory notes to the Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P. (the "Opportunity Funds"). The principal and accrued interest on the convertible notes was converted to approximately 3.3 million shares of our common stock during the second quarter of 2006. The $25.0 million raised with these notes was used to fund a trust account securing future guaranteed payments to the sellers of the subsidiaries now comprising our TGA Operating Unit. The third debt instrument was $15.0 million borrowed under our revolving credit facility to fund the cash required to close the acquisition of the subsidiaries now comprising our TGA Operating Unit. Our public equity offering in 2006 also contributed $24.7 million to cash provided by financing activities. In October 2006, we repaid the promissory note to Newcastle Partners and repaid $12.2 million of the outstanding principal balance of our revolving credit facility, in each case with proceeds received from our public equity offering. Newcastle Partners and the Opportunity Funds are each an affiliate of our Executive Chairman, Mark E. Schwarz.

Credit Facilities

On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit facility was amended and restated on January 27, 2006 to a $20.0 million revolving credit facility, with a $5.0 million letter of credit sub-facility. The credit facility was further amended effective May 31, 2007 to increase the revolving credit facility to $25.0 million and establish a new $5.0 million revolving credit sub-facility for the premium finance operations of PAAC. The credit agreement was again amended effective February 20, 2008 to extend the termination to January 27, 2010, revise various affirmative and negative covenants and decrease the interest rate in most instances to the three month Eurodollar rate plus 1.90 percentage points, payable quarterly in arrears. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets. The revolving credit facility contains covenants which, among other things, require us to maintain certain financial

and operating ratios and restrict certain distributions, transactions and organizational changes. As of December 31, 2007, we were in compliance with all of our covenants.

PAAC had a $5.0 million revolving credit facility with JPMorgan Chase Bank which terminated June 30, 2007. This facility was replaced with the new $5.0 million premium finance sub-facility with The Frost National Bank discussed above.

Trust Preferred Securities

On June 21, 2005, an unconsolidated trust subsidiary completed a private placement of $30.0 million of 30-year floating-rate trust preferred securities. Simultaneously, we borrowed $30.9 million from the trust subsidiary and contributed $30.0 million to AHIC in order to increase policyholder surplus. The note bears an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25 percentage points. As of December 31, 2007, the note balance was $30.9 million.

45

On August 23, 2007, a newly formed unconsolidated trust subsidiary completed a private placement of $25.0 million of 30-year floating trust preferred securities. Simultaneously, we borrowed $25.8 million from the trust subsidiary for working capital and general corporate purposes. The note bears an initial interest rate at 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. As of December 31, 2007 the note balance was $25.8 million.

Structured Settlements

In connection with our acquisition of the subsidiaries now comprising our TGA Operating Unit, we issued to the sellers promissory notes in the aggregate principal amount of $23.7 million, of which $14.2 million was paid on January 2, 2007, and $9.5 million was paid on January 2, 2008. We were also obligated to pay to the sellers an additional $1.3 million, of which $0.8 million was paid on January 2, 2007 and an additional $0.5 million was paid on January 2, 2008, in consideration of the sellers' compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. We secured payment of these future installments of purchase price and restrictive covenant consideration by depositing $25.0 million in a trust account for the benefit of the sellers. We recorded a payable for future guaranteed payments to the sellers of $25.0 million discounted at 4.4%, the rate of two-year U.S. Treasuries (the only permitted investment of the trust account). As of December 31, 2007, the balance of the structured settlements was $10.0 million.

Long-Term Contractual Obligations

Set forth below is a summary of long-term contractual obligations as of December 31, 2007. Amounts represent estimates of gross undiscounted amounts payable over time. In addition, certain unpaid losses and loss adjustment expenses are ceded to others under reinsurance contracts and are, therefore, recoverable. Such potential recoverables are not reflected in the table.

		Estimated Payments by Period			
	Total	**2008**	**2009-2010**	**2011-2012**	**After 2012**
Notes payable	60,814	420	2,432	1,120	56,842
Interest on note payable	125,906	4,650	9,106	8,860	103,290
Structured settlements	10,000	10,000	-	-	-
Unpaid losses and loss adjustment expenses	125,338	60,423	49,713	12,862	2,340
Operating leases	3,909	1,711	1,914	284	-
Purchase obligations	6,322	1,564	1,674	1,550	1,534

Conclusion

Based on 2008 budgeted and year-to-date cash flow information, we believe that we have sufficient liquidity to meet our projected insurance obligations, operational expenses and capital expenditure requirements for the next 12 months.

Effects of Inflation

We do not believe that inflation has a material effect on our results of operations, except for the effect that inflation may have on interest rates and claim costs. The effects of inflation are considered in pricing and estimating reserves for unpaid losses and loss adjustment expenses. The actual effects of inflation on results of operations are not known until claims are ultimately settled. In addition to general price inflation, we are exposed to the upward trend in the judicial awards for damages. We attempt to mitigate the effects of inflation in the pricing of policies and establishing reserves for losses and loss adjustment expenses.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

We believe that interest rate risk, credit risk and equity risk are the types of market risk to which we are principally exposed.

Interest rate risk. Our investment portfolio consists principally of investment-grade, fixed-income securities, all of which are classified as available-for-sale. Accordingly, the primary market risk exposure to these securities is interest rate risk. In general, the fair market value of a portfolio of fixed-income securities increases or decreases inversely with changes in market interest rates, while net investment income realized from future investments in fixed-income securities increases or decreases along with interest rates. The fair value of our fixed-income securities as of December 31, 2007 was $250.7 million. The effective duration of our portfolio as of December 31, 2007 was 2.2 years. Should interest rates increase 1.0%, our fixed-income investment portfolio would be expected to decline in market value by 2.2%, or $5.5 million, representing the effective duration multiplied by the change in market interest rates. Conversely, a 1.0% decline in interest rates would be expected to result in a 2.2%, or $5.5 million, increase in the market value of our fixed-income investment portfolio.

Credit risk. An additional exposure to our fixed-income securities portfolio is credit risk. We attempt to manage the credit risk by investing primarily in investment-grade securities and limiting our exposure to a single issuer. As of December 31, 2007, our fixed-income investments were in the following: U.S. Treasury bonds - 39.5%; municipal bonds - 39.5%; corporate bonds - 20.0%; and U.S. Treasury bills and other short-term - 1.0%. As of December 31, 2007, 91.0% of our fixed-income securities were rated investment-grade by nationally recognized statistical rating organizations.

We are also subject to credit risk with respect to reinsurers to whom we have ceded underwriting risk. Although a reinsurer is liable for losses to the extent of the coverage it assumes, we remain obligated to our policyholders in the event that the reinsurers do not meet their obligations under the reinsurance agreements. In order to mitigate credit risk to reinsurance companies, we use financially strong reinsurers with an A.M. Best rating of “A-” (Excellent) or better.

Equity price risk. Investments in equity securities which are subject to equity price risk made up 6.3% of our portfolio as of December 31, 2007. The carrying values of equity securities are based on quoted market prices as of the balance sheet date. Market prices are subject to fluctuation and, consequently, the amount realized in the subsequent sale of an investment may significantly differ from the reported market value. Fluctuation in the market price of a security may result from perceived changes in the underlying economic characteristics of the issuer, the relative price of alternative investments and general market conditions. Furthermore, amounts realized in the sale of a particular security may be affected by the relative quantity of the security being sold.

The fair value of our equity securities as of December 31, 2007 was $16.9 million. The fair value of our equity securities would increase or decrease by $5.1 million assuming a hypothetical 30% increase or decrease in market prices as of the balance sheet date. This would increase or decrease stockholders’ equity by 1.8%. The selected hypothetical change does not reflect what should be considered the best or worse case scenario.

Item 8. Financial Statements and Supplementary Data.

The following consolidated financial statements of the Company and its subsidiaries are filed as part of this report.

Description	Page Number
Report of Independent Registered Public Accounting Firm	F-2
Consolidated Balance Sheets at December 31, 2007 and 2006	F-3
Consolidated Statements of Operations for the Years Ended December 31, 2007, 2006 and 2005	F-4
Consolidated Statements of Stockholders’ Equity and Comprehensive Income for the Years Ended December 31, 2007, 2006 and 2005	F-5
Consolidated Statements of Cash Flows for the Years Ended December 31, 2007, 2006 and 2005	F-7
Notes to Consolidated Financial Statements	F-8
Unaudited Selected Quarterly Information	F-36
Financial Statement Schedules	F-37

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A(T). Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our principal executive officer and principal financial officer have evaluated our disclosure controls and procedures and have concluded that such controls and procedures are effective as of the end of the period covered by this report.

Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate "internal control over financial reporting", as such phrase is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of management, including our Chief Executive Officer and Chief Accounting Officer, an evaluation of the effectiveness of our internal control over financial reporting was conducted based upon the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon that evaluation, management has concluded that our internal control over financial reporting was effective as of December 31, 2007. During the most recent fiscal quarter, there have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

This report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this report.

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

The information required by Item 10 is incorporated by reference from the Registrant’s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

Item 11. Executive Compensation.

The information required by Item 11 is incorporated by reference from the Registrant’s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information required by Item 12 is incorporated by reference from the Registrant’s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information required by Item 13 is incorporated by reference from the Registrant’s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

Item 14. Principal Accounting Fees and Services.

The information required by Item 14 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

PART IV

Item 15. Exhibits, Financial Statement Schedules.

(a)(1) Financial Statements

The following consolidated financial statements, notes thereto and related information are included in Item 8 of this report:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets at December 31, 2007 and 2006
Consolidated Statements of Operations for the Years Ended December 31, 2007, 2006 and 2005
Consolidated Statements of Stockholders' Equity and Comprehensive Income for the Years Ended December 31, 2007, 2006 and 2005
Consolidated Statements of Cash Flows for the Years Ended December 31, 2007, 2006 and 2005
Notes to Consolidated Financial Statements

(a)(2) Financial Statement Schedules

The following financial statement schedules are included in this report:

Unaudited Selected Quarterly Information
Schedule II - Condensed Financial Information of Registrant - Hallmark Financial Services, Inc. (Parent Company Only)
Schedule III - Supplemental Insurance Information
Schedule IV - Reinsurance
Schedule VI - Supplemental Information Concerning Property-Casualty Insurance Operations

(a)(3) Exhibit Index

The following exhibits are either filed with this report or incorporated by reference:

Exhibit Number	**Description**
3.1	Restated Articles of Incorporation of the registrant (incorporated by reference to Exhibit 3.1 to Amendment No. 1 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).
3.2	Amended and Restated By-Laws of the registrant (incorporated by reference to Exhibit 3.1 to the registrant's Current Report on Form 8-K filed October 1, 2007).
4.1	Specimen certificate for common stock, $0.18 par value, of the registrant (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).

4.2 Indenture dated June 21, 2005, between Hallmark Financial Services, Inc. and JPMorgan Chase Bank, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).

4.3 Amended and Restated Declaration of Trust of Hallmark Statutory Trust I dated as of June 21, 2005, among Hallmark Financial Services, Inc., as sponsor, Chase Bank USA, National Association, as Delaware trustee, and JPMorgan Chase Bank, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005).

4.4 Form of Junior Subordinated Debt Security Due 2035 (included in Exhibit 4.2 above).

4.5 Form of Capital Security Certificate (included in Exhibit 4.3 above).

4.6 First Restated Credit Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and The Frost National Bank (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006).

4.7 Form of Registration Rights Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and Newcastle Special Opportunity Fund I, Ltd. and Newcastle Special Opportunity Fund II, L.P. (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006).

4.8 Indenture dated as of August 23, 2007, between Hallmark Financial Services, Inc. and The Bank of New York Trust Company, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed August 24, 2007).

4.9 Amended and Restated Declaration of Trust of Hallmark Statutory Trust II dated as of August 23, 2007, among Hallmark Financial Services, Inc., as sponsor, The Bank of New York (Delaware), as Delaware trustee, and The Bank of New York Trust Company, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed August 24, 2007).

4.10 Form of Junior Subordinated Debt Security Due 2037 (included in Exhibit 4.8 above).

4.11 Form of Capital Security Certificate (included in Exhibit 4.9 above).

10.1 Office Lease for 14651 Dallas Parkway, Dallas, Texas, dated January 1, 1995, between American Hallmark Insurance Company of Texas and Fults Management Company, as agent for The Prudential Insurance Company of America (incorporated by reference to Exhibit 10(a) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).

10.2 Tenth Amendment to Office Lease for 14651 Dallas Parkway, Dallas, Texas, dated May 5th, 2003, between American Hallmark Insurance Company of Texas and Fults Management Company, as agent for The Prudential Insurance Company of America (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended March 31, 2003).

10.3 Lease Agreement for 777 Main Street, Fort Worth, Texas, dated June 12, 2003 between Hallmark Financial Services, Inc. and Crescent Real Estate Funding I, L.P. (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2003).

10.4 Lease Agreement for 7411 John Smith Drive, San Antonio, Texas, dated February 18, 1997, between Pan American Acceptance Corporation and Medical Plaza Partners, Ltd. (incorporated by reference to Exhibit 10.4 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).

10.5 Amendment No. 1 to Lease Agreement for 7411 John Smith Drive, San Antonio, Texas, dated June 10, 2002, between Pan American Acceptance Corporation and San Antonio Technology Center Corporation, as successor to Medical Plaza Partners, Ltd. (incorporated by reference to Exhibit 10.5 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).

10.6 Amendment No. 2 to Lease Agreement for 7411 John Smith Drive, San Antonio, Texas, dated February 27, 2003, between Pan American Acceptance Corporation and San Antonio

Technology Center Corporation, as successor to Medical Plaza Partners, Ltd. (incorporated by reference to Exhibit 10.6 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).

10.7	Amendment No. 3 to Lease Agreement for 7411 John Smith Drive, San Antonio, Texas, dated November 10, 2004, between Pan American Acceptance Corporation and San Antonio Technology Center Corporation, as successor to Medical Plaza Partners, Ltd. (incorporated by reference to Exhibit 10.7 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.8	Amended and Restated Lease Agreement for 14990 Landmark Boulevard, Addison, Texas, dated December 13, 2005, between Aerospace Managers, Inc. and Donnell Investments, L.L.C. (incorporated by reference to Exhibit 10.8 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).

51

10.9*	1994 Key Employee Long Term Incentive Plan (incorporated by reference to Exhibit 10(f) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).
10.10*	First Amendment to Hallmark Financial Services, Inc. 1994 Key Employee Long Term Incentive Plan (incorporated by reference to Exhibit 10(bm) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002).
10.11*	1994 Non-Employee Director Stock Option Plan (incorporated by reference to Exhibit 10(g) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).
10.12*	First Amendment to Hallmark Financial Services, Inc. 1994 Non-Employee Director Stock Option Plan (incorporated by reference to Exhibit 10(bn) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002).
10.13*	Second Amendment to Hallmark Financial Services, Inc. 1994 Non-Employee Director Stock Option Plan (incorporated by reference to Exhibit 10(e) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2001).
10.14*	Form of Indemnification Agreement between Hallmark Financial Services, Inc. and its officers and directors, adopted July 19, 2002 (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2002).
10.15*	Hallmark Financial Services, Inc. 2005 Long Term Incentive Plan (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 3, 2005).
10.16*	Form of Incentive Stock Option Grant Agreement (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed June 3, 2005).
10.17*	Form of Non-qualified Stock Option Agreement (incorporated by reference to Exhibit 10.3 to the registrant's Current Report on Form 8-K filed June 3, 2005).
10.18*	Employment Agreement dated as of February 1, 2006, among Aerospace Holdings, LLC, Hallmark Financial Services, Inc. and Curtis R. Donnell (incorporated by reference to Exhibit 10.18 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.19*	Employment Agreement dated as of February 1, 2006, between Texas General Agency, Inc. and Donald E. Meyer (incorporated by reference to Exhibit 10.19 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.20	Guarantee Agreement dated as of June 21, 2005, by Hallmark Financial Services, Inc. for the benefit of the holders of trust preferred securities (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).
10.21	Guarantee Agreement dated as of August 23, 2007, by Hallmark Financial Services, Inc. for the benefit of the holders of trust preferred securities (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed August 24, 2007).
10.22	Purchase Agreement dated November 9, 2005, by and among Hallmark Financial Services, Inc. and Samuel M. Cangelosi, Donate A. Cangelosi and Donald E. Meyer (incorporated by reference to Exhibit 4.1 to the

registrant's Current Report on Form 8-K filed November 14, 2005).

10.23 Purchase Agreement dated December 12, 2005, by and among Hallmark Financial Services, Inc. and Donnell Children Revocable Trust and Curtis R. Donnell (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed December 13, 2005).

10.24 Quota Share Reinsurance Treaty Attaching January 1, 2006 by and among American Hallmark Insurance Company, Phoenix Indemnity Insurance Company and Gulf States Insurance Company (n/k/a Hallmark Specialty Insurance Company) (incorporated by reference to Exhibit 10.25 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).

52

10.25	Amendment No. 1 to Quota Share Reinsurance Treaty Attaching January 1, 2006 by and among American Hallmark Insurance Company, Phoenix Indemnity Insurance Company and Gulf States Insurance Company (n/k/a Hallmark Specialty Insurance Company) (incorporated by reference to Exhibit 10.26 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.26	Amendment No. 2 to Quota Share Reinsurance Treaty Attaching January 1, 2006 by and among American Hallmark Insurance Company, Phoenix Indemnity Insurance Company and Gulf States Insurance Company (n/k/a Hallmark Specialty Insurance Company) (incorporated by reference to Exhibit 10.27 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed August 8, 2006).
10.27	Amendment No. 3 to Quota Share Reinsurance Treaty attaching January 1, 2006 by and among American Hallmark Insurance Company, Phoenix Indemnity Insurance Company and Gulf States Insurance Company (n/k/a Hallmark Specialty Insurance Company) (incorporated by reference to Exhibit 10.28 to the registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2006).
21+	List of subsidiaries of the registrant.
23+	Consent of KPMG LLP
31(a)+	Certification of principal executive officer required by Rule 13a-14(a) or Rule 15d-14(b).
31(b)+	Certification of principal financial officer required by Rule 13a-14(a) or Rule 15d-14(b).
32(a)+	Certification of principal executive officer pursuant to 18 U.S.C. 1350.
32(b)+	Certification of principal financial officer pursuant to 18 U.S.C. 1350.
*	Management contract or compensatory plan or arrangement.
+	Filed herewith.

53

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HALLMARK FINANCIAL SERVICES, INC.
(Registrant)

Date: March 17, 2008

/s/ Mark J. Morrison

Mark J. Morrison,
Chief Executive Officer and President
(Principal Executive Officer)

Date: March 17, 2008

/s/ Jeffrey R. Passmore

Jeffrey R. Passmore,
Chief Accounting Officer and Senior Vice President
(Principal Financial Officer and Principal Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: March 17, 2008

/s/ Mark E. Schwarz

Mark E. Schwarz,
Executive Chairman

Date: March 17, 2008

/s/ James H. Graves

James H. Graves,
Director

Date: March 17, 2008

/s/ George R. Manser

George R. Manser,
Director

Date: March 17, 2008

/s/ Scott T. Berlin

Scott T. Berlin,
Director

54

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Description	Page Number
Report of Independent Registered Public Accounting Firm	F-2
Consolidated Balance Sheets at December 31, 2007 and 2006	F-3
Consolidated Statements of Operations for the Years Ended December 31, 2007, 2006 and 2005	F-4
Consolidated Statements of Stockholders' Equity and Comprehensive Income for the Years Ended December 31, 2007, 2006 and 2005	F-5 F-6
Consolidated Statements of Cash Flows for the Years Ended December 31, 2007, 2006 and 2005	F-7
Notes to Consolidated Financial Statements	F-8
Unaudited Selected Quarterly Information	F-36
Financial Statement Schedules	F-37

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Hallmark Financial Services, Inc.:

We have audited the accompanying consolidated balance sheets of Hallmark Financial Services, Inc. and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2007. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedules II, III, IV and VI. These consolidated financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedules based on our audits.

We conducted our audits in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about 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. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Hallmark Financial Services, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

As described in note 1 to the consolidated financial statements, in 2006 the Company changed its method of accounting for stock-based compensation.

/s/ KPMG LLP

KPMG LLP
Dallas, Texas
March 17, 2008

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2007 and 2006
(In thousands)

		2007		2006
ASSETS				
Investments:				
Debt securities, available-for-sale, at fair value	$	248,069	$	133,030
Equity securities, available-for-sale, at fair value		16,868		4,580
Short-term investments, available-for-sale, at fair value		2,625		25,275
Total investments		267,562		162,885
Cash and cash equivalents		145,884		81,474
Restricted cash and investments		16,043		24,569
Prepaid reinsurance premiums		274		1,629
Premiums receivable		46,026		44,644
Accounts receivable		5,219		7,852
Receivable for securities		27,395		5,371
Reinsurance recoverable		4,952		5,930
Deferred policy acquisition costs		19,757		17,145
Excess of cost over fair value of net assets acquired		30,025		31,427
Intangible assets		23,781		26,074
Deferred federal income taxes		275		-
Prepaid expenses		1,240		1,769
Other assets		17,881		5,184
	$	606,314	$	415,953
LIABILITIES AND STOCKHOLDERS' EQUITY				
Liabilities:				
Notes payable	$	60,814	$	35,763
Structured settlements		10,000		24,587
Reserves for unpaid losses and loss adjustment expenses		125,338		77,564
Unearned premiums		102,998		91,606
Unearned revenue		2,949		5,734
Reinsurance balances payable		-		1,060
Accrued agent profit sharing		2,844		1,784
Accrued ceding commission payable		12,099		3,956
Pension liability		1,669		3,126
Deferred federal income taxes		-		2,310
Payable for securities		91,401		-
Current federal income tax payable		630		2,132
Accounts payable and other accrued expenses		16,385		15,600
		427,127		265,222
Commitments and contingencies (Note 15)				

Stockholders’ equity:				
Common stock, $.18 par value, authorized 33,333,333 shares in 2007 and 2006; issued 20,776,080 shares in 2007 and 2006		3,740		3,740
Capital in excess of par value		118,459		117,932
Retained earnings		58,909		31,480
				(2,3444
Accumulated other comprehensive loss		(1,8447)		(2,3447)
Treasury stock, 7,828 shares in 2007 and 2006, at cost		(77)		(77)
Total stockholders’ equity		179,187		150,731
	$	606,314	$	415,953

The accompanying notes are an integral
part of the consolidated financial statements

F-3

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
for the years ended December 31, 2007, 2006 and 2005
(In thousands, except per share amounts)

	2007	2006	2005
Gross premiums written	$ 249,472	$ 213,945	$ 89,467
Ceded premiums written	(11,329)	(11,017)	(1,215)
Net premiums written	238,143	202,928	88,252
Change in unearned premiums	(12,840)	(50,867)	(29,068)
Net premiums earned	225,303	152,061	59,184
Investment income, net of expenses	13,180	10,461	3,836
Gain (loss) on investments	2,586	(1,466)	58
Finance charges	4,702	3,983	2,044
Commission and fees	28,054	35,343	16,703
Processing and service fees	657	2,330	5,183
Other income	16	29	27
Total revenues	274,498	202,741	87,035
Losses and loss adjustment expenses	132,918	87,117	33,784
Other operating costs and expenses	94,272	83,583	38,492
Interest expense	3,914	5,798	1,264
Interest expense from amortization of discount on convertible notes	-	9,625	-
Amortization of intangible asset	2,293	2,293	27
Total expenses	233,397	188,416	73,567
Income before income tax	41,101	14,325	13,468
Income tax expense	13,672	5,134	4,282
Net income	$ 27,429	$ 9,191	$ 9,186
Common stockholders net income per share:			
Basic	$ 1.32	$ 0.53	$ 0.76
Diluted	$ 1.32	$ 0.53	$ 0.76

The accompanying notes are an integral part
of the consolidated financial statements

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
for the years ended December 31, 2007, 2006 and 2005
(in thousands)

	Number of Shares	Par Value	Capital In Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Number of Shares	Total Stockholders' Equity	Comprehensive Income (Loss)
Balance at December 31, 2004	6,143	$ 1,106	$ 19,647	$ 13,103	$ (759)	$ (441)	63	$ 32,656	
Rights offering	8,333	1,500	43,391	-	-	-	-	44,891	
Amortization of fair value of stock options granted	-	-	63	-	-	-	-	63	
Stock options exercised	-	-	(194)	-	-	424	(61)	230	
Comprehensive income:									
Net income	-	-	-	9,186	-	-	-	9,186	$ 9,186
Other comprehensive income:									
Additional minimum pension liability	-	-	-	-	(761)	-	-	(761)	(761)
Net unrealized holding losses arising during period	-	-	-	-	(1,949)	-	-	(1,991)	(1,991)
Reclassification adjustment for gains included in net income	-	-	-	-	(90)	-	-	(48)	(48)
Net unrealized losses on securities					(2,039)			(2,039)	(2,039)
Total other comprehensive loss before tax					(2,800)			(2,800)	(2,800)
Tax effect on other comprehensive loss					962			962	962
Other comprehensive loss after tax					(1,838)			(1,838)	(1,838)
									7,348
Balance at December 31, 2005	14,476	$ 2,606	$ 62,907	$ 22,289	$ (2,597)	$ (17)	2	$ 85,188	
Stock offering	3,000	540	24,149	-	-	-	-	24,689	
Amortization of fair value of stock options granted	-	-	157	-	-	-	-	157	

Stock options exercised	-	5	91	-	-	(60)	6	36	
Discount on convertible note, net of tax	-	-	6,066	-	-	-	-	6,066	
Conversion of note payable to common stock	3,300	589	24,562	-	-	-	-	25,151	
Comprehensive income:									
Net income	-	-	-	9,191	-	-	-	9,191	$ 9,191
Other comprehensive income:									
Change in net actuarial loss	-	-	-	-	(226)	-	-	(226)	(226)
Net unrealized holding loss arising during period	-	-	-	-	(653)	-	-	(653)	(653)
Reclassification adjustment for losses included in net income	-	-	-	-	1,242	-	-	1,242	1,242
Net unrealized gains on securities					589			589	589
Total other comprehensive gain before tax					363			363	363
Tax effect on other comprehensive gain					(110)			(110)	(110)
Other comprehensive gain after tax					253			253	253
Comprehensive income									$ 9,444
Balance at December 31, 2006	20,776	$ 3,740	$ 117,932	$ 31,480	$ (2,344)	$ (77)	8	$ 150,731	

The accompanying notes are an integral part of the consolidated financial statements

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
(Continued)
for the years ended December 31, 2007, 2006 and 2005
(in thousands)

	Number of Shares	Par Value	Capital In Excess of Par Value	Retained Earnings	Accumlated Other Comprehensive Income (Loss)	Treasury Stock	Number of Shares	Total Stockholders' Equity	Comprehensive Income (Loss)
Balance at December 31, 2006	20,776	$ 3,740	$ 117,932	$ 31,480	$ (2,344)	$ (77)	8	$ 150,731	
Amortization of fair value of stock options granted	-	-	527	-	-	-	-	527	
Comprehensive income:									
Net income	-	-	-	27,429	-	-	-	27,429	$ 27,429
Other comprehensive income:									
Change in net actuarial loss	-	-	-	-	1,378	-	-	1,378	1,378
Net unrealized holding losses arising during period	-	-	-	-	(339)	-	-	(339)	(339)
Reclassification adjustment for gains included in net income	-	-	-	-	(270)	-	-	(270)	(270)
Net unrealized losses on securities					(609)			(609)	(609)
Total other comprehensive income before tax					769			769	769
Tax effect on other comprehensive income					(269)			(269)	(269)
Other comprehensive income after tax					500			500	500
Comprehensive income									$ 27,929
Balance at December 31, 2007	20,776	$ 3,740	$ 118,459	$ 58,909	$ (1,844)	$ (77)	8	$ 179,187	

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31, 2007, 2006 and 2005
(In thousands)

	2007	2006	2005
Cash flows from operating activities:			
Net income	$ 27,429	$ 9,191	$ 9,186
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization expense	3,119	3,214	413
Amortization of beneficial conversion feature	-	9,625	-
Amortization of discount on structured settlement	413	1,045	-
Deferred income tax expense (benefit)	(1,481)	(6,529)	2,143
Realized (gain) loss on investments	(2,586)	1,466	(58)
Change in prepaid reinsurance premiums	1,355	(862)	(767)
Change in premiums receivable	(1,382)	6,392	(22,427)
Change in prepaid commissions	487	1,306	-
Change in accounts receivable	2,632	(4,484)	1,411
Change in deferred policy acquisition costs	(2,612)	(7,981)	(1,689)
Change in unpaid losses and loss adjustment expenses	47,774	41,753	6,673
Change in unearned premiums	11,392	51,635	29,835
Change in unearned revenue	(2,785)	(7,861)	(7,228)
Change in accrued agent profit sharing	1,060	(389)	298
Change in reinsurance recoverable	978	(4,846)	2,639
Change in reinsurance balances payable	(1,060)	295	116
Change in current federal income tax payable/recoverable	(1,502)	1,745	(1,043)
Excess tax benefits from share-based payment arrangements	-	(25)	-
Change in accrued ceding commission payable	8,143	(7,474)	9,735
Change in all other liabilities	(673)	(13,075)	3,817
Change in all other assets	(10,364)	1,821	(3,400)
Net cash provided by operating activities	80,337	75,962	29,654
Cash flows from investing activities:			
Purchases of property and equipment	(455)	(685)	(532)
Acquisitions of subsidiaries, net of cash received	-	(25,964)	-
Premium finance notes repaid, net of finance notes originated	(723)	(2,750)	-
Change in restricted cash	8,526	(15,857)	(1,987)
Purchases of debt and equity securities	(226,476)	(75,478)	(60,565)
Proceeds from maturities and redemptions of securities	170,207	41,944	1,747
Net redemptions (purchases) of short-term investments	22,894	(12,776)	(11,832)
Net cash used in investing activities	(26,027)	(91,566)	(73,169)
Cash flows from financing activities:			
Proceeds from borrowings	25,774	52,500	30,928
Debt issuance costs	(674)	-	(907)

Proceeds from equity offerings	-	24,689	44,891
Proceeds from exercise of employee stock options	-	36	230
Excess tax benefits from share-based payment arrangements	-	25	-
Repayment of borrowings	(15,000)	(24,700)	-
Net cash provided by financing activities	10,100	52,550	75,142
Increase in cash and cash equivalents	64,410	36,946	31,627
Cash and cash equivalents at beginning of year	81,474	44,528	12,901
Cash and cash equivalents at end of year	$ 145,884	$ 81,474	$ 44,528
Supplemental cash flow information:			
Interest (paid)	$ (3,402)	$ (4,678)	$ (1,167)
Income taxes (paid)	$ (16,655)	$ (9,830)	$ (3,182)

The accompanying notes are an integral part
of the consolidated financial statements

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

1. Accounting Policies:

General

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company engaged in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing commercial insurance in nine states; marketing, distributing, underwriting and servicing non-standard personal automobile insurance in 11 states; marketing, distributing, underwriting and servicing general aviation insurance in 47 states; and providing other insurance related services.

We pursue our business activities through subsidiaries whose operations are organized into four operating units which are supported by our three insurance company subsidiaries. Our HGA Operating Unit handles commercial insurance products and services and is comprised of American Hallmark Insurance Services, Inc. (“American Hallmark Insurance Services”) and Effective Claims Management, Inc. (“ECM”). Our TGA Operating Unit handles primarily commercial insurance products and services and is comprised of TGA Insurance Managers, Inc. (“Texas General Agency”), Pan American Acceptance Corporation (“PAAC”) and TGA Special Risk, Inc. (“TGASRI”). Our Aerospace Operating Unit handles general aviation insurance products and services and is comprised of Aerospace Insurance Managers, Inc. (“Aerospace Insurance Managers”), Aerospace Special Risk, Inc. (“ASRI”) and Aerospace Claims Management Group, Inc. (“ACMG”). The subsidiaries comprising our TGA Operating Unit and our Aerospace Operating Unit were all acquired effective January 1, 2006. Our Phoenix Operating Unit handles non-standard personal automobile insurance products and services and is comprised of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc. (both of which do business as Phoenix General Agency). Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas (“AHIC”), Phoenix Indemnity Insurance Company (“PIIC”) and Hallmark Specialty Insurance Company (“HSIC”) (f/k/a Gulf States Insurance Company).

These four operating units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment presently consists solely of the HGA Operating Unit and the Personal Segment presently consists solely of our Phoenix Operating Unit. The Specialty Commercial Segment includes both our TGA Operating Unit and our Aerospace Operating Unit.

Basis of Presentation

The accompanying consolidated financial statements include the accounts and operations of Hallmark and its subsidiaries. Intercompany accounts and transactions have been eliminated. The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) which, as to AHIC, PIIC and HSIC, differ from statutory accounting practices prescribed or permitted for insurance companies by insurance regulatory authorities.

Investments

Debt and equity securities available for sale are reported at fair value. Unrealized gains and losses are recorded as a component of stockholders’ equity, net of related tax effects. Debt and equity securities that are determined to have other than temporary impairment are recognized as a realized loss in the Statement of Operations. Debt security premiums and discounts are amortized into earnings using the effective interest method. Maturities of debt securities are recorded in receivable for securities until the cash is settled. Purchases of equity securities are recorded in payable

for securities until the cash is settled.

Short-term investments consist of treasury bills, municipal bonds, and a certificate of deposit which are reported at fair value.

Realized investment gains and losses are recognized in operations on the specific identification method.

Cash Equivalents

We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Recognition of Premium Revenues

Insurance premiums and policy fees are earned pro rata over the terms of the policies. Upon cancellation, any unearned premium is refunded to the insured. Insurance premiums written include gross policy fees of $4.9 million, $5.0 million and $3.9 million for the years ended December 31, 2007, 2006, and 2005, respectively.

Relationship with Third Party Insurers

Through December 31, 2005, our HGA Operating Unit marketed policies on behalf of Clarendon National Insurance Company ("Clarendon"), a third-party insurer. All business of our TGA Operating Unit is currently produced under a fronting agreement with member companies of the Republic Group ("Republic"), a third-party insurer. These insurance contracts on third party paper are accounted for under agency accounting. Ceding commissions and other fees received under these arrangements are classified as unearned revenue until earned pro rata over the terms of the policies.

Recognition of Commission Revenues of Our Standard and Specialty Commercial Segments

Commission revenues and commission expenses related to insurance policies issued by American Hallmark Insurance Services and Texas General Agency on behalf of Clarendon and Republic, respectively, are recognized pro rata during the period covered by the policy. Profit sharing commission is calculated and recognized when the loss ratio, as determined by a qualified actuary, deviates from contractual targets. We receive a provisional commission as policies are produced as an advance against the later determination of the profit sharing commission actually earned. The profit sharing commission is an estimate that varies with the estimated loss ratio and is sensitive to changes in that estimate.

The following table details the profit sharing commission revenue sensitivity to the actual ultimate loss ratio for each effective quota share treaty between the Standard Commercial Segment and Clarendon at 5.0% above and below the current estimate (dollars in thousands).

	Treaty Effective Dates			
	7/1/01	**7/1/02**	**7/1/03**	**7/1/04**
Provisional loss ratio	60.0%	59.0%	59.0%	64.2%
Estimated ultimate loss ratio booked to at December 31, 2007	63.5%	64.5%	67.0%	54.6%
Effect of actual 5.0% above estimated loss ratio at December 31, 2007	-	-	-	($2,793)
Effect of actual 5.0% below estimated loss ratio at December 31, 2007	$ 1,850	$ 3,055	$ 3,360	$ 2,793

As of December 31, 2007, we recorded a $2.1 million profit sharing payable for the quota share treaty effective July 1, 2001, a $4.6 million payable on the quota share treaty effective July 1, 2002, a $5.4 million payable on the quota share treaty effective July 1, 2003 and a $5.4 million receivable on the quota share treaty effective July 1, 2004. The payable or receivable is the difference between the cash received to date and the recognized commission revenue based on the estimated ultimate loss ratio.

The following table details the profit sharing commission revenue sensitivity to the actual ultimate loss ratio for the effective quota share treaty between the Specialty Commercial Segment and Republic at 5% above and below the current estimate (dollars in thousands).

F-9

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

	Treaty Effective Date 1/1/06	Treaty Effective Date 1/1/07
Provisional loss ratio	65.0%	65.0%
Ultimate loss ratio booked to at December 31, 2007	56.0%	65.0%
Effect of actual 5.0% above estimated loss ratio at December 31, 2007	($3,092)	-
Effect of actual 5.0% below estimated loss ratio at December 31, 2007	$ 1,237	$ 1,897

As of December 31, 2007 we recorded a $5.6 million profit share receivable for the quota share treaty effective January 1, 2006 and had not recorded a profit share receivable or payable on the January 1, 2007 quota share treaty since the loss experience on this business has not developed sufficiently to conclude that we will realize any additional profit share revenue.

Recognition of Claim Servicing Fees

Claim servicing fees are recognized in proportion to the historical trends of the claim cycle. We use historical claim count data that measures the close rate of claims in relation to the policy period covered to substantiate the service period. The following table summarizes the year in which claim fee revenue is recognized by type of business.

	Year Claim Fee Revenue Recognized			
	1st	2nd	3rd	4th
Commercial property fees	80%	20%	-	-
Commercial liability fees	60%	30%	10%	-
Personal property fees	90%	10%	-	-
Personal liability fees	49%	33%	12%	6%

Finance Charges

PAAC provides premium financing for policies produced by Texas General Agency and certain unaffiliated general and retail agents. Interest earned on the premium finance notes issued by PAAC for the financing of insurance premiums are recorded as finance charges. This interest is earned on the Rule of 78's method which approximates the interest method for such short-term notes.

We receive premium installment fees for each direct bill payment from policyholders. Installment fee income is classified as finance charges on the statement of operations and is recognized as the fee is invoiced.

Property and Equipment

Property and equipment (including leasehold improvements), aggregating $7.7 million and $7.3 million, at December 31, 2007 and 2006, respectively, which is included in other assets, is recorded at cost and is depreciated using the straight-line method over the estimated useful lives of the assets (three to ten years). Depreciation expense for 2007, 2006 and 2005 was $0.8 million, $0.9 million and $0.4 million, respectively. Accumulated depreciation was $6.4 million and $5.6 million at December 31, 2007 and 2006, respectively.

Premiums Receivable

Premiums receivable represent amounts due from policyholders or independent agents for premiums written and uncollected. These balances are carried at net realizable value.

Deferred Policy Acquisition Costs

Policy acquisition costs (mainly commission, underwriting and marketing expenses) that vary with and are primarily related to the production of new and renewal business are deferred and charged to operations over periods in which the related premiums are earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. In determining estimated realizable value, the computation gives effect to the premium to be earned, related investment income, losses and loss adjustment expenses and certain other costs expected to be incurred as the premiums are earned. If the computation results in an estimated net realizable value less than zero, a liability will be accrued for the premium deficiency. During 2007, 2006 and 2005, we deferred ($57.7) million, ($40.5) million and ($33.3) million of policy acquisition costs and amortized $55.1 million, $32.5 million and $26.8 million of deferred policy acquisition costs, respectively. Therefore, the net deferrals of policy acquisition costs were ($2.6) million, ($8.0) million and ($6.5) million for 2007, 2006 and 2005, respectively.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Losses and Loss Adjustment Expenses

Losses and loss adjustment expenses represent the estimated ultimate net cost of all reported and unreported losses incurred through December 31, 2007, 2006 and 2005. The reserves for unpaid losses and loss adjustment expenses are estimated using individual case-basis valuations and statistical analyses. These estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, we believe that the reserves for unpaid losses and loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations.

Retail Agent Commissions

We pay monthly commissions to retail agents based on written premium produced but recognize the expense pro rata over the term of the policy. If the policy is cancelled prior to its expiration, the unearned portion of the agent commission is refundable to us. The unearned portion of commissions paid to retail agents is included in deferred policy acquisition costs.

Agent Profit Sharing Commissions

We annually pay a profit sharing commission to our independent agency force based upon the results of the business produced by each agent. We estimate and accrue this liability to commission expense in the year the business is produced.

Reinsurance

We are routinely involved in reinsurance transactions with other companies. Reinsurance premiums, losses and loss adjustment expenses are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. (See Note 5.)

Leases

We have several leases, primarily for office facilities and computer equipment, which expire in various years through 2011. Some of these leases include rent escalation provisions throughout the term of the lease. We expense the average annual cost of the lease with the difference to the actual rent invoices recorded as deferred rent which is classified as other accrued expenses on our consolidated balance sheet.

Income Taxes

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end. Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes in effect for the year in which these temporary differences are expected to be recovered or settled.

Earnings Per Share

The computation of earnings per share is based upon the weighted average number of common shares outstanding during the period plus (in periods in which they have a dilutive effect) the effect of common shares potentially issuable, primarily from stock options. (See Notes 10 and 12.)

Business Combinations

We account for business combinations using the purchase method of accounting pursuant to Statement of Financial Accounting Standards No. 141, “Business Combinations.” The cost of an acquired entity is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on their estimated fair values. The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed is an asset referred to as “excess of cost over net assets acquired” or “goodwill.” Indirect and general expenses related to business combinations are expensed as incurred.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Effective January 1, 2006, we acquired all of the issued and outstanding capital stock of Texas General Agency, PAAC and TGASRI for an aggregate cash purchase price of up to $45.6 million, consisting of unconditional consideration of $37.6 million and contingent consideration of $8.0 million. Of the unconditional consideration, $13.9 million was paid at closing, $14.3 million was paid on January 2, 2007, and $9.5 million was paid on January 2, 2008. The payment of any contingent consideration is conditioned on the sellers complying with certain restrictive covenants and the TGA Operating Unit achieving certain operational objectives related to premium production and loss ratios. The contingent consideration, if any, will be payable on or before March 30, 2009, unless the sellers elect to defer payment until March 30 of any subsequent year in order to permit further development of the loss ratios. In addition to the purchase price, we will pay $2.0 million to the sellers in consideration of their compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. Of this additional amount, $750 thousand was paid at closing, $750 thousand was paid on January 2, 2007, and $500 thousand was paid on January 2, 2008.

Texas General Agency is a managing general agency involved in the marketing, underwriting and servicing of property and casualty insurance products, with a particular emphasis on commercial automobile, general liability and commercial property risks produced on an excess and surplus lines basis. Other affiliated companies acquired were HSIC, which reinsures a portion of the business written by Texas General Agency; TGASRI, which brokers mobile home insurance; and PAAC, which finances premiums on property and casualty insurance products marketed by Texas General Agency and certain unaffiliated general and retail agents. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition, January 1, 2006 (in thousands).

Investments	$	19,597
Cash and equivalents		2,199
Premium receivable		17,556
Premium finance notes receivable		6,146
Reinsurance recoverable		640
Tradename		1,973
Customer relationships		19,417
Non-compete/employment agreements		2,477
Goodwill		15,476
Other assets		7,178
Total assets acquired		92,659
Total liabilities assumed		54,260
Net assets acquired	$	38,399

Net assets of $38.4 million acquired equals the $39.6 million unconditional purchase price and restrictive covenant payments discounted at 4.40% (which is the rate of two-year U.S. Treasuries, which is the only permitted investment of the trust account guaranteeing the future payments to the sellers) plus $232 thousand of direct acquisition expenses. The goodwill is not deductible for tax purposes. Certain purchased items above are subject to amortization over their estimated useful life as presented in the following table.

	Years
Tradename	15
Customer relationships	15
Non-compete agreements	5

The aggregate weighted average period to amortize the above captioned assets is approximately 14 years.

F-12

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

The results of operations of Texas General Agency, PAAC and TGASRI are included in the Consolidated Statement of Operations from the effective date of the acquisition. The unaudited pro forma results for the twelve months ended December 31, 2005 as if we had acquired Texas General Agency, PAAC and TGASRI at January 1, 2005 are as follows (in thousands, except per share amounts):

		2005
Revenues	$	137,078
Net income		10,103
Net income per share:		
Basic	$	0.84
Diluted	$	0.75

F-13

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Effective January 1, 2006, we also acquired all of the issued and outstanding membership interests in the subsidiaries now comprising the Aerospace Operating Unit, for an aggregate consideration of up to $15.0 million, consisting of unconditional consideration of $12.5 million due in cash at closing and contingent consideration of up to $2.5 million. The unconditional consideration of $12.5 million is allocated $11.9 million to the purchase price and $0.6 million to the seller's compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. The payment of contingent consideration is conditioned on the seller complying with its restrictive covenants and the Aerospace Operating Unit achieving certain operational objectives related to premium production and loss ratios. The contingent consideration, if any, will be payable in cash on or before March 30, 2009, unless the seller elects to defer a portion of the payment in order to permit further development of loss ratios. Our Aerospace Operating Unit is involved in the marketing and servicing of general aviation property and casualty insurance products with a particular emphasis on private and small commercial aircraft and airports.

Prior to the Company's acquisition of the Aerospace Operating Unit in January, 2006, the primary subsidiary within such operating unit entered into an agreement to lease office space from Donnell Investments, L.L.C., an entity wholly owned and controlled by Curtis R. Donnell, the current president of the Aerospace Operating Unit. The lease pertains to an approximately 8,925 square foot suite in a low-rise office building and expires September 30, 2010. The rent is currently $13,666 per month.

Intangible Assets

We account for our intangible assets according to Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 142 (1) prohibits the amortization of goodwill and indefinite-lived intangible assets, (2) requires testing of goodwill and indefinite-lived intangible assets on an annual basis for impairment (and more frequently if the occurrence of an event or circumstance indicates an impairment), (3) requires that reporting units be identified for the purpose of assessing potential future impairments of goodwill, and (4) removes the forty-year limitation on the amortization period of intangible assets that have finite lives.

Pursuant to SFAS 142, we have identified the components of goodwill and assigned the carrying value of these components among our four operating units, as follows: HGA Operating Unit - $2.1 million; TGA Operating Unit - $15.5 million; Aerospace Operating Unit - $9.7 million; and Phoenix Operating Unit - $2.7 million. As of December 31, 2007, the balance of our goodwill asset is $30.0 million, of which $25.2 million was acquired in 2006 with the acquisition of the subsidiaries now comprising our TGA Operating Unit and our Aerospace Operating Unit. During 2007, 2006 and 2005, we completed the first step prescribed by SFAS 142 for testing for impairment and determined that there was no impairment.

We have obtained various amortizable intangible assets from several acquisitions since 2002. The table below details the gross and net carrying amounts of these assets by major category (in thousands):

	December 31,			
		2007		2006
Gross Carrying Amount:				
Customer/agent relationships	$	22,729	$	22,729
Tradename		2,682		2,682
Non-compete & employment agreements		3,040		3,040
Total gross carrying amount		28,451		28,451

Accumulated Amortization:		
Customer/agent relationships	(3,096)	(1,590)
Tradename	(358)	(179)
Non-compete & employment agreements	(1,216)	(608)
Total accumulated amortization	(4,670)	(2,377)
Total net carrying amount	$ 23,781	$ 26,074

F-14

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

The estimated aggregate amortization expense for these assets for the next five years is as follows (in thousands):

2008	$	2,293
2009	$	2,293
2010	$	2,293
2011	$	1,685
2012	$	1,685

The weighted average amortization period for all intangible assets by major class is as follows:

	Years
Tradename	15
Customer relationships	15
Non-compete agreements	5

The aggregate weighted average period to amortize the above captioned assets is approximately 14 years.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Fair Value of Financial Instruments

Investment Securities: Fair values for fixed income securities and equity securities are obtained from an independent pricing service or based on quoted market prices. (See Note 2.)

Cash and Short-term Investments: The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Restricted Cash : The carrying amount for restricted cash reported in the balance sheet approximates the fair value.

Notes Payable: The carrying value for notes payable approximates their fair value based on the current interest rate for each note.

Structured Settlements: The carrying value for the structured settlements approximates their fair value based on the current interest rate of two-year U.S. Treasuries.

For accrued investment income, amounts recoverable from reinsurers, federal income tax payable and receivable and other liabilities, the carrying amounts approximate fair value because of the short maturity of such financial

instruments.

Recent Accounting Pronouncements

In December 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS 148"). SFAS 148 amended Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") to provide alternative methods of transition for voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amended the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. Effective January 1, 2003, we adopted the prospective method provisions of SFAS 148. Under the prospective method, we have applied the fair value based method of accounting for our stock-based payments for option grants after December 31, 2002.

In December 2004, FASB issued Statement of Financial Accounting Standards No. 123R "Share-Based Payment" ("SFAS 123R"), which revises SFAS 123 and supersedes Accounting Principles Board Opinion No. 25 ("APB 25"). SFAS 123R eliminates an entity's ability to account for share-based payments using APB 25 and requires that all such transactions be accounted for using a fair value based method. We adopted SFAS 123R on January 1, 2006 using the modified-prospective transition method.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Under the modified-prospective transition method, compensation cost recognized during the period should include compensation cost for all share-based payments granted, but not yet vested, as of January 1, 2006, based on grant date fair value estimates in accordance with the original provisions of SFAS 123 and compensation cost for all share-based payments granted after January 1, 2006 in accordance with SFAS 123R. Since we adopted the fair value method of SFAS 123 under the prospective method provision of SFAS 148 beginning January 1, 2003, we have a small amount of unvested share-based payments for grants prior to January 1, 2003. During 2007, we recognized approximately $10 thousand of additional compensation expense under SFAS 123R. SFAS 123R also requires the benefits of tax deductions in excess of recognized stock compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as previously required. (See Note 12.)

The following table illustrates the effect on net income and net income per share if the fair value based method had been applied to all outstanding and unvested awards in each period.

		2005
Net income	$	9,186
Add: stock-based employee compensation expenses included in reported net income, net of tax		41
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of tax		(48)
Pro forma net income	$	9,179
Net income per share:		
Basic - as reported	$	0.76
Basic - pro forma	$	0.76
Diluted - as reported	$	0.76
Diluted - pro forma	$	0.76

In June 2006, FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109” (“FIN 48”), was issued. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company’s financial statements in accordance with FASB Statement of Financial Accounting Standards No. 109, “Accounting for Income Taxes”. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, as well as providing guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 with earlier application permitted as long as the company has not yet issued financial statements, including interim financial statements, in the period of adoption. We adopted the provisions of FIN 48 on January 1, 2007. Since we had no unrecognized tax benefits, we recognized no additional liability or reduction in deferred tax asset as a result of the adoption of FIN 48. We are no longer subject to U. S. federal, state, local or non-U.S. income tax examinations by tax authorities for years prior to 2003.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)” (“SFAS 158”). SFAS 158 requires (1) balance sheet recognition of the funded status of defined benefit plans, (2) recognition in other comprehensive income of various items before they are recognized in periodic benefit cost, (3) the measurement date for plan assets and the benefit obligation to be the balance sheet date, and (4) additional disclosure. Requirements (1), (2), and (4) of SFAS 158 are effective as of the end of the first fiscal year ending after December

15, 2006. As of December 31, 2006, the measurement date for our plan assets and benefit obligation is the balance sheet date. The adoption of SFAS 158 did not have a material impact on our results of operations or financial condition.

In September 2005, the American Institute of Certified Public Accountants issued Statement of Position 05-1 "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts" ("SOP 05-1"). This statement provides guidance on accounting for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in Statement of Financial Accounting Standards No. 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments," previously issued by the FASB. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The adoption of SOP 05-1 had no material impact on our financial condition or results of operations.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 establishes a separate framework for determining fair values of assets and liabilities that are required by other authoritative GAAP pronouncements to be measured at fair value. In addition, SFAS 157 incorporates and clarifies the guidance in FASB Concepts Statement 7 regarding the use of present value techniques in measuring fair value. SFAS 157 does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of adopting SFAS 157 on our financial statements.

In February 2007, FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Liabilities" ("SFAS 159"). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value with changes in fair value included in current earnings. The election is made on specified election dates, can be made on an instrument-by-instrument basis, and is irrevocable. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of SFAS 159 had no impact on our financial statements.

In December 2007, the FASB issued Revised Statement of Financial Accounting Standards No. 141R, "Business Combinations" ("FAS 141R"), a replacement of Statement of Financial Accounting Standards No. 141, "Business Combinations". FAS 141R provides revised guidance on how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. In addition, it provides revised guidance on the recognition and measurement of goodwill acquired in the business combination. FAS 141R also provides guidance specific to the recognition, classification, and measurement of assets and liabilities related to insurance and reinsurance contracts acquired in a business combination. FAS 141R applies to business combinations for acquisitions occurring on or after January 1, 2009. The Company does not expect the provisions of FAS 141R to have a material effect on its results of operations, financial position or liquidity. FAS 141R will impact the accounting for any future acquisition.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51" ("FAS 160"). FAS 160 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. In addition, it clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. FAS 160 is effective on a prospective basis beginning January 1, 2009, except for the presentation and disclosure requirements which are applied on a retrospective basis for all periods presented. The Company does not expect the provisions of FAS 160 to have a material effect on its results of operations, financial position or liquidity.

Reclassification

Certain previously reported amounts have been reclassified to conform to current year presentation. Such reclassification had no effect on net income or stockholders' equity. Investment balances that were previously reported in Restricted Cash and Investments on the balance sheet have been reclassified to debt securities, available-for-sale, at market value during the current period. The amount reclassified from the December 31, 2006 presentation is $7.2 million. Amounts previously reported for net unrealized holding losses arising during the period and the reclassification adjustment for losses included in net income were revised in our Consolidated Statements of Stockholders' Equity and Comprehensive Income in this year's presentation. The result of this reclassification had no effect on Accumulated Other Comprehensive Income, Net Income, Comprehensive Income or Stockholders' Equity for

any period.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Redesignation of Segments

Prior to January 1, 2006, the Standard Commercial Segment was referred to as our Commercial Insurance Operation and the Personal Segment was referred to as our Personal Insurance Operation. Each of our four operating units was reported as a separate segment during the first three quarters of 2006. Commencing in the fourth quarter of 2006, our HGA Operating Unit was designated as the sole component of the Standard Commercial Segment, our TGA Operating Unit and our Aerospace Operating Unit were aggregated in the Specialty Commercial Segment and our Phoenix Operating Unit was designated as the sole component of the Personal Segment.

Reverse Stock Split

All share and per share amounts have been adjusted to reflect a one-for-six reverse split of all issued and unissued shares of our authorized common stock effected July 31, 2006, and a corresponding increase in the par value of our authorized common stock from $0.03 per share to $0.18 per share.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

2. **Investments:**

Major categories of net investment income (in thousands) are summarized as follows:

	Years ended December 31, 2007	2006	2005
Debt securities	$ 7,436	$ 6,587	$ 2,806
Equity securities	300	160	90
Short-term investments	1,765	1,154	161
Cash equivalents	3,890	2,683	832
	13,391	10,584	3,899
Investment expenses	(211)	(123)	(53)
Net investment income	$ 13,180	$ 10,461	$ 3,836

At December 31, 2007 we had an investment of $89.6 million in a U.S. Treasury Note with a maturity date of January 31, 2009 which exceeded 10% of our stockholders equity. No other investment in any entity or its affiliates exceeded 10% of stockholders' equity at December 31, 2007, 2006 or 2005.

Major categories of recognized gains (losses) on investments (in thousands) are summarized as follows:

	Years ended December 31, 2007	2006	2005
Debt securities	$ 70	$ (461)	$ 14
Equity securities	2,889	155	99
Short-term investments	103	-	-
Realized gains (losses)	3,062	(306)	113
Other than temporary impairments	(476)	(1,160)	(55)
Recognized gains (losses)	$ 2,586	$ (1,466)	$ 58

We realized gross gains on investments of $4.9 million, $0.2 million and $0.1 million during the years ended December 31, 2007, 2006 and 2005, respectively. We realized gross losses on investments of $1.8 million, $0.5 million and $0.0 million during the years ended December 31, 2007, 2006 and 2005, respectively.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

The amortized cost and estimated fair value of investments in debt and equity securities (in thousands) by category is as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
As of December 31, 2007				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 98,900	$ 147	$ -	$ 99,047
Corporate debt securities	51,786	46	1,736	50,096
Municipal bonds	98,547	628	252	98,923
Mortgage backed securities	3	-	-	3
Total debt securities	249,236	821	1,988	248,069
Equity securities	16,789	397	318	16,868
Short term securities	2,622	4	1	2,625
Total debt and equity securities	$ 268,647	$ 1,222	$ 2,307	$ 267,562
As of December 31, 2006				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 40,417	$ 48	$ 58	$ 40,407
Corporate debt securities	41,288	83	888	40,483
Municipal bonds	52,244	192	304	52,132
Mortgage backed securities	8	-	-	8
Total debt securities	133,957	323	1,250	133,030
Equity securities	4,146	453	19	4,580
Short term securities	25,258	17	-	25,275
Total debt and equity securities	$ 163,361	$ 793	$ 1,269	$ 162,885

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

2. **Investments**, continued:

The amortized cost and estimated fair value of investments in debt and equity securities with a gross unrealized loss position at December 31, 2007 and 2006 (in thousands) is as follows:

	Amortized Cost	Fair Value	Gross Unrealized Loss
As of December 31, 2007			
5 Equity Positions	$ 7,272	$ 6,954	$ 318
45 Bond Positions	71,510	69,522	1,988
1 Short Term Position	353	352	1
	$ 79,135	$ 76,828	$ 2,307
As of December 31, 2006			
10 Equity Positions	$ 249	$ 230	$ 19
195 Bond Positions	73,589	72,339	1,250
	$ 73,838	$ 72,569	$ 1,269

Of the gross unrealized loss at December 31, 2007, $1.0 million is more than twelve months old, consisting of 22 bond positions. Of the gross unrealized loss at December 31, 2006, $1.2 million is more than twelve months old, consisting of 139 bond positions. We consider these losses as a temporary decline in value as they are predominately on bonds where we believe we have the ability to hold our positions until maturity and whose decline in fair value is driven by interest rate increases. We see no other indications that the decline in value of these securities is other than temporary.

The amortized cost and estimated fair value of debt securities at December 31, 2007 by contractual maturity are as follows. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties.

Maturity (in thousands):	Amortized Cost	Fair Value
Due in one year or less	$ 15,185	$ 15,189
Due after one year through five years	162,972	162,524
Due after five years through ten years	53,942	53,305
Due after ten years	19,756	19,673
Mortgage-backed securities	3	3
	$ 251,858	$ 250,694

At December 31, 2007 and 2006, investments in debt securities with an approximate carrying value of $18.5 million and $23.8 million, respectively, were pledged for the benefit of various state insurance departments, reinsurers and the sellers of our TGA Operating Unit.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

3. Other Assets:

The following table details our other assets as of December 31, 2007 and 2006 (in thousands):

		2007		2006
Profit sharing commission receivable	$	10,961	$	649
Accrued investment income		4,104		2,002
Debt issuance costs		1,465		826
Fixed assets		1,272		1,644
Other assets		79		63
	$	17,881	$	5,184

Our profit sharing commission receivable increased $10.3 million in 2007 due to favorable loss development on the 2004 and 2006 treaty years for our Standard Commercial and Specialty Commercial Segments, respectively, partially offset by unfavorable loss development on the 2001-2003 treaty years for our Standard Commercial Segment. Our accrued investment income increased $2.1 million due to a larger investment portfolio in 2007 as compared to 2006. Our debt issuance costs increased $0.6 million due to the issuance of trust preferred securities during 2007.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

4. Reserves for Unpaid Losses and Loss Adjustment Expenses:

Activity in the reserves for unpaid losses and loss adjustment expenses (in thousands) is summarized as follows:

	2007	2006	2005
Balance at January 1	$ 77,564	$ 26,321	$ 19,648
Plus acquisition of Phoenix at January 1	-	4,562	-
Less reinsurance recoverable	4,763	324	1,948
Net Balance at January 1	72,801	30,559	17,700
Incurred related to:			
Current year	139,332	88,294	36,184
Prior years	(6,414)	(1,177)	(2,400)
Total incurred	132,918	87,117	33,784
Paid related to:			
Current year	54,809	28,154	17,414
Prior years	30,061	16,721	8,073
Total paid	84,870	44,875	25,487
Net Balance at December 31	120,849	72,801	25,997
Plus reinsurance recoverable	4,489	4,763	324
Balance at December 31	$ 125,338	$ 77,564	$ 26,321

The $6.4 million, $1.2 million and $2.4 million favorable development in prior accident years recognized in 2007, 2006 and 2005, respectively, represent normal changes in our loss reserve estimates primarily attributable to favorable loss development in each of our segments. The loss reserve estimates for prior years were decreased to reflect this favorable loss development when the available information indicated a reasonable likelihood that the ultimate losses would be less than the previous estimates.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

5. Reinsurance:

We reinsure a portion of the risk we underwrite in order to control the exposure to losses and to protect capital resources. We cede to reinsurers a portion of these risks and pay premiums based upon the risk and exposure of the policies subject to such reinsurance. Ceded reinsurance involves credit risk and is generally subject to aggregate loss limits. Although the reinsurer is liable to us to the extent of the reinsurance ceded, we are ultimately liable as the direct insurer on all risks reinsured. Reinsurance recoverables are reported after allowances for uncollectible amounts. We monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Reinsurers are selected based on their financial condition, business practices and the price of their product offerings.

The following table presents our gross and net premiums written and earned and reinsurance recoveries for each of the last three years:

		2007		2006		2005
Premium Written :						
Direct	$	157,202	$	129,669	$	44,237
Assumed		92,270		84,276		45,230
Ceded		(11,329)		(11,017)		(1,215)
	$	238,143	$	202,928	$	88,252
Premium Earned:						
Direct	$	151,276	$	97,082	$	23,747
Assumed		86,804		65,134		35,885
Ceded		(12,777)		(10,155)		(448)
	$	225,303	$	152,061	$	59,184
Reinsurance recoveries	$	3,862	$	5,225	$	(492)

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Our insurance company subsidiaries presently retain 100% of the risk associated with all non-standard personal automobile policies marketed by our Phoenix Operating Unit. We currently reinsure the following exposures on business generated by our HGA Operating Unit, our TGA Operating Unit and our Aerospace Operating Unit:

- ***Property catastrophe.*** Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our commercial property insurance lines. Catastrophes might include multiple claims and policyholders. Catastrophes include hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Our property catastrophe reinsurance is excess-of-loss reinsurance, which provides us reinsurance coverage for losses in excess of an agreed-upon amount. We utilize catastrophe models to assist in determining appropriate retention and limits to purchase. The terms of our property catastrophe reinsurance, effective July 1, 2007, are:

  - We retain the first $2.0 million of property catastrophe losses; and

- Our reinsurers reimburse us 100% for each $1.00 of loss in excess of our $2.0 million retention up to $28.0 million for each catastrophic occurrence, subject to a maximum of two events for the contractual term.

- ***Commercial property.*** Our commercial property reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event or catastrophic loss may have on our results. The terms of our commercial property reinsurance, effective July 1, 2007, are:

  - We retain the first $1.0 million of loss for each commercial property risk;

  - Our reinsurers reimburse us for the next $5.0 million for each commercial property risk; and

- Individual risk facultative reinsurance is purchased on any commercial property with limits above $6.0 million.

- ***Commercial casualty.*** Our commercial casualty reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event loss may have on our results. The terms of our commercial casualty reinsurance, effective July 1, 2007, are:

  - We retain the first $1.0 million of any commercial liability risk; and

  - Our reinsurers reimburse us for the next $5.0 million for each commercial liability risk.

- ***Aviation.*** We purchase reinsurance specific to the aviation risks underwritten by our Aerospace Operating Unit. This reinsurance provides aircraft hull and liability coverage and airport liability coverage on a per occurrence basis on the following terms:

  - We retain the first $350,000 of each aircraft hull or liability loss or airport liability loss;

- Our reinsurers reimburse us for the next $1.15 million of each aircraft hull loss and for the next $650,000 of each airport liability loss; and

- Our reinsurers provide additional reimbursement of $4.0 million for each airport liability loss and aircraft liability loss, excluding passenger liability.

6. Notes Payable:

On June 21, 2005, an unconsolidated trust subsidiary completed a private placement of $30.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed $30.9 million from the trust subsidiary and contributed $30.0 million to one of our insurance company subsidiaries in order to increase policyholder surplus. The note bears an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three month LIBOR rate plus 3.25 percentage points. Under the terms of the note, we pay interest only each quarter and the principal of the note at maturity. As of December 31, 2007 and 2006, the note balance was $30.9 million.

On January 27, 2006, we borrowed $15.0 million under our revolving credit facility to fund the cash required to close the acquisition of the subsidiaries now comprising our TGA Operating Unit. As of December 31, 2007 and 2006, the balance on the revolving note was $2.8 million, which currently bears interest at 6.73% per annum. Also included in notes payable as of December 31, 2007 and 2006 is $1.3 million and $2.0 million, respectively, outstanding under PAAC’s revolving credit facility, which also currently bears interest at 6.73% per annum. (See Note 8.)

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

On August 23, 2007, a newly formed unconsolidated trust subsidiary completed a private placement of $25.0 million of 30-year floating trust preferred securities. Simultaneously, we borrowed $25.8 million from the trust subsidiary for working capital and general corporate purposes. The note bears an initial interest rate at 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Under the terms of the note, we pay interest only each quarter and the principal of the note at maturity. As of December 31, 2007 the note balance was $25.8 million.

7. Structured Settlements

In connection with our acquisition of the subsidiaries now comprising our TGA Operating Unit, we recorded a payable for future guaranteed payments of $25.0 million discounted at 4.4%, the rate of two-year U.S. Treasuries (the only investment permitted on the trust account securing such future payments). As of December 31, 2007, the balance of the structured settlements was $10.0 million.

8. Credit Facilities:

On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit facility was amended and restated on January 27, 2006 to a $20.0 million revolving credit facility, with a $5.0 million letter of credit sub-facility. The credit facility was further amended effective May 31, 2007 to increase the revolving credit facility to $25.0 million and establish a new $5.0 million revolving credit sub-facility for the premium finance operations of PAAC. The credit agreement was again amended effective February 20, 2008 to extend the termination to January 27, 2010, revise various affirmative and negative covenants and decrease the interest rate in most instances to the three month Eurodollar rate plus 1.90 percentage points, payable quarterly in arrears. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets. The revolving credit facility contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of December 31, 2007, we were in compliance with all of our covenants.

PAAC had a $5.0 million revolving credit facility with JPMorgan Chase Bank which terminated June 30, 2007. This facility was replaced with the new $5.0 million premium finance sub-facility with The Frost National Bank as discussed above. As of December 31, 2007, there was $1.3 million outstanding under this credit facility.

9. Segment Information:

We pursue our business activities through subsidiaries whose operations are organized into producing units and are supported by our insurance carrier subsidiaries. Our non-carrier insurance activities are organized by producing units into the following reportable segments:

- ***Standard Commercial Segment.*** The Standard Commercial Segment includes the standard lines commercial property/casualty insurance products and services handled by our HGA Operating Unit which is comprised of our American Hallmark Insurance Services and ECM subsidiaries.

- ***Specialty Commercial Segment.*** The Specialty Commercial Segment primarily includes the excess and surplus lines commercial property/casualty insurance products and services handled by our TGA Operating Unit and the general aviation insurance products and services handled by our Aerospace Operating Unit. The Specialty Commercial

Segment also includes a relatively small amount of non-strategic legacy personal lines insurance products handled by our TGA Operating Unit. Our TGA Operating Unit is comprised of our Texas General Agency, PAAC and TGARSI subsidiaries. Our Aerospace Operating Unit is comprised of our Aerospace Insurance Managers, ASRI and ACMG subsidiaries. All of the subsidiaries included in the Specialty Commercial Segment were acquired effective January 1, 2006.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

- ***Personal Segment.*** The Personal Segment includes the non-standard personal automobile insurance products and services handled by our Phoenix Operating Unit which is comprised of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc., both of which do business as Phoenix General Agency.

The retained premium produced by these reportable segments is supported by the following insurance company subsidiaries:

- ***American Hallmark Insurance Company of Texas*** presently retains all of the risks on the commercial property/casualty policies marketed within the Standard Commercial Segment and assumes a portion of the risks on the commercial and aviation property/casualty policies marketed within the Specialty Commercial Segment.

- ***Hallmark Specialty Insurance Company***, which was acquired effective January 1, 2006, presently assumes a portion of the risks on the commercial property/casualty policies marketed within the Specialty Commercial Segment.

- ***Phoenix Indemnity Insurance Company*** presently assumes all of the risks on the non-standard personal automobile policies marketed within the Personal Segment and assumes a portion of the risks on the aviation property/casualty products marketed within the Specialty Commercial Segment.

Effective January 1, 2006, our insurance company subsidiaries entered into a pooling arrangement which was subsequently amended on December 15, 2006 pursuant to which AHIC retains 46.0% of the total net premiums written, PIIC retains 34.1% of our total net premiums written and HSIC retains 19.9% of our total net premiums written.

Prior to January 1, 2006, the Standard Commercial Segment was referred to as our Commercial Insurance Operation and the Personal Segment was referred to as our Personal Insurance Operation. The retained premium produced by our operating units prior to January 1, 2006 was supported by our AHIC and PIIC insurance subsidiaries. Periods prior to January 1, 2006 do not include the operations of the Specialty Commercial Segment, all of which was acquired on January 1, 2006.

Each of our four operating units was reported as a separate segment during the first three quarters of 2006. Commencing in the fourth quarter of 2006, our HGA Operating Unit was designated as the sole component of the Standard Commercial Segment, our TGA Operating Unit and our Aerospace Operating Unit were aggregated in the Specialty Commercial Segment and our Phoenix Operating Unit was designated as the sole component of the Personal Segment.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

The following is additional business segment information for the twelve months ended December 31, 2007, 2006, and 2005 (in thousands):

	2007	2006	2005
Revenues			
Standard Commercial Segment	$ 86,139	$ 75,325	$ 43,067
Speciality Commercial Segment	126,255	80,689	-
Personal Segment	58,268	46,998	43,907
Corporate	3,836	(271)	61
Consolidated	$ 274,498	$ 202,741	$ 87,035
Depreciation Expense			
Standard Commercial Segment	$ 188	$ 183	$ 144
Speciality Commercial Segment	343	468	-
Personal Segment	222	238	226
Corporate	73	32	16
Consolidated	$ 826	$ 921	$ 386
Interest Expense			
Standard Commercial Segment	$ -	$ -	$ -
Speciality Commercial Segment	151	258	-
Personal Segment	1	4	10
Corporate	3,762	5,536	1,254
Consolidated	$ 3,914	$ 5,798	$ 1,264
Tax Expense			
Standard Commercial Segment	$ 3,211	$ 2,759	$ 1,194
Speciality Commercial Segment	8,426	4,279	-
Personal Segment	1,956	2,072	3,225
Corporate	79	(3,976)	(137)
Consolidated	$ 13,672	$ 5,134	$ 4,282
Pre-tax Income			
Standard Commercial Segment	$ 12,042	$ 11,757	$ 6,651
Speciality Commercial Segment	28,043	14,309	-
Personal Segment	7,523	8,760	11,647
Corporate	(6,507)	(20,501)	(4,830)
Consolidated	$ 41,101	$ 14,325	$ 13,468

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

9. Segment Information, continued

The following is additional business segment information as of the following dates (in thousands):

	December 31,			
		2007		2006
Assets				
Standard Commercial Segment	$	211,428	$	133,697
Specialty Commercial Segment		229,138		162,441
Personal Segment		100,986		71,754
Corporate		64,762		48,061
Consolidated	$	606,314	$	415,953

10. Earnings Per Share

We have adopted the provisions of Statement of Financial Accounting Standards No. 128, "Earnings per Share," ("SFAS 128") requiring presentation of both basic and diluted earnings per share. A reconciliation of the numerators and denominators of the basic and diluted per share calculations (in thousands, except per share amounts) is presented below:

		2007		2006		2005
Numerator for both basic and diluted earnings per share:						
Net income	$	27,429	$	9,191	$	9,186
Denominator, basic shares		20,768		17,181		12,008
Effect of dilutive securities:						
Stock options		-		13		96
Denominator, diluted shares		20,768		17,194		12,104
Basic earnings (loss) per share:	$	1.32	$	0.53	$	0.76
Diluted earnings (loss) per share:	$	1.32	$	0.53	$	0.76

Options to purchase 109,166 shares of common stock priced at $11.34 were outstanding at December 31, 2006, but were not included in the computation of diluted earnings per share because the inclusion would result in an anti-dilutive effect in the period where the option exercise price exceeded the average market price per share for the period.

11. Regulatory Capital Restrictions:

AHIC, as a property/casualty insurance company domiciled in the State of Texas, is limited in the payment of dividends in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. PIIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholders surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. HSIC, domiciled in Oklahoma, is limited in

the payment of dividends to the greater of 10% of prior year policyholders surplus or prior year's statutory net income, without prior written approval from the Oklahoma Insurance Department. During 2008, our insurance company subsidiaries’ ordinary dividend capacity is $16.3 million. None of our insurance company subsidiaries paid a dividend to Hallmark during the year ended December 31, 2007 or 2006.

The state insurance departments also regulate financial transactions between our insurance subsidiaries and their affiliated companies. Applicable regulations require approval of management fees, expense sharing contracts and similar transactions. Phoenix General Agency paid $1.9 million, $1.3 million and $1.8 million in management fees to Hallmark during 2007, 2006 and 2005, respectively. PIIC paid $1.2 million in management fees to Phoenix General Agency during each of 2007, 2006 and 2005. AHIC did not pay any management fees during 2007, 2006 or 2005. HSIC did not pay any management fees during 2007 or 2006.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Statutory capital and surplus is calculated as statutory assets less statutory liabilities. The various state insurance departments that regulate our insurance company subsidiaries require us to maintain a minimum statutory capital and surplus. As of December 31, 2007, our insurance company subsidiaries reported statutory capital and surplus of $132.0 million, substantially greater than the minimum requirements for each state. For the year ended December 31, 2007, our insurance company subsidiaries reported statutory net income of $19.6 million.

The National Association of Insurance Commissioners requires property/casualty insurers to file a risk-based capital calculation according to a specified formula. The purpose of the formula is twofold: (1) to assess the adequacy of an insurer’s statutory capital and surplus based upon a variety of factors such as potential risks related to investment portfolio, ceded reinsurance and product mix; and (2) to assist state regulators under the RBC for Insurers Model Act by providing thresholds at which a state commissioner is authorized and expected to take regulatory action. As of December 31, 2007, the adjusted capital under the risk-based capital calculation of each of our insurance company subsidiaries substantially exceeded the minimum requirements.

12. Share-based Payment Arrangements:

Our 2005 Long Term Incentive Plan (“2005 LTIP”) is a stock compensation plan for key employees and non-employee directors that was approved by the shareholders on May 26, 2005. There are 833,333 shares authorized for issuance under the 2005 LTIP. Our 1994 Key Employee Long Term Incentive Plan (the “1994 Employee Plan”) and 1994 Non-Employee Director Stock Option Plan (the “1994 Director Plan”) both expired in 2004 but have unexercised options outstanding.

As of December 31, 2007, there were incentive stock options to purchase 717,499 shares of our common stock outstanding under the 2005 LTIP, leaving 115,834 shares reserved for future issuance. As of December 31, 2007, there were incentive stock options to purchase 93,001 shares outstanding under the 1994 Employee Plan and non-qualified stock options to purchase 20,834 shares outstanding under the 1994 Director Plan. In addition, as of December 31, 2007, there were outstanding non-qualified stock options to purchase 16,666 shares of our common stock granted to certain non-employee directors outside the 1994 Director Plan in lieu of fees for service on our board of directors in 1999. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

Incentive stock options granted under the 1994 Employee Plan prior to October 31, 2003, vest 40% six months from the date of grant and an additional 20% on each of the first three anniversary dates of the grant and terminate ten years from the date of grant. Incentive stock options granted under the 2005 LTIP and the 1994 Employee Plan after October 31, 2003, vest 10%, 20%, 30% and 40% on the first, second, third and fourth anniversary dates of the grant, respectively, and terminate five to ten years from the date of grant. Non-qualified stock options granted under the 2005 LTIP vest 100% six months after the date of grant and terminate ten years from the date of grant. All non-qualified stock options granted under the 1994 Director Plan vest 40% six months from the date of grant and an additional 10% on each of the first six anniversary dates of the grant and terminate ten years from the date of grant. The options granted to non-employee directors outside the Director Plan fully vested six months after the date of grant and terminate ten years from the date of grant. We recognize the compensation expense related to these option grants on a straight-line basis over the required service period for each separately vesting portion of the award.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

A summary of the status of our stock options as of and changes during the year-to-date ended December 31, 2007 is presented below:

	Number of Shares		Weighted Average Exercise Price	Average Remaining Contractual Term (Years)		Aggregate Intrinsic Value ($000)
Outstanding at January 1, 2007	332,334	$	7.04	-		-
Granted	520,000	$	12.52	-		-
Exercised	-	$	-	-		-
Forfeited or expired	4,334	$	5.08	-		-
Outstanding at December 31, 2007	848,000	$	10.41	7.9	$	4,620
Exercisable at December 31, 2007	176,250	$	6.54	4.7	$	1,643

The following table details the intrinsic value of options exercised, total cost of share-based payments charged against income before income tax benefit and the amount of related income tax benefit recognized in income for the periods indicated (in thousands):

		2007		2006		2005
Intrinsic value of options exercised	$	-	$	162	$	260
Cost of share-based payments (non-cash)	$	527	$	157	$	63
Income tax benefit of share-based payments recognized in income	$	185	$	55	$	22

As of December 31, 2007, there was $2.6 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which $0.6 million is expected to be recognized in 2008, $0.8 million is expected to be recognized in each of 2009 and 2010 and $0.4 million is expected to be recognized in 2011.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on historical volatility of our common stock. The risk-free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options' expected lives on the dates of grant. The following table details the grant date fair value and related assumptions for the periods indicated:

		2007		2006		2005
Grant date fair value per share	$	4.04	$	6.26	$	4.01
Expected term		6		5		5
Expected volatility		19.4%		59.1%		62.5%
Risk free interest rate		4.5%		4.9%		3.9%

13. Retirement Plans:

Certain employees of the Standard Commercial Segment were participants in a defined cash balance plan covering all full-time employees who had completed at least 1,000 hours of service. This plan was frozen in March 2001 in anticipation of distribution of plan assets to members upon plan termination. All participants were vested when the plan was frozen.

The following tables provide detail of the changes in benefit obligations, components of benefit costs, weighted-average assumptions, and plan assets for the retirement plan as of and for the twelve months ending December 31, 2007, 2006 and 2005 (in thousands) using a measurement date of December 31.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

	2007	2006	2005
Assumptions (end of period):			
Discount rate used in determining benefit obligation	5.75%	5.75%	5.50%
Rate of compensation increase	N/A	N/A	N/A
Reconciliation of funded status (end of period):			
Accumulated benefit obligation	$ (12,053)	$ (12,994)	$ (12,959)
Projected benefit obligation	$ (12,053)	$ (12,994)	$ (12,959)
Fair value of plan assets	10,384	9,868	10,027
Funded status	$ (1,669)	$ (3,126)	$ (2,932)
Net actuarial loss	(1,752)	(3,130)	(2,847)
Accumulated other comprehensive loss	(1,752)	(3,130)	(2,847)
Prepaid/(accrued) pension cost	83	4	(85)
Net amount recognized as of December 31	$ (1,669)	$ (3,126)	$ (2,932)
Changes in projected benefit obligation:			
Benefit obligation as of beginning of period	$ 12,994	$ 12,959	$ 13,081
Interest cost	720	720	724
Actuarial liability (gain)/loss	(749)	198	352
Benefits paid	(912)	(883)	(1,198)
Benefit obligation as of end of period	$ 12,053	$ 12,994	$ 12,959
Change in plan assets:			
Fair value of plan assets as of beginning of period	$ 9,868	$ 10,027	$ 10,901
Actual return on plan assets (net of expenses)	1,073	321	192
Employer contributions	355	403	132
Benefits paid	(912)	(883)	(1,198)
Fair value of plan assets as of end of period	$ 10,384	$ 9,868	$ 10,027
Net periodic pension cost:			
Service cost - benefits earned during the period	$ -	$ -	$ -
Interest cost on projected benefit obligation	720	720	724
Expected return on plan assets	(642)	(633)	(682)
Recognized actuarial loss	199	227	81
Net periodic pension cost	$ 277	$ 314	$ 123
Discount rate	5.75%	5.50%	5.75%
Expected return on plan assets	6.50%	6.50%	6.50%
Rate of compensation increase	N/A	N/A	N/A

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Estimated future benefit payments by fiscal year (in thousands):

2008	$	892
2009	$	883
2010	$	881
2011	$	880
2012	$	878
2013-2017	$	4,362

As of December 31, 2007, the fair value of the plan assets was composed of cash and cash equivalents of $0.2 million, bonds and notes of $3.6 million and equity securities of $6.6 million.

Our investment objectives are to preserve capital and to achieve long-term growth through a favorable rate of return equal to or greater than 5% over the long-term (60 year) average inflation rate as measured by the consumer price index. The objective of the equity portion of the portfolio is to achieve a return in excess of the Standard & Poor’s 500 index. The objective of the fixed income portion of the portfolio is to add stability, consistency, safety and total return to the total fund portfolio.

We prohibit investments in options, futures, precious metals, short sales and purchase on margin. We also restrict the investment in fixed income securities to “A” rated or better by Moody’s or Standard & Poor’s rating services and restrict investments in common stocks to only those that are listed and actively traded on one or more of the major United States stock exchanges, including NASDAQ. We manage to an asset allocation of 45% to 75% in equity securities. An investment in any single stock issue is restricted to 5% of the total portfolio value and 90% of the securities held in mutual or commingled funds must meet the criteria for common stocks.

To develop the expected long-term rate of return on assets assumption, we consider the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. This resulted in the selection of the 6.5% long-term rate of return on assets assumption. To develop the discount rate used in determining the benefit obligation we used Moody’s Aaa corporate bond yields at the measurement date to match the timing and amounts of projected future benefits.

We estimate contributing $0.8 million to the defined benefit cash balance plan during 2008. We expect our 2008 periodic pension cost to be $0.1 million, the components of which are interest cost of $0.7 million, expected return on plan assets of ($0.7) million and amortization of actuarial loss of $0.1 million.

The following table shows the weighted-average asset allocation for the defined benefit cash balance plan held as of December 31, 2007 and 2006.

	12/31/07	12/31/06
Asset Category:		
Fixed income securities	35%	34%
Equity securities	63%	62%
Other	2%	4%
Total	100%	100%

We sponsor two defined contribution plans. Under these plans, employees may contribute a portion of their compensation on a tax-deferred basis, and we may contribute a discretionary amount each year. We contributed $0.2 million, $0.3 million and $0.1 million for each of the twelve months ended December 31, 2007, 2006 and 2005, respectively.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

14. Income Taxes:

The composition of deferred tax assets and liabilities and the related tax effects (in thousands) as of December 31, 2007 and 2006, are as follows:

	2007	2006
Deferred tax liabilities:		
Deferred policy acquisition costs	$ (6,915)	$ (6,425)
Profit sharing commission	(-)	(257)
Agency relationship	(142)	(151)
Intangible assets	(8,182)	(8,975)
Fixed assets	(100)	(166)
Purchase discount	(2)	(156)
Other	(242)	(183)
Total deferred tax liabilities	$ (15,583)	$ (16,313)
Deferred tax assets:		
Unearned premiums	$ 7,197	$ 6,398
Deferred ceding commissions	942	1,315
Amortization of non-compete agreements	774	-
Pension liability	584	1,096
Net operating loss carry-forward	1,217	1,217
Unrealized holding losses on investments	380	166
Allowance for bad debt	-	9
Unpaid loss and loss adjustment expense	3,280	2,030
Goodwill	929	1,083
Rent reserve	57	80
Investment impairments	408	242
Unearned revenue	-	20
Capital loss	-	410
Other	90	140
Total deferred tax assets	$ 15,858	$ 14,206
Net deferred tax asset (liability) before valuation allowance	275	(2,107)
Valuation allowance	-	203
Net deferred tax asset (liability)	$ 275	$ (2,310)

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

14. Income Taxes, continued:

A reconciliation of the income tax provisions (in thousands) based on the statutory tax rate to the provision reflected in the consolidated financial statements for the years ended December 31, 2007, 2006 and 2005, is as follows:

		2007		**2006**		**2005**
Computed expected income tax expense at statutory regulatory tax rate	$	14,385	$	5,014	$	4,579
Meals and entertainment		23		15		6
Tax exempt interest		(813)		(507)		(302)
Dividends received deduction		(43)		(9)		(11)
State taxes (net of federal benefit)		194		301		158
Valuation allowance		(203)		203		-
Other		129		117		(148)
Income tax expense	$	13,672	$	5,134	$	4,282
Current income tax expense	$	15,153	$	11,663	$	2,139
Deferred tax expense (benefit)		(1,481)		(6,529)		2,143
Income tax expense	$	13,672	$	5,134	$	4,282

Approximately $0.1 million of the 2007 current income tax provision results from tax deductible goodwill from the PIIC acquisition.

We have available, for federal income tax purposes, unused net operating loss of approximately $3.5 million at December 31, 2007. The losses were acquired as part of the PIIC acquisition and may be used to offset future taxable income. Utilization of the losses is limited under Internal Revenue Code Section 382. The Internal Revenue Code has provided that effective with tax years beginning September 1997, the carry-back and carry-forward periods are 2 years and 20 years, respectively, with respect to newly generated operating losses. The net operating losses (in thousands) will expire, if unused, as follows:

Year		
2021	$	2,600
2022		878
	$	3,478

15. Commitments and Contingencies:

We have several leases, primarily for office facilities and computer equipment, which expire in various years through 2011. Certain of these leases contain renewal options. Rental expense amounted to $2.1 million, $1.9 million and $1.2 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Future minimum lease payments (in thousands) under non-cancelable operating leases as of December 31, 2007 are as follows:

Year

2008	$	1,711
2009		1,074
2010		840
2011		284
2012		-
2013 and thereafter		-
Total minimum lease payments	$	3,909

From time to time, assessments are levied on us by the guaranty association of the State of Texas. Such assessments are made primarily to cover the losses of policyholders of insolvent or rehabilitated insurers. Since these assessments can be recovered through a reduction in future premium taxes paid, we capitalize the assessments as they are paid and amortize the capitalized balance against our premium tax expense. There were no assessments during 2007 or 2005. We were assessed $34 thousand in 2006.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2007

Payments of license and maintenance fees for computer software presently under development will become due after implementation and acceptance of various software modules. We presently estimate that, if the software developer satisfactorily performs, a total of $4.1 million will become due in approximately equal amounts in 2009 through 2015.

16. Concentrations of Credit Risk:

We maintain cash equivalents in accounts with seven financial institutions in excess of the amount insured by the Federal Deposit Insurance Corporation. We monitor the financial stability of the depository institutions regularly and do not believe excessive risk of depository institution failure exists at December 31, 2007.

We are also subject to credit risk with respect to reinsurers to whom we have ceded underwriting risk. Although a reinsurer is liable for losses to the extent of the coverage it assumes, we remain obligated to our policyholders in the event that the reinsurers do not meet their obligations under the reinsurance agreements. In order to mitigate credit risk to reinsurance companies, we monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Most of our reinsurance recoverable balance as of December 31, 2007 are with reinsurers that have an A.M. Best rating of "A-" or better.

Unaudited Selected Quarterly Information

	2007				2006			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Total revenue	$ 63,958	$ 68,736	$ 72,218	$ 69,586	$ 44,520	$ 47,187	$ 56,365	$ 54,669
Total expense	56,245	55,804	62,409	58,939	40,991	50,969	48,733	47,723
Income (loss) before tax	7,713	12,932	9,809	10,647	3,529	(3,782)	7,632	6,946
Income tax expense (benefit)	2,743	4,117	3,227	3,585	1,103	(940)	2,755	2,216
Net income (loss)	$ 4,970	$ 8,815	$ 6,582	$ 7,062	$ 2,426	($2,842)	$ 4,877	$ 4,730
Basic earnings per share:	$ 0.24	$ 0.42	$ 0.32	$ 0.34	$ 0.17	($0.18)	$ 0.27	$ 0.23
Diluted earnings per share:	$ 0.24	$ 0.42	$ 0.32	$ 0.34	$ 0.17	($0.18)	$ 0.27	$ 0.23

FINANCIAL STATEMENT SCHEDULES

Schedule II - Condensed Financial Information of Registrant (Parent Company Only)

HALLMARK FINANCIAL SERVICES, INC.
BALANCE SHEETS
December 31, 2007 and 2006
(In thousands)

	2007	2006
ASSETS		
Debt securities, available-for-sale, at fair value	$ -	$ 4,969
Equity securities, available-for-sale, at fair value	11,467	998
Cash and cash equivalents	14,226	2,910
Restricted cash	10,644	20,862
Investment in subsidiaries	214,335	184,792
Accounts receivable	-	184
Current federal income tax receivable	-	1,920
Deferred federal income taxes	289	-
Other assets	2,651	2,201
	$ 253,612	$ 218,836
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable	$ 59,503	$ 33,729
Structured settlements	10,000	24,587
Unpaid losses and loss adjustment expenses	1	16
Current federal income tax payable	724	-
Deferred federal income taxes	-	101
Accounts payable and other accrued expenses	4,197	9,672
	74,425	68,105
Stockholders' equity:		
Common stock, $.18 par value, authorized 33,333,333 shares; issued 20,776,080 shares in 2007 and 2006	3,740	3,740
Capital in excess of par value	118,459	117,932
Retained earnings	58,909	31,480
Accumulated other comprehensive income	(1,844)	(2,344)
Treasury stock, 7,828 shares in 2007 and 2006, at cost	(77)	(77)
Total stockholders' equity	179,187	150,731
Total liabilities and stockholder's equity	$ 253,612	$ 218,836

See accompanying report of independent registered public accounting firm.

FINANCIAL STATEMENT SCHEDULES

Schedule II (Continued) - Condensed Financial Information of Registrant (Parent Company Only)

HALLMARK FINANCIAL SERVICES, INC.
STATEMENTS OF OPERATIONS
for the years ended December 31, 2007, 2006 and 2005
(In thousands)

	2007	2006	2005
Investment income, net of expenses	$ 457	$ 1,195	$ 61
Realized gain (loss)	508	(3)	-
Management fee income	7,205	9,413	4,830
	8,170	10,605	4,891
Losses and loss adjustment expenses	(15)	(33)	(65)
Other operating costs and expenses	6,596	5,102	3,701
Interest expense	3,762	5,536	1,254
Interest expense from amortization of discount on convertible notes	-	9,625	-
	10,343	20,230	4,890
Income (loss) before equity in undistributed earnings of subsidiaries and income tax expense	(2,173)	(9,625)	1
Income tax benefit	(653)	(3,464)	(137)
Income (loss) before equity in undistributed earnings of subsidiaries	(1,520)	(6,161)	138
Equity in undistributed share of net earnings in subsidiaries	28,949	15,352	9,048
Net income	$ 27,429	$ 9,191	$ 9,186

See accompanying report of independent registered public accounting firm.

FINANCIAL STATEMENT SCHEDULES

Schedule II (Continued) - Condensed Financial Information of Registrant (Parent Company Only)

HALLMARK FINANCIAL SERVICES, INC.
STATEMENT OF CASH FLOW
For the years ended December 31, 2007, 2006 and 2005
(In thousands)

	2007	2006	2005
Cash flows from operating activities:			
Net income	$ 27,429	$ 9,191	$ 9,186
Adjustments to reconcile net income to cash used in operating activities:			
Depreciation and amortization expense	486	1,077	16
Amortization of discount on convertible notes	-	9,625	-
Deferred income tax expense (benefit)	170	(3,877)	14
Change in unpaid losses and loss adjustment expenses	(15)	(33)	(65)
Undistributed share of net earnings of subsidiaries	(28,949)	(15,352)	(9,048)
Recognized investment losses (gains)	(508)	3	-
Change in accounts receivable	184	(184)	-
Change in current federal income tax payable/recoverable	2,644	(2,413)	(566)
Excess tax benefits from share-based payments	-	(25)	-
Change in all other liabilities	(5,475)	2,930	2,928
Change in all other assets	209	699	(286)
Net cash provided by (used in) operating activities	(3,825)	1,641	2,179
Cash flows from investing activities:			
Purchases of property and equipment	(50)	(206)	(30)
Acquisition of subsidiaries	-	(27,396)	-
Change in restricted cash	10,218	(20,862)	-
Purchase of fixed maturity and equity securities	(60,580)	(24,747)	(928)
Maturities and redemptions of investment securities	55,453	19,989	-
Capital contributed to insurance company subsidiaries	-	-	(75,000)
Net cash provided by (used in) investing activities	5,041	(53,222)	(75,958)
Cash flows from financing activities:			
Proceeds from exercise of employee stock options	-	36	230
Excess tax benefits from share-based payments	-	25	-
Proceeds from borrowings	25,774	52,500	30,928
Debt issuance costs	(674)	-	(907)
Proceeds from equity offerings	-	24,689	44,891
Repayment of borrowings	(15,000)	(24,700)	-
Net cash provided by financing activities	10,100	52,550	75,142
Increase in cash and cash equivalents	11,316	969	1,363
Cash and cash equivalents at beginning of year	2,910	1,941	578

Cash and cash equivalents at end of year	$	14,226	$	2,910	$	1,941
Supplemental cash flow information:						
Interest paid	$	(3,250)	$	(4,417)	$	(1,157)
Income taxes recovered (paid)	$	2,957	$	(2,516)	$	(415)

See accompanying report of independent registered public accounting firm.

FINANCIAL STATEMENT SCHEDULES

Hallmark Financial Services
Schedule III - Supplementary Insurance Information
(In thousands)

Column A	Column B	Column C	Column D	Column E	Column F	Column G	Column H	Column I	Column J	Column K
Segment	Deferred Policy Acquisition Cost	Future Policy Benefits, Losses, Claims and Loss Adjustment Expenses	Unearned Premiums	Other Policy Claims and Benefits Payable	Premium Revenue	Net Investment Income	Benefits, Claims, Losses and Settlement Expenses	Amortization of Deferred Policy Acquisition Costs	Other Operating Expenses	Premiums Written
2007										
Personal Segment	$ 2,436	$ 19,939	$ 10,991	$ -	$ 53,505	$ 1,717	$ 35,969	$ 11,459	$ 15,291	$ 55,916
Standard Commercial Segment	8,019	81,417	42,664	-	83,382	5,304	48,480	23,006	25,869	84,222
Specialty Commercial Segment	9,302	23,981	49,343	-	88,416	4,911	48,484	20,642	49,128	98,005
Corporate	-	1	-	-	-	1,248	(15)	-	6,596	-
Consolidated	$ 19,757	$ 125,338	$ 102,998	$ -	$ 225,303	$ 13,180	$ 132,918	$ 55,107	$ 96,884	$ 238,143
2006										
Personal Segment	$ 1,919	$ 17,597	$ 8,581	$ -	$ 42,317	$ 2,301	$ 26,443	$ 9,382	$ 12,392	$ 45,135
Standard Commercial Segment	7,740	36,596	43,272	-	70,074	3,737	38,799	16,520	24,636	82,220
Specialty Commercial Segment	7,486	23,355	39,753	-	39,670	3,228	21,908	6,651	49,432	75,573
Corporate	-	16	-	-	-	1,195	(33)	-	5,102	-
Consolidated	$ 17,145	$ 77,564	$ 91,606	$ -	$ 152,061	$ 10,461	$ 87,117	$ 32,553	$ 91,562	$ 202,928
2005										
Personal Segment	$ 1,318	$ 16,457	$ 5,762	$ -	$ 37,433	$ 2,283	$ 21,239	$ 11,626	$ 10,839	$ 37,003
Standard Commercial Segment	7,846	9,815	30,265	-	21,751	1,492	12,610	15,216	30,448	51,249
Corporate	-	49	-	-	-	61	(65)	-	3,701	-

Consolidated	$ 9,164	$ 26,321	$ 36,027	$ -	$ 59,184	$ 3,836	$ 33,784	$ 26,842	$ 44,988	$ 88,252

See accompanying report of independent registered public accounting firm.

FINANCIAL STATEMENT SCHEDULES

Hallmark Financial Services
Schedule IV - Reinsurance
(In thousands)

Column A	Column B Gross Amount	Column C Ceded to Other Companies	Column D Assumed From Other Companies	Column E Net Amount	Column F Percentage of Amount Assumed to Net
Year Ended December 31, 2007					
Life insurance in force	$ -	$ -	$ -	$ -	
Premiums					
Life insurance	-	-	-	-	
Accident and health insurance	-	-	-	-	
Property and liability insurance	151,276	12,777	86,804	225,303	38.5%
Title Insurance	-	-	-	-	
Total premiums	$ 151,276	$ 12,777	$ 86,804	$ 225,303	38.5%
Year Ended December 31, 2006					
Life insurance in force	$ -	$ -	$ -	$ -	
Premiums					
Life insurance	-	-	-	-	
Accident and health insurance	-	-	-	-	
Property and liability insurance	97,082	10,155	65,134	152,061	42.8%
Title Insurance	-	-	-	-	
Total premiums	$ 97,082	$ 10,155	$ 65,134	$ 152,061	42.8%
Year Ended December 31, 2005					
Life insurance in force	$ -	$ -	$ -	$ -	
Premiums					
Life insurance	-	-	-	-	
Accident and health insurance	-	-	-	-	
Property and liability insurance	23,747	448	35,885	59,184	60.6%
Title Insurance	-	-	-	-	
Total premiums	$ 23,747	$ 448	$ 35,885	$ 59,184	60.6%

See accompanying report of independent registered public accounting firm.

FINANCIAL STATEMENT SCHEDULES

Hallmark Financial Services
Schedule VI - Supplemental Information Concerning Property-Casualty Insurance Operations
(In thousands)

Column A	Column B	Column C	Column D	Column E	Column F	Column G	Column H		Column I	Column J	Column K
							Claims and Claim Adjustment Expenses Incurred Related to				
Affiliation With Registrant	Deferred Policy Acquisition Costs	Reserves for Unpaid Claims and Claim Adjustment Expenses	Discount if any, Deducted In Column C	Unearned Premiums	Earned Premiums	Net Investment Income	(1) Current Year	(2) Prior Years	Amortization of Deferred Policy Acquisition Costs	Paid Claims and Claims Adjustment Expenses	Premiums Written
(a) Consolidated property-casualty Entities											
2007	$ 19,757	$ 125,338	$ -	$ 102,998	$ 225,303	$ 13,180	$ 139,332	$ (6,414)	$ 55,107	$ 84,870	$ 238,143
2006	$ 17,145	$ 77,564	$ -	$ 91,606	$ 152,061	$ 10,461	$ 88,294	$ (1,177)	$ 32,553	$ 44,875	$ 202,928
2005	$ 9,164	$ 26,321	$ -	$ 36,027	$ 59,184	$ 3,836	$ 36,184	$ (2,400)	$ 26,842	$ 25,487	$ 88,252

See accompanying report of independent registered public accounting firm.