HALLMARK FINANCIAL SERVICES INC
Form 8-K/A
April 14, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

FORM 8-K/A

CURRENT REPORT

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

Date of Report (Date of earliest event reported): January 27, 2003

HALLMARK FINANCIAL SERVICES, INC.
(Exact name of registrant as specified in its charter)

Nevada	0-16090	87-0447375
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Identification No.)

14651 Dallas Parkway, Suite 900, Dallas, Texas	75254
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (972) 404-1637

Not Applicable
(Former name or former address, if changed since last report.)

The registrant hereby amends Item 7(a) and Item 7(b) of its Current Report on Form 8-K filed on January 29, 2003, for the purpose of providing financial statements required in connection with the Registrant's acquisition of Phoenix Indemnity Insurance Company.

Item 7. Financial Statements and Exhibits.
a) Financial statements of business acquired

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Report of Independent Accountants

To Board of Directors of
Phoenix Indemnity Insurance Company

In our opinion, the accompanying balance sheet as of December 31, 2002 and the related statements of operations, comprehensive income, stockholder's equity and cash flows present fairly, in all material respects, the financial position of Phoenix Indemnity Insurance Company at December 31, 2002, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP
PricewaterhouseCoopers LLP
Dallas, Texas

April 14, 2003

Report of Independent Accountants

To Board of Directors of
Phoenix Indemnity Insurance Company

We have audited the accompanying balance sheet of Phoenix Indemnity Insurance Company (the "Company") as of December 31, 2001 and the related statements of operations, comprehensive income, stockholder's equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2001 and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

December 10, 2002
(January 27, 2003 as to Note 12)

/s/ Deloitte and Touche LLP

Phoenix Indemnity Insurance Company
BALANCE SHEETS

	December 31, 2002	December 31, 2001
ASSETS		
Investments:		
Debt securities, at estimated fair value, cost of $8,072,325 for 2002 and $11,812,870 for 2001	$ 8,355,363	$ 11,986,036
Equity securities, at estimated fair value, cost of $1,898,483 for 2002 and $1,984,113 for 2001	2,182,548	2,209,192
Short-term investments	334,881	334,902
Total investments	10,872,792	14,530,130
Cash and cash equivalents	6,944,946	12,161,194
Investment income due and accrued	126,900	97,071
Reinsurance receivables	11,086,237	12,305,940
Prepaid reinsurance	38,264	4,231,383
Premium receivable, net of allowance of $403,581 for 2002 and $416,792 for 2001	1,745,534	2,901,058
Deferred policy acquisition costs	918,429	115,377
Property and equipment, net	65,414	198,458
Due from affiliates, net	487,536	449,998
Other assets	21,744	48,543
Total assets	$ 32,307,796	$ 47,039,152
LIABILITIES AND STOCKHOLDER'S EQUITY		
Reserve for losses and loss adjustment expenses	$ 15,740,230	$ 21,408,007
Unearned premium	4,014,141	7,045,450
Reinsurance payable	-	4,522,999
Accounts payable and accrued expenses	800,858	533,324
Other liabilities	232,497	244,462
Total liabilities	20,787,726	33,754,242
Commitments and contingencies (Note 11)		
Stockholder's equity:		
Common stock, $6 par value; 500,000 shares		

authorized, issued and outstanding	3,000,000	3,000,000
Additional paid-in capital	18,795,457	19,658,190
Accumulated deficit)	(10,644,100)	(9,632,238)
Accumulated other comprehensive income, net of tax	368,713	258,958
Total stockholder's equity	11,520,070	13,284,910
Total liabilities and stockholder's equity	$ 32,307,796	$ 47,039,152

The accompanying notes are an integral part of these financial statements

Phoenix Indemnity Insurance Company
STATEMENTS OF OPERATIONS

	Year Ended December 31 2002	2001
Revenues:		
Net premiums earned	$ 16,717,486	$ 21,879,973
Net investment income	593,757	1,860,209
Net realized capital gains and losses	34,662	843,671
Total revenues	17,345,905	24,583,853
Costs and expenses:		
Losses and loss adjustment expenses	12,883,053	15,883,816
Amortization of deferred policy acquisition costs	4,315,028	5,432,936
Underwriting and operating expenses	716,017	4,057,903
Total costs and expenses	17,914,098	25,374,655
Operating loss	(568,193)	(790,802)
Other expense	(502,769)	(582,055)
Loss before income taxes	(1,070,962)	(1,372,857)
Income tax expense (benefit)	(59,100)	260,000
Net loss	$ (1,011,862)	$ (1,632,857)

The accompanying notes are an integral part of these financial statements

Phoenix Indemnity Insurance Company
STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31 2002	2001
Net loss	$ (1,011,862)	$ (1,632,857)

Other comprehensive income (loss), before income tax:		
Unrealized holding gains (losses) arising during period	134,193	(1,586,249)
Reclassification adjustment for gains (losses) included in net loss	34,662	843,671
Other comprehensive income (loss), before income tax	168,855	(742,578)
Income tax benefit (provision) related to items of other comprehensive income (loss)	(59,100)	260,000
Other comprehensive income (loss), net of income tax	109,755	(482,578)
Net comprehensive loss	$ (902,107)	$ (2,115,435)

The accompanying notes are an integral part
of these financial statements

Phoenix Indemnity Insurance Company
STATEMENTS OF STOCKHOLDER'S EQUITY

	Common Stock	Additional Paid in Capital	Accumulated Deficit	Acc O Comp I (
Balance at January 1, 2001	$ 3,000,000	$ 21,158,190	$ (7,999,381)	$
Net loss			(1,632,857)	
Change in net unrealized holding gains losses), net of tax provision of $260,000				
Return of capital		(1,500,000)		
Balance at December 31, 2001	3,000,000	19,658,190	(9,632,238)	
Net loss			(1,011,862)	
Changes in net unrealized holding gains (losses), net of tax benefit of $59,000				
Capital contribution		337,267		
Return of capital		(1,200,000)		
Balance at December 31, 2002	$ 3,000,000	$ 18,795,457	$(10,644,100)	

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

Phoenix Indemnity Insurance Company
STATEMENTS OF CASH FLOWS

	Year Ended December 31 2002	2001

Cash flows from operating activities:		
Net loss	$ (1,011,862)	$ (1,632,857)
Adjustments to reconcile net income to cash used in operating activities:		
Depreciation and amortization	133,044	102,906
Deferred income taxes	(59,100)	260,000
Net realized gains on investments	(34,662)	(843,671)
Changes in operating assets and liabilities:		
Accrued investment income	(29,829)	220,660
Reinsurance receivables	1,901,975	(7,744,902)
Premiums receivables	1,155,524	5,069,883
Deferred acquisition costs	(803,051)	849,817
Other assets	26,799	11,843
Reserve for losses and loss adjustment expenses	(5,667,777)	(5,565,009)
Unearned premiums	1,161,810	(5,915,381)
Accounts payable and accrued expenses	267,534	(348,830)
Reinsurance payable	(5,205,271)	3,483,038
Due from affiliate, net	(37,538)	(651,418)
Other liabilities	26,212	9,318
Net cash used in operating activities	(8,176,192)	(12,694,603)
Cash flows from investing activities:		
Purchases of property and equipment	-	(8,389)
Proceeds from investment maturities and sales	7,178,439	33,027,062
Purchases of investments	(3,355,783)	(6,645,100)
Change in other investments	21	(17,776)
Net cash provided by investing activities	3,822,677	26,355,797
Cash flows from financing activities:		
Capital contribution	337,267	-
Return of Capital	(1,200,000)	(1,500,000)
Net cash used in financing activities	(862,733)	(1,500,000)
Net (decrease) increase in cash and cash equivalents	(5,216,248)	12,161,194
Cash and cash equivalents, beginning of year	12,161,194	-
Cash and cash equivalents, end of year	$ 6,944,946	$ 12,161,194
Supplemental cash flow disclosures:		
Cash paid during the year for:		
Income taxes	$ -	$ 333,510

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

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Phoenix Indemnity Insurance Company (the "Company"), a stock property and casualty insurer, is licensed in 24 states and currently writes non-standard private passenger automobile coverages in New Mexico and Arizona. At December 31, 2002 the Company was a wholly owned subsidiary of Millers American Group, Inc. ("MAG"), a holding company incorporated in Texas. MAG also owned, prior to December 1, 2002, Trilogy Holdings, Inc. ("Trilogy"), The Millers Insurance Company ("Millers"), Millers Holding Corporation, Inc. ("Holding"), a wholly owned subsidiary of Millers, The Millers Casualty Insurance Company ("Casualty"), and Millers General Agency, Inc. ("MGA"). On December 1, 2002, Hallmark Financial Services Inc. ("Hallmark") acquired MGA. Effective January 1, 2003, Hallmark acquired the Company.

Summary of significant accounting policies

The accompanying financial statements are presented in conformity with accounting principles generally accepted in the United States of America ("GAAP"). These accounting principles differ in certain respects from accounting practices prescribed or permitted by the Arizona Department of Insurance.

Use of Estimates - The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates include those used in determining deferred policy acquisition costs and reserves for losses and loss adjustment expenses. Actual results could differ significantly from those estimates.

Investments - Debt and equity securities and other investments are classified as available for sale and are carried at estimated fair values with unrealized holding gains and losses net of income tax effects are reported as a separate component of equity until realized. Realized gains and losses upon disposition of securities are determined by using the specific identification method.

Costs of debt securities and equity securities are adjusted for impairments, which are declines in value that are considered to be other than temporary. Impairment adjustments are included in "Net realized capital gains and losses." In evaluating whether a decline in value is other than temporary, the Company considers several factors including, but not limited to the following: (1) whether the decline is substantial; (2) the duration (generally greater than six months); (3) the reasons for the decline in value (credit event, interest related or market fluctuation); (4) the Company's ability and intent to hold the investments for a period of time to allow for a recovery of value; and (5) the financial condition of and near-term prospects of the issuer.

Cash and Cash Equivalents - The Company considers all investments with maturities at acquisition of three months or less to be cash equivalents.

Deferred Policy Acquisition Costs - Acquisition costs such as commissions, premium taxes and certain other expenses which vary with and are directly related to the production of business, are deferred and amortized over the effective period of the related insurance policies. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to premiums to be earned, loss and loss adjustment expenses and certain other maintenance costs expected to be incurred as the premiums are earned but does not include consideration of anticipated investment income. To the extent that deferred policy acquisition costs are not realizable, the deficiency is charged to income currently.

Reinsurance Receivables - Reinsurance is commonly utilized within the industry as a means of risk sharing, and the Company is involved in many reinsurance treaties to protect from catastrophic losses. The reinsuring companies are obligated to the Company to the extent of the reinsured portion of the underlying risks. The amounts for ceded losses, loss adjustment expenses and unearned premiums represent a continuing liability for the Company in the event that reinsurers are unable to meet their obligations under the reinsurance agreements.

Property and Equipment - Property and equipment are stated at cost less accumulated depreciation. Depreciation and amortization are computed using the straight-line method with estimated useful lives ranging from 5 to 7 years for furniture and equipment.

Reserve for Losses and Loss Adjustment Expenses - The reserve for unpaid losses and loss adjustment expenses is based on aggregate case basis estimates for reported losses and estimates of incurred but not reported losses based on past experience. Such reserve is based upon estimates and, while management believes that the amount is fairly stated, the ultimate liability may vary from the amount provided. The methods used to make such estimates and to establish the resulting liability are continually reviewed and any adjustments to these methods are reflected in current operations.

Premiums - Premiums are earned on a pro rata basis over the terms of the policies. Unearned premiums represent the portion of premiums written that relates to the unexpired terms of the policies in force. Prepaid reinsurance represents the unearned portion of premiums paid to reinsurers. Earned premiums include amounts relating to assumed reinsurance and are stated net of reinsurance ceded.

Income Taxes - Effective September 1, 2000, the Company was included in MAG's consolidated federal income tax return. Federal income taxes are calculated as if the Company and MAG filed on a separate return basis. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities of their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period the change becomes effective.

Recently issued accounting pronouncements
In June 2001, the FASB issued SFAS No. 141 "Business Combinations" ("SFAS 141") and No. 142 "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 141 prohibits the use of the pooling of interests method for business combinations initiated after June 30, 2001 and also applies to all business combinations accounted for by the purchase method that are completed after June 30, 2001. There are also transition provisions that apply to business combinations completed before July 1, 2001 that were accounted for by the purchase method. SFAS 142 is effective for fiscal years beginning after December 15, 2001 for all goodwill and intangible assets recognized in an entity's statement of financial position at that date regardless of when those assets were initially recognized. The adoption of SFAS 141 and SFAS 142 did not have a material effect on the Company's financial statements.

The FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations" ("SFAS 143") in June 2001 and SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144") in August 2001. SFAS 143 addresses reporting for future legal obligations associated with the retirement of tangible long-lived assets and the related asset retirement costs. SFAS 144 supercedes earlier guidance with respect to accounting for assets that are impaired or will be disposed of through sale or otherwise and is effective for years beginning after December 15, 2001. The adoption of SFAS 143 and SFAS 144 did not have a material effect on the Company's financial statements.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No 13, and Technical Corrections" ("SFAS 145"). SFAS 145 rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt," and an amendment of that Statement, SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." This Statement also rescinds SFAS No. 44, "Accounting for Intangible Assets of Motor Carriers." This Statement amends SFAS No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. SFAS 145 is effective for financial statements issued on or after May 15, 2002. The adoption of SFAS 145 did not have a material effect on the Company's financial statements.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated With Exit or Disposal Activities" ("SFAS 146"). SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force ("EITF") Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS 146 is effective for exit or disposal activities that are initiated after December 31, 2002. The Company does not expect the adoption of SFAS 146 to have a material effect on its financial statements.

In October 2002, the FASB issued SFAS No. 147, "Acquisitions of Certain Financial Institutions" ("SFAS 147"). Except for transactions between two or more mutual enterprises, this Statement removes acquisitions of financial institutions from the scope of both Statement 72 and Interpretation 9 and requires that those transactions be accounted for in accordance with SFAS 141 and SFAS 142. In addition, this Statement amends SFAS 144 to include in its scope long-term customer-relationship intangible assets of financial institutions such as depositor - and borrower-relationship intangible assets and credit cardholder intangible assets. This statement was effective October 1, 2002. The adoption of SFAS 147 did not have a material effect on the Company's financial statements.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for years ending after December 15, 2002. The adoption of FIN 45 did not have a material effect on the Company's financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure" ("SFAS 148"). The Statement amends 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 amends 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. SFAS 148 is effective for financial statements for fiscal years ending after December 15, 2002. The adoption of SFAS 148 did not have a material effect on the Company's financial statements.

In January 2003, the FASB issued Interpretation No. 46 "Consolidation of Variable Interest Entities, an interpretation of ARB 51" ("FIN 46"). The primary objectives of FIN 46 are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights ("variable interest entities" or "VIEs") and how to determine when and which business enterprise should consolidate the VIE (the "primary beneficiary"). This new model for consolidation applies to an entity which either (1) the equity investors (if any) do not have a controlling financial interest or (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, FIN 46 requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE make additional disclosures. The Company does not expect the adoption of FIN 46 to have a material effect on its financial statements.

Statutory financial information

The Company prepares its statutory basis financial statements in accordance with accounting principles and practices prescribed or permitted by the Arizona Department of Insurance. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners ("NAIC"), as well as state laws, regulations and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.

In March 1998, the NAIC adopted the Codification of Statutory Accounting Principles ("Codification"). The Codification, which is intended to standardize regulatory accounting and reporting for the insurance industry, was effective January 1, 2001. However, statutory accounting principles will continue to be established by individual state laws and permitted practices. The impact of adoption of the Codification was not material to the Company's statutory basis capital and surplus.

Reconciliations of statutory basis capital and surplus as of December 31, 2002 and 2001, to the respective amounts as reported in the accompanying financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") are as follows:

	2002	2001

Statutory basis capital and surplus	$ 10,137,673	$ 11,492,335
Deferred acquisition costs	918,429	115,377
Reinstatement of non-admitted assets	49,590	106,764
Adjustment of written premiums ceded	131,340	1,393,039
Adjustment of the carrying value of investment securities	283,038	177,395
GAAP stockholder's equity	$ 11,520,070	$ 13,284,910

Reconciliations of statutory basis net loss for the years ended December 31, 2002 and 2001, to the respective amounts as reported in the accompanying financial statements prepared in accordance with GAAP are as follows:

	2002	2001
Statutory basis net loss	$ (2,877,621)	$ (1,803,714)
Adjustment of bad debt allowance	319,751	-
Changes in deferred acquisition costs	803,052	(849,817)
Valuation allowances on premiums receivable	-	(137,768)
Valuation allowances on related party receivables	-	(766,713)
Adjustment of written premiums ceded	-	1,393,039
Recovery of intercompany balance receivable	593,423	-
Realized gains on sales of investments	12,872	792,116
Deferred income taxes	59,100	(260,000)
Other income	77,561	-
GAAP net loss as reported herein	$ (1,011,862)	$ (1,632,857)

2. INVESTMENTS

Net investment income for the years ended December 31 is as follows:

	2002	2001
Gross investment income:		
Debt securities	$ 374,451	$ 1,330,753
Equity securities	105,876	157,540
Cash and cash equivalents	123,376	389,342
Other	4,678	54
Total investment income	608,381	1,877,689
Less investment expenses	(14,624)	(17,480)
Net investment income	$ 593,757	$ 1,860,209

Proceeds from sales, gross realized gains, gross realized losses, and net realized gains (losses) from sales of investment securities for the years ended December 31, 2002 and 2001, consist of the following:

	December 31, 2002		
	Gross Realized	Gross Realized	Net Realized

	Proceeds	Gains	Losses	Gains
Bonds	$ 7,108,665	$ 269,895	$ (6,738)	$ 263,157
Common stocks (non- affiliated)	69,774	52,132	-	52,132
	$ 7,178,439	$ 322,027	$ (6,738)	$ 315,289

	December 31, 2001			
	Proceeds	Gross Realized Gains	Gross Realized Losses	Net Realized Gains
Bonds	$ 31,072,176	$ 815,794	$ (73,203)	$ 742,591
Preferred stocks	1,448,886	125,152	(24,072)	101,080
	$ 32,521,062	$ 940,946	$ (97,275)	$ 843,671

At December 31, 2002, the Company identified two debt securities, which were considered to be impaired, and reduced their carrying values by $212,640. Also at December 31, 2002, the Company identified two equity securities, which were considered to be impaired, and reduced their carrying value by $67,987. These impairment losses have been included in "Net realized capital gains and losses".

The cost or amortized cost, gross unrealized gains and losses, and estimated fair value of investments in available-for-sale securities as of December 31, 2002 and 2001, are as follows:

	December 31, 2002			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt securities:				
U.S. Treasury activities and obligations of U.S. government agencies	$ 3,601,171	$ 174,923	$ -	$ 3,776,094
Corporate securities	4,471,154	108,115	-	4,579,269
Total debt maturities	$ 8,072,325	$ 283,038	$ -	$ 8,355,363
Equity securities:				
Preferred stocks	$ 1,220,700	$ 84,330	$ (6,500)	$ 1,298,530
Common stocks	677,783	229,113	(22,878)	884,018
Total equity securities	$ 1,898,483	$ 313,443	$ (29,378)	$ 2,182,548

	December 31, 2001			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value

Debt securities:				
U.S. Treasury activities and obligations of U.S. government agencies	$ 5,394,235	$ 337,363	$ (64,552)	$ 5,667,046
Corporate securities	6,418,635	-	(99,645)	6,318,990
Total debt maturities	$11,812,870	$ 337,363	$ (164,197)	$11,986,036
Equity securities:				
Preferred stocks	$ 1,220,700	$ 31,800	$ (22,500)	$ 1,230,000
Common stocks	763,413	273,385	(57,606)	979,192
Total equity securities	$ 1,984,113	$ 305,185	$ (80,106)	$ 2,209,192

Property and casualty insurance companies are required to maintain assets with state regulatory authorities. Such assets are included as components of debt securities and have an aggregate fair value of $3,601,172 and $3,968,916 at December 31, 2002 and 2001, respectively.

The amortized cost and estimated fair value of debt securities at December 31, 2002, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalties.

	December 31, 2002	
	Amortized Cost	Estimated Fair Value
Due in one year or less	$ -	$ -
Due after one year through five years	6,025,335	6,285,277
Due after five years through ten years	1,184,982	1,208,078
Due after ten years	862,008	862,008
Total	$ 8,072,325	$ 8,355,363

3. FAIR VALUE OF FINANCIAL INSTRUMENTS

In the normal course of business, the Company invests in various financial assets and incurs various financial liabilities. Estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The Company's financial instruments include: cash and cash equivalents, investments, premiums and reinsurance receivable, reinsurance premiums payable, accounts payable and drafts outstanding. The Company has estimated that the carrying amount of cash and cash equivalents, short-term investments, premiums and reinsurance receivable, reinsurance premiums payable, accounts payable and drafts outstanding approximates fair value due to the short-term maturities of these instruments. The fair value of the Company's investments was

$10,537,911 as of December 31, 2002, which exceeded the amortized cost by $567,103. The fair value of the Company's investments was $14,195,228 as of December 31, 2001, which exceeded the amortized cost by $398,245.

4. DEFERRED POLICY ACQUISITION COSTS

Deferred policy acquisition costs ("DPAC") and the components of the change in DPAC were as follows:

	Year Ended December 31, 2002	Year Ended December 31, 2001
Balance, beginning of year	$ 115,377	$ 965,194
Change in balance:		
Deferrals	5,002,703	4,583,119
Amortization	(4,015,593)	(4,622,467)
Premium deficiency	(184,058)	(810,469)
Net change	803,052	(849,817)
Balance, end of year	$ 918,429	$ 115,377

5. PROPERTY AND EQUIPMENT

Property and equipment are carried at cost, less allowances for depreciation, and consist of the following at December 31, 2002 and 2001:

	2002	2001
Leasehold improvements	$ 7,200	$ 7,200
Furniture and equipment	2,275,853	2,275,853
	2,283,053	2,283,053
Accumulated depreciation	(2,217,639)	(2,084,595)
Property and equipment, net	$ 65,414	$ 198,458

Depreciation expense was $133,044 and $217,027 for 2002 and 2001, respectively.

6. RESERVE FOR LOSSES AND LOSS ADJUSTMENT EXPENSES

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

	2002	2001
Balance at January 1	$ 21,408	$ 26,973
Less reinsurance receivables	8,115	4,483
Net balance at January 1	13,293	22,490
Incurred related to:		

Current year	12,184	18,870
Prior years	699	(2,986)
Total incurred	12,883	15,884
Paid related to:		
Current year	6,467	12,085
Prior years	9,517	12,996
Total paid	15,984	25,081
Net balance at December 31	10,192	13,293
Plus reinsurance receivables	5,548	8,115
Balance at December 31	$ 15,740	$ 21,408

Changes in the provision for incurred losses and loss adjustment expenses are the result of ongoing analysis of recent loss development trends. Original estimates are increased or decreased as additional information becomes known regarding individual claims. For the year ended December 31, 2002 and 2001, the provisions for incurred losses and loss adjustment expenses attributable to insured events of prior years increased by approximately $0.7 million and decreased approximately $3.0 million, respectively, as a result of higher than anticipated losses and loss adjustment expenses in 2002 and lower than anticipated losses and loss adjustment expenses in 2001 principally on auto liability lines of insurance.

7. REINSURANCE

The Company limits the maximum net loss on any one incident by reinsuring (ceding) certain levels of risks principally through quota share agreements with other insurers or reinsurers, either on an automatic basis under general reinsurance contracts or on an individual risk basis. Reinsurance contracts do not relieve the Company from obligations to its policyholders. In the event that the reinsuring companies are unable to meet their obligations under reinsurance agreements significant losses to the Company could occur. Management believes that all amounts currently due from reinsurers are fully collectible.

For the years ended December 31, 2002 and 2001, amounts assumed and ceded under reinsurance agreements were as follows (in thousands):

	December 31, 2002			
	Direct	Assumed	Ceded	Net
Premiums written	$ 24,312	$ 19	$ (6,270)	$ 18,061
Earned premium	30,346	46	(13,675)	16,717
Losses and loss adjustment expenses incurred	22,083	479	(9,679)	12,883

	December 31, 2001			
	Direct	Assumed	Ceded	Net

Premiums written	$ 35,521	$ 1,823	$ (23,414)	$ 13,930
Earned premium	39,360	3,899	(21,379)	21,880
Losses and loss adjustment expenses incurred	29,050	3,016	(16,182)	15,884

The maximum amount of unearned premium which would have been due from or to the Company if all of the Company's reinsurance had been canceled as of December 31, 2002 and 2001, would be as follows:

	2002	2001
Assumed unearned premium reserve payable	$ 3,893	$ 31,500
Ceded unearned prepaid premium	38,264	4,231,000

The Company has unsecured reinsurance recoverables for loss and loss adjustment expenses, unearned premiums ceded, and contingent commissions, net of related allowance for doubtful accounts, which are significant in relation to stockholder's equity, with the following reinsurers:

	2002	2001
St. Paul Fire & Marine Insurance Company	$ 112,000	$1,050,000
Acceptance Insurance Company	-	805,000
AXA Reassurances	-	7,918,000

8. INCOME TAXES

The Company's federal tax return was combined with MAG, Trilogy, Millers, Millers Holding, Casualty, and MGA. The method of tax allocation among the companies was subject to written agreement, approved by the Board of Directors, whereby the allocation was based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually when the return is filed.

As of December 31, 2002, the Company had operating loss carry forwards in the amount of approximately $5,300,000. All operating loss carry forwards will expire in 2021. The Company has no income taxes incurred in current and prior years that will be available for recoupment in the event of future losses.

The income tax provision consist of the following components for the years ended December 31:

	2002	2001
Current	$ -	$ -
Deferred	(59,100)	260,000
Provision for income taxes	$ (59,100)	$ 260,000

The provision for federal income taxes incurred is different from that which would be obtained by applying the statutory federal income tax rate to income before income taxes. The significant items causing this difference are as follows:

	2002	2001

Provision (benefit) computed at statutory rate	$ (328,987)	$ (597,290)
Change in valuation allowance	285,000	1,030,000
Dividends received deduction	(21,573)	(38,413)
Tax exempt interest	-	(5,979)
Investments	-	(138,613)
Other	6,460	10,295
Provision for income taxes	$ (59,100)	$ 260,000

The tax effect of temporary differences are separately calculated and recorded when such differences arise. A valuation allowance, reducing any recognized deferred tax asset, is recorded if it is determined that it is more likely than not that such deferred tax asset will not be realized. The Company established a valuation allowance of $4,285,000 and $4,627,000 at December 31, 2002 and 2001, respectively, as it determined that it is not more likely than not that the Company will realize the benefit of its deferred tax assets.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities were as follows (in thousands):

	2002	2001
Deferred tax assets:		
Discounted losses and loss adjustment expense reserves and unearned premiums	$ 635	$ 1,253
Tax credit and net operating loss carryforwards	1,849	772
Goodwill	1,978	2,147
Investment impairments	176	81
Premium receivable allowance	152	531
Other deferred assets	92	73
Total deferred tax assets	4,882	4,857
Deferred policy acquisition costs	321	40
Unrealized holding gain on investments	198	139
Other deferred tax liabilities	78	51
Total deferred tax liabilities	597	230
Valuation allowance	(4,285)	(4,627)
Net deferred tax asset	$ -	$ -

9. DIVIDEND RESTRICTIONS

Arizona insurance regulations generally limit distributions of unassigned surplus made by property and casualty insurers in any year, without prior regulatory approval, to the lesser of 10% of policyholders' surplus of the previous year-end or net investment income for the prior year. No distributions are available in 2003 without prior regulatory approval. Distributions of $1,200,000 and $1,500,000 were made during 2002 and 2001, respectively. The distribution for 2002 exceeded the amount allowed by the Arizona Department of Insurance and was subsequently reclassified as a return of shareholder's capital.

10.RELATED PARTY TRANSACTIONS

The Company had a receivable of $480,000 from MGA at December 31, 2002. Hallmark assumed the obligation to the Company in connection with its acquisition of MGA effective December 1, 2002. A portion of the receivable in the amount of $337,267, is included in equity as a capital contribution for the year ended December 31, 2002. The Company had receivables of $549,004 from Millers and payables of $99,004 to MAG at December 31, 2001.

The Company repaid capital of $1,200,000 and $1,500,000 to MAG during 2002 and 2001, respectively.

The Company paid management fees of $1,200,000 to MAG during 2002 and 2001, respectively.

The Company has an agreement whereby MAG provides policy and claims administration services through a third party administrator. Fees for such services are based on varying percentages of earned premiums, fees per policy processed or fees per claim processed. Total fees paid to MAG under this agreement during the year ended December 31, 2002 were $2,371,306 for policy administration and $2,056,410 for claim administration. Total fees paid to MAG under this agreement during the year ended December 31, 2001 were $2,949,375 for policy administration and $3,813,129 for claims administration.

During the year ended December 31, 2002, MAG defaulted on payments of $510,000 to the third party administrator for policy and claims services for the Company's business. The Company had previously paid MAG for such services pursuant to an inter-company agreement. The Company has continued receiving services from the third party administrator after year-end and is now paying the provider directly for such services.

11. COMMITMENTS AND CONTINGENCIES

In the normal course of its operations, the Company has been named as defendant in various legal actions, some of which seek substantial amounts for denied claims and other punitive damages. In the opinion of management and its legal counsel, the ultimate liability, if any resulting from the disposition of these claims, will not have a material adverse effect on the Company's financial position, results of operations or cash flows.

12. SUBSEQUENT EVENTS

In 2002, Hallmark purchased from a bank a promissory note in default payable by MAG (the "Millers Note") which was guaranteed by Trilogy and secured by all of the issued and outstanding capital stock of Millers and the Company.

In lieu of immediate foreclosure of the collateral securing the Millers Note, Hallmark negotiated with MAG to accept all of the outstanding capital stock of the Company in satisfaction of $7.0 million of the outstanding balance of the Millers Note. The proposed exchange was contingent on execution of a mutually acceptable definitive agreement and regulatory approval of Hallmark's Form A application for change of control previously filed with the Arizona Department of Insurance. The

Arizona Department of Insurance approved the transaction on January 27, 2003. The effective date of the transaction was January 1, 2003. Therefore, effective January 1, 2003, the Company became a wholly-owned subsidiary of Hallmark.

Item 7. Financial Statements and Exhibits

b) Pro forma financial information

The following unaudited Pro Forma Consolidated Balance Sheet of Hallmark is presented as if the acquisition of the Company had occurred on December 31, 2002. The following unaudited Pro Forma Consolidated Statements of Operations of Hallmark for the year ended December 31, 2002 assume this transaction had occurred as of January 1, 2002. The Pro Forma Consolidated Balance Sheet was derived from the Consolidated Balance Sheet of Hallmark and its subsidiaries filed with Hallmark's Annual Report on Form 10-KSB as of and for the year ended December 31, 2002. The Pro Forma Consolidated Statement of Operations were derived from the Consolidated Statements of Operations of Hallmark and its subsidiaries filed with Hallmark's Annual Report on Form 10-KSB as of and for the year ended December 31, 2002. In management's opinion, all of the material adjustments necessary to reflect the effects of the acquisition transaction have been made. The Pro Forma Consolidated Balance Sheet is not necessarily indicative of what the actual financial position would have been assuming the transaction had been completed as of December 31, 2002, nor does it purport to present the future financial position of Hallmark. Additionally, the Pro Forma Consolidated Statement of Operations is not necessarily indicative of what the actual results of operations of Hallmark would have been assuming the transaction had been completed at the beginning of the period presented, nor does it purport to present the results of operations for future periods.

The Acquisition

In 2002, Hallmark purchased from a bank a promissory note in default payable by MAG (the "Millers Note") which was guaranteed by Trilogy and secured by all of the issued and outstanding capital stock of Millers and the Company.

In lieu of immediate foreclosure of the collateral securing the Millers Note, Hallmark negotiated with MAG to accept all of the outstanding capital stock of the Company in satisfaction of $7.0 million of the outstanding balance of the Millers Note. The proposed exchange was contingent on execution of a mutually acceptable definitive agreement and regulatory approval of Hallmark's Form A application for change of control previously filed with the Arizona Department of Insurance. The Arizona Department of Insurance approved the transaction on January 27, 2003. The effective date of the transaction was January 1, 2003. Therefore, effective January 1, 2003, the Company became a wholly-owned subsidiary of Hallmark.

The acquisition of the Company was accounted for by Hallmark as a purchase transaction in accordance with SFAS 141. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed by Hallmark at the date of acquisition:

At January 1, 2003
($ In Thousands)

Investments	$ 10,873
Cash and cash equivalents	6,945
Furniture, fixtures and equipment	-
Deferred tax asset, net	4,285
Other assets	12,997
Intangible assets	-
Goodwill	-
Total assets acquired	35,100
Unpaid losses and loss adjustment expense	15,886
Other liabilities	3,642
Total liabilities assumed	19,528
Net assets acquired	$ 15,572

Hallmark Financial Services, Inc.
UNAUDITED CONSOLIDATED PRO FORMA BALANCE SHEET
($ in thousands)

	Hallmark Financial Services, Inc. December 31, 2002 (Audited)	Phoenix Indemnity Insurance Company December 31, 2002 (Audited)	Combined Historical December 31, 2002
Assets			
Investments:			
Debt securities, held to maturity, at amortized cost	$ 7,679	$ 8,355	$ 16,034
Equity securities, available for sale, at market value	122	2,183	2,305
Short-term investments, at cost which approximates market value	8,927	335	9,262
Total investments	16,728	10,873	27,601
Cash and cash equivalents	8,453	6,945	15,398
Restricted cash	1,072		1,072
Prepaid reinsurance premiums	8,550	38	8,588
Premiums receivable from lender for financed premiums (net of allowance for doubtful accounts)	11,593		11,593
Premiums receivable	1,012	1,745	2,757
Accounts receivable	2,129	128	2,257
Reinsurance recoverable	12,929	11,086	24,015
Deferred policy acquisition costs	1,367	918	2,285
Prepaid commissions	3,899		3,899
Excess of cost over net assets acquired	5,171		5,171
Intangible assets	540		540
Note receivable	6,500		6,500
Current federal income taxes recoverable	33		33
Deferred federal income taxes	1,021		1,021
Other assets	1,832	575	2,407
Total assets	$ 82,829	$ 32,308	$ 115,137

(a) Elimination of intercompany balance
(b) Recognition of $706 of acquired identified intangible assets for insurance in force and licenses
(c) Adjustments of assets acquired and liabilities assumed to estimated fair value as required by SFAS 141
(d) Consolidation entry

Hallmark Financial Services, Inc.
UNAUDITED CONSOLIDATED PRO FORMA BALANCE SHEET
($ in thousands)

	Hallmark Financial Services, Inc. December 31, 2002 (Audited)	Phoenix Indemnity Insurance Company December 31, 2002 (Audited)	Combined Historical December 31, 2002
Liabilities and stockholder's equity			
Liabilities:			
Notes payable	$ 1,803	$ -	$ 1,803
Note payable related party	8,600		8,600
Net advances from lender for financed premiums	10,905		10,905
Unpaid losses and loss adjustment expense	17,667	15,740	33,407
Unearned premiums	15,551	4,014	19,565
Unearned revenue	6,872		6,872
Accrued agent profit sharing	450		450
Reinsurance balances payable	3,764		3,764
Accrued ceding commission payable	2,536		2,536
Accounts payable and other accrued expenses	5,542	1,034	6,576
Pension liability	604		604
Total liabilities	74,294	20,788	95,082
Stockholder's equity:			
Common stock	356	3,000	3,356
Capital in excess of par value	10,875	18,795	29,670
Retained earnings	(1,491)	(10,644)	(12,135)
Accumulated other comprehensive income	(162)	369	207
Treasury stock	(1,043)	-	(1,043)
Total stockholder's equity	8,535	11,520	20,055
Total liabilities and stockholder's equity	$ 82,829	$ 32,308	$ 115,137

(a) Elimination of intercompany balance
(b) Recognition of $706 of acquired identified intangible assets for insurance in force and licenses
(c) Adjustments of assets acquired and liabilities assumed to estimated fair value as required by SFAS 141

(d) Consolidation entry

Hallmark Financial Services, Inc.
UNAUDITED CONSOLIDATED PRO FORMA STATEMENTS OF OPERATIONS
($ in thousands, except shares and per share amounts)

	Hallmark Financial Services, Inc. 12 Months Ending December 31, 2002	Phoenix Indemnity Insurance Company 12 Months Ending December 31, 2002	Combined Historical Twelve Months Ending December 31, 2002
Revenues			
Gross premiums earned	$ 52,486	$ 17,878	$ 70,364
Ceded premiums earned	(32,273)	(1,161)	(33,434)
Net premiums earned	20,213	$ 16,717	36,930
Commission & fees	1,561		1,561
Investment income, net of expenses	531	594	1,125
Finance charges	2,484		2,484
Processing and service fees	457		457
Other income	551	35	586
Total revenue	25,797	17,346	43,143
Losses and expenses:			
Losses and loss adjustment expenses	36,463	12,883	49,346
Reinsurance recoveries	(21,161)	-	(21,161)
Net losses and loss adjustment expenses	15,302	12,883	28,185
Acquisition costs, net	(605)	4,315	3,710
Other acquisition and underwriting expenses (net of ceding commission)	7,468		7,468
Operating expenses	2,611	1,219	3,830
Interest expense	983		983
Amortization of intangible assets	2		2
Total benefits, losses and expenses	25,761	18,417	44,178
Income (loss) from operations before federal income tax	36	(1,071)	(1,035)
Federal income tax expense (benefit)	13	(59)	(46)
Income (loss) before cumulative effect of change in accounting principle and extraordinary gain	23	(1,012)	(989)
Cumulative effect of change in accounting principle	(1,694)	-	(1,694)
Extraordinary gain	-	-	-
Net income (loss)	$ (1,671)	$ (1,012)	$ (2,683)

Basic and diluted earnings per share (11,049,133 and 11,126,822 shares outstanding)			
Loss before cumulative effect of change in accounting principle	$ -	$ (0.09)	$ (0.09)
Cumulative effect of change in accounting principle	(0.15)	-	(0.15)
Extraordinary gain	-	-	-
Net income (loss)	$ (0.15)	$ (0.09)	$ (0.24)

(a) Represents additional interest expense of $637 related to debt incurred to complete the acquisition.
(b) Represents extraordinary gain from excess of fair value of net assets acquired over cost

Item 7. Exhibits

Exhibits.

2(a) * Purchase Agreement dated December 6, 2002, among Hallmark Financial Services, Inc., Millers American Group, Inc. and Trilogy Holdings, Inc.

* Previously filed with the Company's Form 8-K filed with the Commission on January 27, 2003.

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.

HALLMARK FINANCIAL SERVICES, INC.

Date: April 14, 2003

By: /s/ Timothy A. Bienek

Timothy A. Bienek, President and Chief Operating Officer