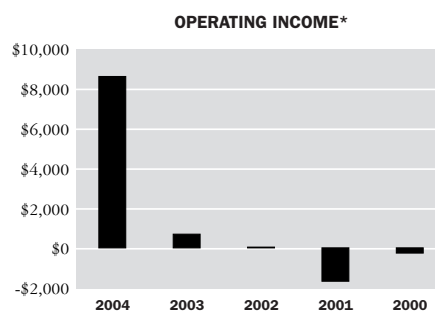
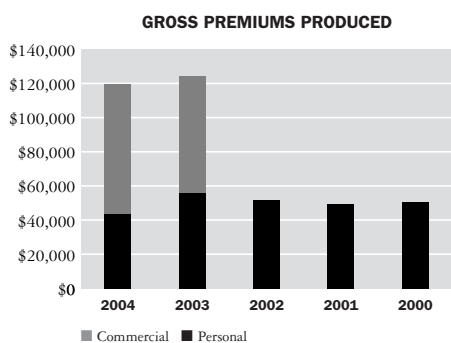
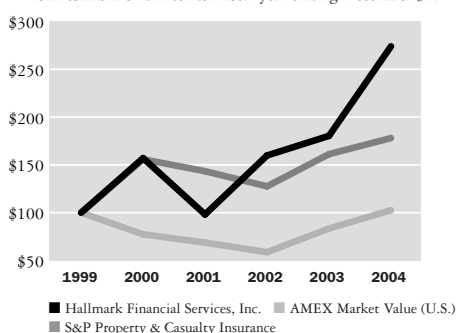


HALLMARK FINANCIAL SERVICES
FINANCIAL HIGHLIGHTS

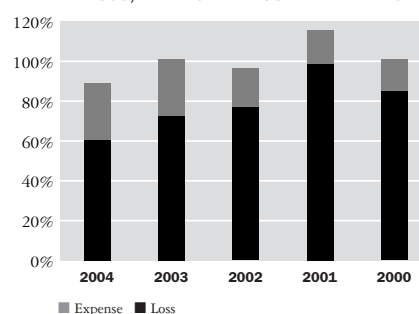
(Dollars in thousands, except per share amounts)	For the Years Ended December 31,				
	2004	2003	2002	2001	2000
OPERATING RESULTS					
Gross premiums produced	\$119,305	\$124,264	\$51,643	\$49,614	\$50,469
Net premiums earned	\$ 32,445	\$ 41,975	\$20,213	\$16,376	\$17,395
Operating income (loss)*	\$ 8,602	\$ 686	\$ 36	\$ (1,674)	\$ (261)
Net income (loss)	\$ 5,849	\$ 8,745	\$ (1,671)	\$ (1,130)	\$ (233)
Weighted average shares outstanding – diluted	36,688	18,787	11,127	\$11,049	11,049
PER SHARE					
Operating income (loss) – diluted	\$ 0.16	\$ 0.03	\$ 0.00	\$ (0.10)	\$ (0.02)
Net income (loss) – diluted	\$ 0.16	\$ 0.46	\$ (0.15)	\$ (0.10)	\$ (0.02)
Book value	\$ 0.90	\$ 0.75	\$ 0.77	\$ 0.94	\$ 1.04
SELECTED BALANCE SHEET ITEMS					
Total investments	\$ 32,121	\$ 29,855	\$16,728	\$16,223	\$13,577
Total assets	\$ 82,511	\$ 83,853	\$83,761	\$73,605	\$75,553
Unpaid loss and loss adjustment expenses	\$ 19,648	\$ 28,456	\$17,667	\$20,089	\$22,298
Unearned premiums	\$ 6,192	\$ 5,862	\$15,957	\$16,793	\$16,711
Total liabilities	\$ 49,855	\$ 56,456	\$75,226	\$63,237	\$64,065
Total stockholders' equity	\$ 32,656	\$ 27,397	\$ 8,535	\$10,368	\$11,488
Return on equity (excluding extraordinary gains)	21.3%	7.7%	-16.1%	-9.8%	-2.0%
STATUTORY RATIOS					
Loss ratio	60.4%	72.5%	76.8%	98.6%	84.7%
Expense ratio	28.3%	28.6%	19.5%	16.7%	16.4%
Combined ratio	88.7%	101.1%	96.3%	115.3%	101.1%



COMPARISON OF 5-YEAR CUMULATIVE TOTAL RETURN
\$100 invested on 12/31/99 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.



LOSS, EXPENSE AND COMBINED RATIO



*Operating income is income before income tax, cumulative effect of change in accounting principle and extraordinary gain.

HALLMARK FINANCIAL SERVICES
TO OUR SHAREHOLDERS

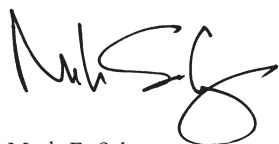
I am pleased to report that 2004 was a record year of operating profitability for Hallmark. Our \$8.6 million in operating income reflects improved contributions from both personal lines and commercial lines business segments, as well as increased investment income. We also finished the year with a 21% after-tax return on equity and a significantly strengthened loss reserve position.

In our Personal Lines Group, the focus on underwriting discipline resulted in less top line premium volume, but significantly more bottom line profit. This willingness to forego premium growth is often talked about in the insurance business, but less often seen. The Group's increased profitability is evidenced by a combined ratio of 88.7%, the lowest ever in our Company's history. On the operational front, the integration of Phoenix Indemnity Insurance Company, which was acquired by the Company in the first quarter of 2003, was fully and successfully completed. The Personal Lines Group is now operating from a common location with a shared management team and information systems. This Group is now focused on maintaining its underwriting discipline while identifying profitable future growth opportunities.

Our Commercial Lines Group's operating profit more than doubled over 2003 results. The Group's increased profit is due to more premium produced, better underwriting results and improved commission terms. Growth in premium benefited from increases in rate and not just increased risk exposure. The Commercial Lines Group has been focused on renewing its best quality risks and proactive in maintaining its underwriting standards, even in the hard market cycle. Looking into the future, we are evaluating additional investment in information systems that will support geographic expansion and possible new programs or acquisitions.

Since acquiring our commercial operation in late 2002, a major strategic objective of Hallmark has been to recapture the underwriting margin currently shared with our third-party partners and ultimately produce policies on our own company that we currently write through an issuing carrier. We made significant strides in this regard in 2004 and are looking forward to fully realizing this objective in 2005 through our recently announced plan to realign and further capitalize our insurance subsidiaries. The plan to increase the capitalization of our company is expected to enhance the financial strength ratings from our ratings agencies and support the retention of our existing commercial business.

This is an exciting time at Hallmark as we continue the transformation and growth of the Company. The ongoing hard work, dedication and passion of our employees, management team and board of directors are much appreciated.



Mark E. Schwarz
Chairman and Chief Executive Officer

April 11, 2005

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

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended DECEMBER 31, 2004

Or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 0-16090

Hallmark Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Nevada

(State or Other Jurisdiction of Incorporation or Organization)

87-0447375

(I.R.S. Employer Identification No.)

777 Main Street, Suite 1000, Fort Worth, Texas

(Address of Principal Executive Offices)

76102

(Zip Code)

Issuer's Telephone Number, Including Area Code: (817) 348-1600

Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class

Common Stock \$.03 par value

Name of Each Exchange on
Which Registered

American Stock Exchange

Emerging Company Marketplace

Securities registered under Section 12(g) of the Exchange Act: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. \$10,070,731

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. Common stock, \$.03 par value 36,497,291 shares outstanding as of March 17, 2005.

DOCUMENTS INCORPORATED BY REFERENCE

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

RISKS ASSOCIATED WITH FORWARD-LOOKING STATEMENTS INCLUDED IN THIS FORM 10-K

This Form 10-K contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which are intended to be covered by the safe harbors created thereby. Forward-looking statements include statements which are predictive in nature, which depend upon or refer to future events or conditions, or which include words such as “expects”, “anticipates”, “intends”, “plans”, “believes”, “estimates,” or similar expressions. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of the Company’s business activities and availability of funds. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of the Company. Although the Company believes that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-K will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by the Company or any other person that the objectives and plans of the Company will be achieved.

ITEM 1. BUSINESS.

INTRODUCTION

Hallmark Financial Services, Inc. (“HFS”) and its wholly owned subsidiaries (collectively, the “Company”) engage in the sale of property and casualty insurance products. The Company’s business involves marketing and underwriting of non-standard personal automobile insurance in Texas, New Mexico and Arizona; marketing commercial insurance in Texas, New Mexico, Idaho, Oregon and Washington; affiliate and third party claims administration; and other insurance related services.

OVERVIEW

The Company pursues its business activities through integrated insurance groups handling non-standard personal automobile insurance (the “Personal Lines Group”) and commercial insurance (the “Commercial Lines Group”). The members of the Personal Lines Group are a Texas domiciled property and casualty insurance company, American Hallmark Insurance Company of Texas (“Hallmark”); an Arizona domiciled property and casualty insurance company, Phoenix Indemnity Insurance Company (“Phoenix”); a managing general agency, American Hallmark General Agency, Inc. (“AHGA”); a premium finance company, Hallmark Finance Corporation (“HFC”); and an affiliate and third party claims administrator, Hallmark Claims Services, Inc. (“HCS”). The members of the Commercial Lines Group are a managing general agency, Hallmark General Agency, Inc. (“HGA”), and a third party claims administrator, Effective Claims Management, Inc. (“ECM”).

Hallmark writes non-standard automobile liability and physical damage coverage in Texas through a network of independent agents. Hallmark currently provides insurance through a reinsurance arrangement with an unaffiliated company, Old American County Mutual Fire Insurance Company (“OACM”) for policies written after September 30, 2003. Prior to October 1, 2003, Hallmark provided insurance through a reinsurance arrangement with an unaffiliated company, State & County Mutual Fire Insurance Company (“State & County”). Through either State & County or OACM, Hallmark provides insurance for drivers who do not qualify for standard-rate insurance due to driving record, claims history, residency status, or type of vehicle.

The Company acquired Phoenix effective as of January 1, 2003. Phoenix is licensed in 24 states and writes non-standard automobile liability and physical damage coverage in Arizona and New Mexico through a network of independent agents. Phoenix underwrites its own policies and retains 100% of the business it writes. Phoenix targets non-urban markets and underwrites policies produced by approximately 150 independent agents.

AHGA holds a managing general agency appointment from OACM to manage the sale and servicing of OACM policies. Effective October 1, 2004 Hallmark reinsures 100% of the OACM policies produced by AHGA under a related reinsurance agreement. Prior to October 1, 2004, Hallmark reinsured 45% of the OACM policies produced by AHGA. AHGA markets OACM policies in Texas through approximately 519 independent agents operating under their own names.

HFC previously offered premium financing for policies sold by independent agents managed by AHGA. The Company discontinued writing new and renewal premium finance policies effective July 1, 2003.

HCS provides fee-based claims adjustment, salvage and subrogation recovery, and litigation services to Hallmark and unaffiliated MGAs.

Effective December 1, 2002, the Company purchased HGA, ECM and a financial administrative service company, Financial and Actuarial Resources, Inc. (“FAR”). Through approximately 150 independent agents operating under their own names, HGA markets commercial insurance policies primarily in the non-urban areas of Texas, New Mexico, Idaho, Oregon and Washington. HGA currently produces policies on behalf of Clarendon National Insurance Company (“CNIC”). HGA earns a commission based on a percentage of the earned premium it produces for CNIC. The commission percentage is determined by the underwriting results of the policies produced for CNIC.

ECM provides fee-based claims adjustment, salvage and subrogation recovery, and litigation services on behalf of CNIC. The Company discontinued the business of FAR during the third quarter of fiscal 2003.

PERSONAL LINES GROUP OPERATIONS

Formed in 1987, HFS commenced its current operations in 1990 when it acquired, through several transactions, most of the companies now referred to as the Personal Lines Group. HFS manages Hallmark, Phoenix, AHGA, HFC and HCS as an integrated Personal Lines Group that shares common management and office space.

Hallmark offers both liability and physical damage (comprehensive and collision) coverages. Hallmark's bodily injury liability coverage is limited to \$20,000 per person and \$40,000 per accident, and property damage liability coverage is limited to \$15,000 per accident. Physical damage coverage is limited to \$40,000 and \$30,000 for vehicles insured under six-month and monthly policies, respectively.

Phoenix offers both liability and physical damage (comprehensive and collision) coverages. Phoenix's bodily injury liability coverage is limited to \$15,000 per person and \$30,000 per accident, and property damage liability coverage is limited to \$10,000 per accident, for the Arizona direct bill program. Bodily injury liability coverage is limited to \$25,000 per person and \$50,000 per accident, and property damage liability coverage is limited to \$10,000 per accident, for the New Mexico direct bill program. Physical damage coverage is limited to a vehicle value of \$35,000 and \$30,000 for the Arizona and New Mexico direct bill programs, respectively. Phoenix offers optional bodily injury liability coverage up to \$100,000 per person and \$300,000 per accident, and property damage liability coverage up to \$50,000, for both programs.

All purchasers of Hallmark and Phoenix policies are individuals. No single customer or group of related customers has accounted for more than 1% of net premiums written during any of the last three years.

The Company currently writes monthly and six-month policies. The Company's core net premium volume was composed of a policy mix of 51.8% monthly and 48.2% six-month policies in 2004; 6.2% annual, 43.6% monthly and 50.2% six-month policies in 2003; and 50.7% annual, 46.1% monthly and 3.2% six-month policies in 2002. The Company discontinued writing annual premium financed policies in July 2003 in order to focus on products which are more competitive in the current marketplace. The Company's typical customer is unable or unwilling to pay a half year's premium in advance. Accordingly, the Company currently offers monthly policies and six-month policies, the premiums for which are directly billed to the insured on a monthly basis.

HCS provides claims adjustment and related litigation services to both the Company and unaffiliated MGAs. Fees are charged on a per-file basis, as a percentage of earned premiums or, in certain instances, a combination of both methods. When HCS receives notice of a loss, a claim file and an estimated loss reserve are established. HCS's adjusters review, investigate and initiate claim payments. The Company has an in-house litigation department that closely manages its claims-related litigation. Management believes that the Company achieves superior efficiency and cost effectiveness by principally utilizing its trained employee-adjusters and in-house litigation department.

The following table shows, for each of the years in the three year period ended December 31, 2004 (i) the amount of the Personal Lines Group gross premiums written, and (ii) the underwriting results, of the Personal Lines Group, as measured by the net statutory loss and loss adjustment expense ("LAE") ratio, the statutory expense ratio, and the statutory combined ratio for the calendar year. The loss and LAE ratio is the ratio of incurred losses and LAE to net premiums earned, the statutory expense ratio is the ratio of underwriting and operating expenses to net premiums written, and the combined ratio is the sum of the loss and LAE ratio and the statutory expense ratio.

	2004	2003	2002
Gross Premiums Written	\$33,389	\$43,338	\$51,643
Statutory Loss & LAE Ratio	60.4%	72.5%	76.8%
Statutory Expense Ratio	28.3%	28.6%	19.5%
Statutory Combined Ratio	88.7%	101.1%	96.3%

COMMERCIAL LINES GROUP OPERATIONS

The Company's Commercial Lines Group consists of a regional managing general agency and a third party claims administration company which were acquired December 1, 2002. HGA markets commercial insurance policies through an independent agency force primarily in the non-urban areas of Texas, New Mexico, Idaho, Oregon, and Washington. ECM administers the claims on insurance policies produced by HGA. These insurance policies consist of small to medium sized commercial risks, which as a group have relatively stable loss ratios. The Commercial Lines Group's underwriting criteria exclude lines of business and classes of risks that are considered to be high hazard or volatile, or which involve significant latent injury potential or other long-tail liability exposures. Selection criteria include specific classes of businesses, occupancies, and operations with lower hazard ratings, which present a relatively lower exposure to loss and are charged a correspondingly lower premium. The lines of business underwritten are primarily commercial auto, commercial multi-peril, business owner's package policy, umbrella and other liability.

HGA currently markets these policies on behalf of CNIC. HGA earns a commission based on a percentage of the earned premium it produces for CNIC. The commission percentage is determined by the underwriting results of the policies produced for CNIC. ECM receives a claim servicing fee based on a percentage of the earned premium produced for CNIC, with a portion deferred for casualty claims.

UNDERWRITING AND OTHER RATIOS

An insurance company's underwriting performance is traditionally measured by its statutory loss and LAE ratio, its statutory expense ratio and its statutory combined ratio. The statutory loss and LAE ratio, which is calculated as the ratio of net losses and LAE incurred to net premiums earned, helps to assess the adequacy of the insurer's rates, the propriety of its underwriting guidelines and the performance of its claims department. The statutory expense ratio, which is calculated as the ratio of underwriting and operating expenses to net premiums written, assists in measuring the insurer's cost of processing and managing the business. The statutory combined ratio, which is the sum of the statutory loss and LAE ratio and the statutory expense ratio, is indicative of the overall profitability of an insurer's underwriting activities, with a combined ratio of less than 100% indicating profitable underwriting results.

During 2004, 2003 and 2002, the Company experienced statutory loss and LAE ratios of 60.4%, 72.5% and 76.8%, respectively. During the same periods, it experienced statutory expense ratios of 28.3%, 28.6% and 19.5%, respectively, and statutory combined ratios of 88.7%, 101.1% and 96.3%, respectively. These statutory ratios do not reflect the deferral of policy acquisition costs, investment income, premium finance revenues, or the elimination of inter-company transactions required by accounting principles generally accepted in the United States of America ("GAAP").

The statutory expense ratio for 2003 increased over the 2002 statutory expense ratio primarily as a result of the change in the reinsurance structure effective April 1, 2003. Under the prior structure, Hallmark assumed 100% of the Texas non-standard automobile business produced by AHGA and underwritten by State & County and retroceded a portion to Dorinco Reinsurance Company ("Dorinco"). Under this arrangement, the ceding commission from Dorinco was treated as an offset to Hallmark's underwriting expenses. Beginning April 1, 2003, Dorinco directly assumed its share of the Texas non-standard automobile business produced by AHGA and underwritten either by State & County (for policies written from April 1, 2003 through September 30, 2003) or OACM (for policies written from October 1, 2003 through September 30, 2004). Under this arrangement, ceding commissions from Dorinco were treated as revenue to AHGA rather than an offset to the underwriting expenses of Hallmark. Effective October 1, 2004, Hallmark entered into a new quota share reinsurance agreement with OACM pursuant to which Hallmark assumes and retains the reinsurance of 100% of the Texas non-standard automobile policies produced by AHGA.

Under Texas Department of Insurance ("TDI") and Arizona Department of Insurance ("AZDOI") guidelines, property and casualty insurance companies are expected to maintain a premium-to-surplus percentage of not more than 300%. The premium-to-surplus percentage measures the relationship between net premiums written in a given period (premiums written, less returned premiums and reinsurance ceded to other carriers) to surplus (admitted assets less liabilities), all determined on the basis of statutory accounting practices ("SAP") prescribed or permitted by insurance regulatory authorities. For 2004, 2003, and 2002, Hallmark's premium-to-surplus percentages were 122%, 150% and 263%, respectively. Phoenix's premium-to-surplus percentages were 135% and 215% for 2004 and 2003, respectively.

REINSURANCE ARRANGEMENTS

For policies originated prior to April 1, 2003, Hallmark assumed the reinsurance of 100% of the Texas non-standard auto business produced by AHGA and underwritten by State & County and retroceded 55% of the business to Dorinco. Under this arrangement, Hallmark remained obligated to policyholders in the event that Dorinco did not meet its obligations under the retrocession agreement. From April 1, 2003 through September 30, 2004, Hallmark assumed the reinsurance of 45% of the Texas non-standard automobile policies produced by AHGA and underwritten either by State & County (for policies written from April 1, 2003 through September 30, 2003) or OACM (for policies written from October 1, 2003 through September 30, 2004). During this period, the remaining 55% of each policy was directly assumed by Dorinco. Under these reinsurance arrangements, Hallmark was obligated to policyholders only for the portion of the risk assumed by Hallmark. Effective October 1, 2004, Hallmark assumes and retains the reinsurance of 100% of the Texas non-standard automobile policies produced by AHGA and underwritten by OACM. Phoenix underwrites its own policies and does not cede any portion of the business to reinsurers.

Under Hallmark's prior insurance arrangements, the Company earned ceding commissions based on Dorinco's loss ratio experience on the portion of policies reinsured by Dorinco. The Company received a provisional commission as policies were produced as an advance against the later determination of the commission actually earned. The provisional commission is adjusted periodically on a sliding scale based on expected loss ratios. As of December 31, 2004 and 2003, the accrued ceding commission payable to Dorinco was \$1.0 million and \$1.2 million, respectively. This accrual represents the difference between the provisional ceding commission received and the ceding commission earned based on current loss ratios.

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

(In thousands)	2004	2003	2002
Gross premiums written	\$33,389	\$ 43,338	\$ 51,643
Ceded premiums written	(322)	(6,769)	(29,611)
Net premiums written	\$33,067	\$ 36,569	\$ 22,032
Gross premiums earned	\$33,058	\$ 57,447	\$ 52,486
Ceded premiums earned	(613)	(15,472)	(32,273)
Net premiums earned	\$32,445	\$ 41,975	\$ 20,213
Reinsurance recoveries	\$ 163	\$ 11,071	\$ 21,161

MARKETING

The Company's customers for non-standard automobile insurance typically fall into two groups. The first are drivers who do not meet the underwriting qualifications for standard auto insurance due to driving record, claims history, residency status, type of vehicle, or adverse credit history. The second group is drivers who live in areas in which there is limited availability of standard rate insurance.

AHGA acts as a managing general agency for OACM to manage 519 independent agents in Texas writing non-standard automobile policies. Phoenix's policies are generated through 150 independent agents in New Mexico and Arizona. Field marketing representatives promote the Company's non-standard automobile insurance programs to prospective independent agents and service existing independent agents. The independent agents represent other insurers and sell other insurance products in addition to the Company's policies. During fiscal 2004, the top 10 independent agency groups produced 21%, and no individual agency group produced more than 4%, of the total premium volume of the Personal Lines Group.

HGA markets commercial insurance policies through a force of approximately 150 independent agencies primarily in the rural areas of Texas, New Mexico, Idaho, Oregon, and Washington. HGA targets customers that are in low hazard classifications in the standard commercial market (typically referred to as “main street” accounts). The typical customer is a small to medium sized business and will have a policy that covers property, general liability and auto exposures. HGA has historically maintained excellent relationships with its producing agents. During fiscal 2004, the top 10 independent agency groups produced 32%, and no individual agency group produced more than 7%, of the total premium volume of the Commercial Lines Group.

COMPETITION

The property and casualty insurance market, the Company’s primary source of revenue, is highly competitive and, except for regulatory considerations, has very few barriers to entry. According to A.M. Best Company, Inc., there were 3,107 property and casualty insurance companies and 1,980 property and casualty insurance groups operating in North America as of July 22, 2004. Although the Company’s Personal Lines Group competes with large national insurers such as Allstate, State Farm and Progressive, as a participant in the non-standard personal automobile marketplace, the Company’s competition is most directly associated with numerous regional companies and managing general agencies. The Company’s Commercial Lines Group competes with a variety of large national standard commercial lines carriers such as Hartford, Zurich, St. Paul Travelers and Safeco, as well as numerous smaller regional companies. The Company’s competitors include entities which have, or are affiliated with entities which have, greater financial and other resources than the Company.

Generally, the Company competes based upon price, customer service, coverages offered, claims handling, financial stability, agent commission and support, customer recognition and geographic coverage. The Company competes with companies using independent agents, captive agent networks, direct marketing channels, or a combination thereof.

The competitive environment in the personal non-standard automobile market has historically been driven primarily by reinsurance capacity and terms, but the current environment is increasingly impacted by newly capitalized or recapitalized carriers or holding company groups, such as Direct General Corporation, Bristol West Holdings, Infinity Property and Casualty, and Affirmative Insurance Holdings. The current reinsurance market remains disciplined and terms offered provide a barrier to entry for new programs and/or limitations on an existing program manager’s authority to reduce premium rates without justification. Although the reinsurance market remains a significant factor, the current competitive pressures are perceived by management to be driven in large part by the newly capitalized entities requiring premium growth either organically or through acquisitions to meet expected revenue targets and return on equity. This pressure has resulted in a general bias towards neutral overall rate adjustments with targeted rate decreases.

The Commercial Lines Group experienced some increased rate pressure in 2004. However, because the Company focuses the distribution of its commercial products to the smaller non-urban markets that are less price sensitive, the Company was able to obtain an overall rate increase of approximately 5% in 2004. Management believes this rate pressure will continue through 2005 and is not projecting rate increases for its commercial products for years beyond 2005.

INSURANCE REGULATION

The operations of Hallmark, AHGA and HFC are regulated by the TDI. AZDOI regulates the operations of Phoenix. Hallmark and Phoenix are required to file quarterly and annual statements of their financial condition with TDI and AZDOI, respectively, prepared in accordance with SAP. Hallmark’s and Phoenix’s financial condition, including the adequacy of surplus, loss reserves and investments, is subject to review by TDI and AZDOI, respectively. Hallmark does not write its insurance directly, but assumes business written through a county mutual insurance company. Under Texas insurance regulation, premium rates and underwriting guidelines of county mutuals are not subject to the same degree of regulation imposed on standard insurance companies. AHGA is also subject to TDI licensing requirements. HFC is subject to licensing, financial reporting and certain financial requirements imposed by TDI and is also regulated by the Texas Office of Consumer Credit Commissioner.

TDI and AZDOI have broad authority to enforce insurance laws and regulations through examinations, administrative orders, civil and criminal enforcement proceedings, and suspension or revocation of an insurer's certificate of authority or an agent's license. In extreme cases, including actual or pending insolvency, they may take over, or appoint a receiver to take over, the management or operations of an insurer or an agent's business or assets. In addition, all insurance companies are subject to assessments for state administered funds which cover the claims and expenses of insolvent or impaired insurers. The size of the assessment is determined each year by the total claims on the fund that year. Each insurer is assessed a pro-rata share based on its direct premiums written. Payments to the fund may be recovered by the insurer through deductions from its premium taxes at a rate of 10% per year over ten years.

HFS is also regulated as an insurance holding company by TDI and AZDOI. Financial transactions between HFS or any of its affiliates and Hallmark or Phoenix are subject to regulation. Applicable regulations require approval of management and expense sharing contracts, inter-company loans and asset transactions, investments in the Company's securities by Hallmark or Phoenix and similar transactions. Further, dividends and distributions to HFS by Hallmark or Phoenix are restricted.

The National Association of Insurance Commissioners ("NAIC") requires property/casualty insurers to file a risk-based capital ("RBC") calculation according to a specified formula. The purpose of the NAIC-designed 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. Hallmark's 2004, 2003 and 2002 adjusted capital under the RBC calculation exceeded the minimum requirement by 412%, 186% and 143%, respectively. Phoenix's 2004 and 2003 adjusted capital under the RBC calculation exceeded the minimum requirement by 254% and 117%, respectively.

HGA is subject to and in compliance with the licensing requirements of the department of insurance in each state in which it produces business. Generally, each state requires one officer of HGA to maintain an agent license. Claims adjusters employed by ECM and HCS are also subject to the licensing requirements of each state in which they conduct business. Each claims adjuster employed by the Company either holds or has applied for the required licenses.

ANALYSIS OF HALLMARK'S LOSSES AND LAE

The Company's consolidated financial statements include an estimated reserve for unpaid losses and LAE. The Company estimates its reserve for unpaid losses and LAE by using case-basis evaluations and statistical projections, which include inferences from both losses paid and losses incurred. The Company also uses recent historical cost data, periodic reviews of underwriting standards and claims management to modify the statistical projections. The Company gives consideration to the impact of inflation in determining its loss reserves, but does not discount reserve balances.

The amount of reserves represents management's estimates of the ultimate net cost of all unpaid losses and LAE incurred through December of each year. These estimates are subject to the effect of trends in claim severity and frequency. Management continually reviews the estimates and adjusts them as claims experience develops and new information becomes known. Such adjustments are included in current operations, including increases and decreases, net of reinsurance, in the estimate of ultimate liabilities for insured events of prior years.

Changes in loss development patterns and claim payments can significantly affect the ability of insurers to estimate reserves for unpaid losses and related expenses. The Company seeks to continually improve its loss estimation process by refining its ability to analyze loss development patterns, claim payments and other information within a legal and regulatory environment which affects development of ultimate liabilities. Future changes in estimates of claim costs may adversely affect future period operating results. However, such effects cannot be reasonably estimated currently.

Reconciliation of Reserve for Unpaid Losses and LAE. The following table provides a 2004, 2003 and 2002 reconciliation of the beginning and ending reserve balances, on a gross-of-reinsurance basis, to the gross amounts reported in the Company's balance sheet at December 31, 2004, 2003 and 2002 (in thousands):

	2004	2003	2002
Reserve for unpaid losses and LAE, net of reinsurance recoverables, January 1	\$21,197	\$ 8,411	\$ 7,919
Acquisition of Phoenix January 1, 2003	–	10,338	–
Provision for losses and LAE for claims occurring in the current period	20,331	29,724	15,125
Increase (decrease) in reserve for unpaid losses and LAE for claims occurring in prior periods	(1,194)	464	177
Payments for losses and LAE, net of reinsurance:			
Current period	(10,417)	(21,895)	(9,119)
Prior periods	(12,217)	(5,845)	(5,691)
Reserve for unpaid losses and LAE at December 31, net of reinsurance recoverable	\$17,700	\$21,197	\$ 8,411
Reinsurance recoverable on unpaid losses and LAE at December 31	1,948	7,259	9,256
Reserve for unpaid losses and LAE at December 31, gross of reinsurance	\$19,648	\$28,456	\$17,667

The \$1.2 million favorable development in prior accident years recognized in 2004 represents normal changes in actuarial estimates which had a \$0.8 million favorable impact on reinsurance recoverable. The 2003 provision for losses and LAE for claims occurring in the current period includes a \$2.1 million settlement of a bad faith claim, net of reinsurance, and adverse development primarily related to newly acquired business.

SAP/GAAP Reserve Reconciliation. The differences between the reserves for unpaid losses and LAE reported in the Company's consolidated financial statements prepared in accordance with GAAP and those reported in the annual statements filed with TDI and AZDOI in accordance with SAP for years 2004 and 2003 are summarized below (in thousands):

	December 31	
	2004	2003
Reserve for unpaid losses and LAE on a SAP basis (net of reinsurance recoverables on unpaid losses)	\$16,416	\$21,132
Loss reserve discount from the Phoenix acquisition	(80)	(155)
Unamortized risk premium reserve discount from the Phoenix acquisition	114	220
Estimated future unallocated LAE reserve for HCS*	1,250	–
Reserve for unpaid losses and LAE on a GAAP basis (net of reinsurance recoverables on unpaid losses)	\$17,700	\$21,197

*New agreement for 2004.

ANALYSIS OF LOSS AND LAE RESERVE DEVELOPMENT

The following table shows the development of the Company's loss reserves, net of reinsurance, for 1994 through 2004. Section A of the table shows the estimated liability for unpaid losses and LAE, net of reinsurance, recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of losses and LAE for claims arising in prior years that are unpaid at the balance sheet date, including losses that have been incurred but not yet reported to Hallmark. Section B of the table shows the re-estimated amount of the previously recorded liability, based on experience as of the end of each succeeding year. The estimate is increased or decreased as more information becomes known about the frequency and severity of claims.

Cumulative Redundancy/Deficiency (Section C of the table) represents the aggregate change in the estimates over all prior years. Thus, changes in ultimate development estimates are included in operations over a number of years, minimizing the significance of such changes in any one year.

INVESTMENT POLICY

The Company's investment objective is to maximize current yield while maintaining safety of capital together with sufficient liquidity for ongoing insurance operations. The investment portfolio is composed of fixed income and equity securities. The fixed income securities are made up of 74.1% state and local securities, 17.2% corporate securities, 8.6% U.S. Government or U.S. Government agency securities and 0.1% mortgage-backed securities. The average maturity of the Company's fixed income portfolio as of December 31, 2004 is 5.9 years. The fair value of the Company's fixed income securities as of December 31, 2004 was \$30.8 million, of which \$2.6 million is classified as restricted investments. If market rates were to change 1%, the fair value of the company's fixed income securities would change approximately \$1.5 million as of December 31, 2004.

In addition, as part of the Company's overall investment strategy, the Company maintains an integrated cash management system utilizing on-line banking services and daily overnight investment accounts to maximize investment earnings on all available cash. During 2004, the Company's investment income totaled approximately \$1.4 million compared to approximately \$1.2 million for 2003.

EMPLOYEES

On December 31, 2004, the Company employed 179 people on a full-time basis as compared to 186 people at December 31, 2003. None of the Company's employees are represented by labor unions. The Company considers its employee relations to be excellent.

ITEM 2. PROPERTIES.

The Company's corporate headquarters and Commercial Lines Group are located at 777 Main Street, Suite 1000, Fort Worth, Texas. The suite is located in a high-rise office building and contains approximately 27,808 square feet of space. Effective June 1, 2003, the Company negotiated its lease for a period of 97 months to expire June 30, 2011. The rent is currently \$31,168 per month.

The Company's Personal Lines Group is located at 14651 Dallas Parkway, Suite 400, Dallas, Texas. The suite is located in a high-rise office building and contains approximately 25,559 square feet of space. The Company renegotiated its lease on May 5, 2003 for a period of 66 months to expire November 30, 2008. The rent is currently \$50,075 per month.

ITEM 3. LEGAL PROCEEDINGS.

The Company is engaged in various legal proceedings which are routine in nature and incidental to the Company's business. None of these proceedings, either individually or in the aggregate, are believed, in the opinion of management, to have a material adverse effect on the consolidated financial position of the Company or the results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

During the fourth quarter of 2004, the Company did not submit any matter to a vote of its security holders.

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

MARKET FOR COMMON STOCK

The Company's common stock has traded on the American Stock Exchange's Emerging Company Marketplace under the symbol "HAFEC" since January 6, 1994. The following table shows the high and low sales prices of the Company's common stock on the AMEX Emerging Company Marketplace for each quarter since January 1, 2003.

Period	High Sale	Low Sale
2003		
First Quarter	\$0.75	\$0.50
Second Quarter	0.95	0.65
Third Quarter	1.15	0.31
Fourth Quarter	0.80	0.50
2004		
First Quarter	\$0.79	\$0.45
Second Quarter	0.90	0.60
Third Quarter	1.20	0.75
Fourth Quarter	1.40	0.75
2005		
First Quarter (through March 18, 2005)	\$1.60	\$1.11

As of February 28, 2005 there were approximately 156 shareholders of record of the Company's common stock.

DIVIDENDS

The Company has never paid dividends on its Common Stock. The Board of Directors intends to continue this policy for the foreseeable future in order to retain earnings for development of the Company's business.

EQUITY COMPENSATION PLAN INFORMATION

The following table provides information as of December 31, 2004, concerning common stock of the Company that may subsequently be issued upon the exercise of incentive stock options and nonqualified stock options granted to directors, officers and key employees of the Company:

Plan Category	Number of securities to be issued upon exercise of outstanding Options, warrants and Rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)] (c)
Equity compensation plans approved by security holders	1,208,500	\$0.65	– 0 –
Equity compensation plans not approved by security holders ¹	150,000	\$0.38	– 0 –
Total	1,358,500	\$0.62	– 0 –

¹) Represents nonqualified options granted to independent directors in lieu of fees for board service in 1999.

ITEM 6. SELECTED FINANCIAL DATA.

(In thousands, except per share amounts)	2004	2003 ^{1,2}	2002 ^{1,3}	2001	2000
Gross premiums written	\$33,389	\$43,338	\$ 51,643	\$ 49,614	\$ 50,469
Ceded premiums written	(322)	(6,769)	(29,611)	(33,822)	(31,396)
Net premiums written	33,067	36,569	22,032	15,792	19,073
Change in unearned premiums	(622)	5,406	(1,819)	584	(1,678)
Net premiums earned	32,445	41,975	20,213	16,376	17,395
Investment income, net of expenses	1,386	1,198	773	1,043	1,264
Realized losses	(27)	(88)	(5)	—	—
Finance charges	2,183	3,544	2,503	3,095	2,926
Commission and fees	21,100	17,544	1,108	—	—
Processing and service fees	6,003	4,900	921	1,120	1,952
Other income	31	486	284	368	348
Total revenues	63,121	69,559	25,797	22,002	23,885
Loss and loss adjustment expenses	19,137	30,188	15,302	15,878	14,558
Other operating costs and expenses	35,290	37,386	9,474	6,620	7,858
Interest expense	64	1,271	983	1,021	1,138
Amortization of intangible assets	28	28	2	157	157
Litigation costs	—	—	—	—	435
Total expenses	54,519	68,873	25,761	23,676	24,146
Income (loss) before income tax, cumulative effect of change in accounting principle and extraordinary gain	8,602	686	36	(1,674)	(261)
Income tax expense (benefit)	2,753	25	13	(544)	(28)
Income (loss) before cumulative effect of change in accounting principle and extraordinary gain	5,849	661	23	(1,130)	(233)
Cumulative effect of change in accounting principle, net of tax	—	—	(1,694)	—	—
Extraordinary gain	—	8,084	—	—	—
Net income (loss)	\$ 5,849	\$ 8,745	\$ (1,671)	\$ (1,130)	\$ (233)
Basic earnings (loss) per share:					
Income before cumulative effect of change in accounting principle and extraordinary gain	\$ 0.16	\$ 0.03	\$ 0.00	\$ (0.10)	\$ (0.02)
Cumulative effect of change in accounting principle	0.00	0.00	(0.15)	0.00	0.00
Extraordinary gain	0.00	0.44	0.00	0.00	0.00
Net income (loss)	\$ 0.16	\$ 0.47	\$ (0.15)	\$ (0.10)	\$ (0.02)
Diluted earnings (loss) per share:					
Income before cumulative effect of change in accounting principle and extraordinary gain	\$ 0.16	\$ 0.03	\$ 0.00	\$ (0.10)	\$ (0.02)
Cumulative effect of change in accounting principle	0.00	0.00	(0.15)	0.00	0.00
Extraordinary gain	0.00	0.43	0.00	0.00	0.00
Net income (loss)	\$ 0.16	\$ 0.46	\$ (0.15)	\$ (0.10)	\$ (0.02)
Balance Sheet Items:					
Total investments	\$32,121	\$29,855	\$ 16,728	\$ 16,223	\$ 13,577
Total assets	\$82,511	\$83,853	\$ 83,761	\$ 73,605	\$ 75,553
Unpaid loss and loss adjustment expenses	\$19,648	\$28,456	\$ 17,667	\$ 20,089	\$ 22,298
Unearned premiums	\$ 6,192	\$ 5,862	\$ 15,957	\$ 16,793	\$ 16,711
Total liabilities	\$49,855	\$56,456	\$ 75,226	\$ 63,237	\$ 64,065
Total stockholders' equity	\$32,656	\$27,397	\$ 8,535	\$ 10,368	\$ 11,488
Book value per share	\$ 0.90	\$ 0.75	\$ 0.77	\$ 0.94	\$ 1.04

Notes:

1) The acquisitions of the Commercial Lines Group and Phoenix were financed through an \$8.6 million loan from a related party that was repaid from \$10 million of proceeds from the Company's rights offering in 2003.

2) In January 2003, the Company acquired Phoenix in satisfaction of \$7.0 million of a \$14.85 million balance on a note receivable due from Millers American Group, Inc. This resulted in the Company recognizing a \$8.1 million extraordinary gain in 2003.

3) In 2002, the Company adopted Statement of Financial Accounting Standards ("SFAS"), No. 142 "Goodwill and Other Intangible Assets", which prohibits amortization of goodwill and requires annual testing of goodwill for impairment. In the year of adoption, the Company recognized a charge to earnings of \$1.7 million to reflect an impairment loss that was reported as a cumulative effect of change in accounting principle. In December 2002, the Company acquired the Commercial Lines Group from Millers American Group, Inc.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion of the Company's financial condition and the results of its operations should be read in conjunction with the consolidated financial statements and related notes included in this report.

MANAGEMENT OVERVIEW

The Company's business involves marketing and underwriting of non-standard personal automobile insurance in Texas, New Mexico and Arizona; marketing commercial insurance in Texas, New Mexico, Idaho, Oregon and Washington; affiliate and third party claims administration; and other insurance related services. The Company pursues its business activities through subsidiaries organized into a Personal Lines Group, which handles non-standard personal automobile insurance, and a Commercial Lines Group, which handles commercial insurance.

For the year ended December 31, 2004, the Company reported income before extraordinary gain of \$5.8 million, representing a 785% increase over the \$0.7 million reported for the prior year. The Company reported net income of \$5.8 million for the year ended December 31, 2004, compared with net income of \$8.7 million for 2003, which included an \$8.1 million extraordinary gain related to the acquisition of a new Personal Lines Group subsidiary.

On a diluted per share basis, net income was \$0.16 for the year ended December 31, 2004, compared with net income of \$0.47 per diluted share in 2003. The decrease in net income per diluted share was primarily attributable to the combined impact of the \$8.1 million extraordinary gain in 2003 and an increase in the weighted average shares outstanding to 36.7 million diluted shares during 2004, compared to 18.8 million diluted shares during 2003, primarily as a result of a successful shareholder rights offering completed in the third quarter of 2003.

The increased operating earnings in 2004 reflect benefits achieved from the integration of recent acquisitions, ongoing initiatives to improve underwriting performance and sustained favorable market conditions. Both the Personal Lines Group and the Commercial Lines Group contributed to the enhanced operating results for 2004. The improvement in the Personal Lines Group operating earnings in 2004 was primarily driven by better underwriting results. The improvement in the Commercial Lines Group operating earnings in 2004 was driven largely by increased commission revenue attributable to the combination of increased premiums written and favorable underwriting performance.

CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

The Company's significant accounting policies requiring management estimates and judgments are discussed below. Such estimates and judgments are based on historical experience, changes in laws and regulations, observance of industry trends and information received from third parties. While the estimates and judgments associated with the application of these accounting policies may be affected by different assumptions or conditions, the Company believes the estimates and judgments associated with the reported consolidated financial statement amounts are appropriate in the circumstances. For additional discussion of the Company's accounting policies, see Note 1 to the consolidated financial statements included in this report.

Investments. The Company completes a detailed analysis each quarter to assess whether the decline in the fair value of any investment below cost is deemed other-than-temporary. All securities with an unrealized loss are reviewed. Unless other factors cause us to reach a contrary conclusion, investments with a fair market value less than cost for more than 180 days are deemed to have a decline in value that is other-than-temporary. A decline in value that is considered to be other-than-temporary is charged to earnings based on the fair value of the security at the time of assessment, resulting in a new cost basis for the security.

Risks and uncertainties are inherent in the Company's other-than-temporary decline in value assessment methodology. Risks and uncertainties include, but are not limited to, incorrect or overly optimistic assumptions about financial condition or liquidity, incorrect or overly optimistic assumptions about future prospects, unfavorable changes in economic or social conditions and unfavorable changes in interest rates or credit ratings.

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. Ceding commissions from reinsurers, which include expense allowances, are deferred and recognized over the period premiums are earned for the underlying policies reinsured.

The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. A premium deficiency exists if the sum of expected claim costs and claim adjustment expenses, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums and expected investment income on those unearned premiums, as computed on a product line basis. The Company routinely evaluates the realizability of deferred policy acquisition costs. At December 31, 2004 and 2003, there was no premium deficiency related to deferred policy acquisition costs.

Goodwill. The Company's consolidated balance sheet as of December 31, 2004 includes goodwill of acquired businesses of approximately \$4.8 million. This amount has been recorded as a result of prior business acquisitions accounted for under the purchase method of accounting. Under SFAS 142, "Goodwill and Other Intangible Assets", which the Company adopted as of January 1, 2002, goodwill is tested for impairment annually. The Company completed its annual test for impairment during the fourth quarter of 2004 and determined that there was no indication of impairment.

A significant amount of judgment is required in performing goodwill impairment tests. Such tests include estimating the fair value of the Company's reporting units. As required by SFAS 142, the Company compares the estimated fair value of each reporting unit with its carrying amount, including goodwill. Under Statement No. 142, fair value refers to the amount for which the entire reporting unit may be bought or sold. Methods for estimating reporting unit values include market quotations, asset and liability fair values and other valuation techniques, such as discounted cash flows and multiples of earnings or revenues. With the exception of market quotations, all of these methods involve significant estimates and assumptions.

Deferred Tax Assets. The Company files 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. A valuation allowance is provided against the Company's deferred tax asset to the extent that management does not believe it is more likely than not that future taxable income will be adequate to realize these future tax benefits. This valuation allowance was \$884,000 at December 31, 2004 and 2003. This valuation allowance was necessary due to the limitation imposed by Section 382 of the Internal Revenue Code on utilizing the net operating loss acquired as part of the Phoenix acquisition.

Reserves for Unpaid Losses and Loss Adjustment Expenses. Reserves for unpaid losses and LAE are established by the Company for claims which have already been incurred by the policyholder but which have not been paid by the Company. Losses and LAE represent the estimated ultimate net cost of all reported and unreported losses incurred through December 31, 2004 and 2003. The reserves for unpaid losses and LAE are estimated using individual case-basis valuations and statistical analyses. These estimates are subject to the effects of trends in loss severity and frequency. See, "Item 1. Business – Analysis of Hallmark's Losses and LAE" and "-Analysis of Loss and LAE Reserve."

Although considerable variability is inherent in such estimates, management believes that the reserves for unpaid losses and LAE are adequate. Due to the inherent uncertainty in estimating unpaid losses and LAE, the actual ultimate amounts may differ from the recorded amounts. A small percentage change could result in a material effect on reported earnings. For example, a 1% change in December 31, 2004 unpaid losses and LAE would produce a \$196 thousand change to pre-tax earnings. The estimates are continually reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations.

The range of unpaid losses and LAE estimated by the Company's actuaries as of December 31, 2004 was \$13.0 million to \$22.3 million. Management's best estimate of unpaid losses and LAE as of December 31, 2004 is \$19.6 million. In setting this estimate of unpaid losses and LAE, management has assumed, among other things, that current trends in loss frequency and severity will continue and that the actuarial analysis was empirically valid. In the absence of any specific factors indicating actual experience at either extreme of the actuarial range, management has established a best estimate of unpaid losses and LAE, which is approximately \$1.9 million higher than the midpoint of the actuarial range. The actuarial range is determined independently of management's best estimate and is only used to check the reasonableness of that estimate. It would be expected that management's best estimate would move within the actuarial range from year to year due to changes in the Company's operations and changes within the marketplace.

The Company's reserve requirements are also interrelated with product pricing and profitability. The Company must price its products at a level sufficient to fund its policyholder benefits and still remain profitable. Because the Company's claim expenses represent the single largest category of its expenses, inaccuracies in the assumptions used to estimate the amount of such benefits can result in the Company failing to price its products appropriately and to generate sufficient premiums to fund its operations.

Ceding Commissions of the Personal Lines Group. Under Hallmark's reinsurance arrangements prior to October 1, 2004, the Company earned ceding commissions based on Dorinco's loss ratio (ultimate losses and loss expenses incurred to earned premium) experience on the portion of policies reinsured by Dorinco. The Company received a provisional commission as policies were produced as an advance against the later determination of the commission actually earned. The ceding commission is an estimate that varies with the estimated loss ratio and is sensitive to changes in that estimate. The provisional commission is adjusted periodically on a sliding scale based on expected loss ratios. The following table details the ceding commission sensitivity to the actual ultimate loss ratio for each effective quota share treaty with Dorinco at 0.5% above and below the provisional loss ratio.

	Treaty Effective Dates					
	4/1/01- 6/30/01	7/1/01- 9/30/01	10/1/01- 9/30/02	10/1/02- 3/31/03	4/1/03- 9/30/03	10/1/03- 9/30/04
Provisional loss ratio	65.0%	65.0%	65.5%	65.5%	61.0%	62.5%
Ultimate loss ratio booked at 12/31/04	77.0%	78.3%	67.5%	61.0%	65.5%	65.5%
Effect of actual 0.5% above provisional	\$(45,359)	\$(37,073)	\$(157,346)	\$(76,516)	\$(40,717)	\$(69,411)
Effect of actual 0.5% below provisional	\$ 45,359	\$ 37,073	\$ 157,346	\$ 76,516	\$ 40,717	\$ 69,411

Recognition of Profit Sharing Commission Revenues of the Commercial Lines Group. Profit sharing commission of the Commercial Lines Group is calculated and recognized when the loss ratio, as determined by a qualified actuary, deviates from contractual thresholds. 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 at 0.5% above and below the provisional loss ratio.

	Treaty Effective Dates			
	7/1/01- 6/30/02	7/1/02- 6/30/03	7/1/03- 6/30/04	7/1/04- 6/30/05
Provisional loss ratio	60.0%	59.0%	59.0%	64.2%
Ultimate loss ratio booked to at 12/31/04	57.5%	58.5%	59.0%	62.2%
Effect of actual 0.5% above provisional	\$(199,402)	\$(305,122)	\$(298,457)	\$(44,755)
Effect of actual 0.5% below provisional	\$ 139,581	\$ 201,381	\$ 196,982	\$ 44,755

LIQUIDITY AND CAPITAL RESOURCES

The Company's sources of funds are principally derived from insurance related operations. The major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), ceding commissions, and processing and service fees. Other sources of funds are from financing and investment activities.

On a consolidated basis, the Company's cash and investments increased approximately 11.5% as of December 31, 2004 as compared to December 31, 2003. This was primarily a result of improved underwriting results and increased commercial premium volume in 2004. The Company's consolidated cash, cash equivalents and investments at December 31, 2004 and 2003 were \$45.0 million and \$40.4 million, respectively. These amounts exclude restricted cash and investments of \$6.5 million and \$5.4 million, respectively, which primarily secures the credit exposure of OACM and State & County on their quota share reinsurance treaties with Hallmark.

The Company's operating activities provided \$7.3 million in net cash during 2004 as compared to \$0.7 million in 2003. The Company collected \$3.5 million more in ceding commissions in 2004 as a result of increased commission premium volume, paid \$2.0 million less in loss and LAE, net of reinsurance, as a result of improved underwriting performance, and paid \$1.4 million less in interest as a result of repaying a related party promissory note in 2003. These cash flow improvements were partially offset by a \$0.4 million reduction in other income collected due to the sale of the Company's retail agencies in the first quarter of 2003.

Cash used in investing activities during 2004 was \$4.0 million compared to cash provided by investing activities of \$11.7 million in 2003. Premium finance notes repaid over notes originated decreased by \$11.5 million in 2004 over 2003 due to the discontinuation of the premium finance program in 2003. During 2003, the Company received \$6.9 million in cash from the acquisition of Phoenix. During 2004, the Company purchased \$0.2 million more in investment securities than it redeemed whereas in 2003 the Company purchased \$2.0 million more in investment securities that it redeemed. The Company also transferred \$0.8 million less from cash and investments to restricted trust accounts in 2004 than in 2003. These restricted trust accounts are established to secure the credit exposure of OACM and State & County from their quota share reinsurance treaties with Hallmark.

Cash used in financing activities decreased by \$9.4 million during 2004 as compared to 2003 primarily due to the discontinuation of the Company's premium finance program in 2003. The Company had net repayments to the premium finance lender of \$10.9 million in 2003 which paid off all outstanding advances. Also contributing to the decrease in cash used in financing activities in 2004 was the repayment of an \$8.6 million promissory note to a related party in 2003 from \$10.0 million in proceeds from a rights offering the Company completed in the third quarter of 2003.

HFS is dependent on dividend payments and management fees from its insurance company operations and free cash flow of its non-insurance companies to meet operating expenses and debt obligations. As of December 31, 2004, cash and invested assets of HFS were \$0.6 million. Cash and invested assets of non-insurance subsidiaries were \$8.1 million as of December 31, 2004. Property and casualty insurance companies domiciled in the State of Texas are limited in the payment of dividends to their shareholders in any twelve-month period, without the prior written consent of the Commissioner 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. During 2004, Hallmark's ordinary dividend capacity was \$2.2 million. During 2004, Hallmark paid \$0.2 million in dividends to HFS that were declared in 2003. Based on surplus at December 31, 2004, Hallmark could pay up to \$1.5 million in dividends to HFS during 2005 without TDI approval. Phoenix, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholder surplus or prior year's net investment income, without prior written approval from the AZDOI. During 2004, Phoenix's ordinary dividend capacity was \$0.6 million. In order to strengthen policyholder surplus, Phoenix did not declare any dividends in 2004. The maximum dividend that Phoenix can pay HFS in 2005 without prior approval of the AZDOI is \$0.8 million.

TDI regulates financial transactions between Hallmark, HFS and affiliated companies. Applicable regulations require TDI's approval of management and expense sharing contracts and similar transactions. Although TDI has approved Hallmark's

payment of management fees to HFS and commissions to AHGA, since the second half of 2000 management has elected not to pay all the approved commissions or management fees. AHGA paid management fees of \$0.6 million to HFS during 2004 and 2003.

The AZDOI regulates financial transactions between Phoenix and affiliated companies. Applicable regulations require AZDOI's approval of management and expense sharing contracts and similar transactions. Phoenix paid \$1.2 million in management fees to AHGA during 2004 and paid no management fees in 2003.

Statutory capital and surplus is calculated as statutory assets less statutory liabilities. TDI requires that Hallmark maintain minimum statutory capital and surplus of \$2.0 million and AZDOI requires that Phoenix maintain minimum statutory capital and surplus of \$1.5 million. As of December 31, 2004, Hallmark and Phoenix exceeded the minimum required statutory capital and surplus by 477% and 836%, respectively. At December 31, 2004, Hallmark reported statutory capital and surplus of \$11.5 million, which reflects an increase of \$1.5 million from the \$10.0 million reported at December 31, 2003. At December 31, 2004, Phoenix reported statutory capital and surplus of \$14.0 million, which is \$3.9 million more than the \$10.1 million reported at December 31, 2003. Hallmark reported statutory net income of \$1.5 million during 2004 compared to \$2.2 million in 2003. Phoenix reported statutory net income of \$3.4 million during 2004 compared to a statutory net loss of \$0.3 million in 2003. At December 31, 2004, Hallmark's premium-to-surplus percentage was 122% as compared to 150% for the year ended December 31, 2003. Phoenix's premium-to-surplus percentage was 135% for the year ended December 31, 2004 as compared to 215% for the year ended December 31, 2003.

Information regarding the Company's contractual obligations under operating leases as of December 31, 2004 is incorporated by reference to Note 13 of the consolidated financial statements included in this report.

Based on 2005 budgeted and year-to-date cash flow information, the Company believes that it has sufficient liquidity to meet its projected insurance obligations, operational expenses and capital expenditure requirements for the foreseeable future. However, management is pursuing opportunities for future growth, and additional capital may be required to fund further expansion of the Company.

RESULTS OF OPERATIONS

Fiscal 2004 Versus Fiscal 2003

Total revenues for 2004 decreased \$6.4 million, or 9.3%, as compared to 2003, primarily as a result of a \$10.1 million decline in total revenues from the Personal Lines Group partially offset by a \$3.7 million increase in total revenues from the Commercial Lines Group. However, income before tax and extraordinary gain for 2004 increased \$7.9 million as compared to 2003. The improvement in operating earnings in 2004 reflects better underwriting results for the Personal Lines Group, additional commission revenue in the Commercial Lines Group and an overall reduction in interest expense as a result of the repayment of a related party note in September 2003.

The following is additional business segment information for the twelve months ended December 31, 2004 and 2003 (in thousands):

	2004	2003
Revenues		
Personal Lines Group	\$39,555	\$49,665
Commercial Lines Group	23,563	19,891
Corporate	3	3
Consolidated	\$63,121	\$69,559
Pre-tax Income		
Personal Lines Group	\$ 8,109	\$ 1,950
Commercial Lines Group	3,028	1,311
Corporate	(2,535)	(2,575)
Consolidated	\$ 8,602	\$ 686

Personal Lines Group

Net premiums written decreased \$3.5 million, or 9.6% during 2004 to \$33.1 million compared to \$36.6 million in 2003. The decrease in net premiums written was primarily attributable to the cancellation of unprofitable agents and programs, a shift in marketing focus from annual term premium financed policies to six month term direct bill policies, a reduction in policy counts caused by targeted rate adjustments and increased competition from newly capitalized entities entering the marketplace. Net premiums earned decreased \$9.6 million, or 22.7%, to \$32.4 million in 2004 compared to \$42.0 million in 2003. Primarily as a result of the decline in net premiums earned, total revenue for the Personal Lines Group decreased \$10.1 million, or 20.4%, to \$39.6 million in 2004 compared to \$49.7 million in 2003.

Although revenue for the Personal Lines Group declined, its pre-tax income increased \$6.2 million, or 315.8%, to \$8.1 million in 2004 as compared to \$2.0 million in 2003. The increase in pre-tax income was primarily due to improved underwriting results, as evidenced by a loss and LAE ratio of 59.3% for 2004 as compared to 72.5% for 2003. Also contributing to the improved pre-tax results were reduced salary and related expenses of \$1.0 million due to the successful integration of the Phoenix operations in late 2003 and the overall reduction in premium volume and increased net investment income of \$0.2 million. These improvements were partially offset by the discontinuation of the premium finance program which caused finance charge revenue to decrease by \$1.5 million which was partially offset by reduced interest expense of \$0.4 million.

Commercial Lines Group

Total revenue for the Commercial Lines Group of \$23.6 million for 2004 was \$3.7 million, or 18.5%, more than the \$19.9 million reported for 2003. The improvement was primarily due to a \$2.9 million increase in commission revenue and a \$0.7 million increase in claim servicing revenue. Commercial premium volume growth was the primary cause of the increased commission and claim fee revenue for 2004. Earned premium generated by the Commercial Lines Group for 2004 was \$72.5 million compared to \$62.9 million for 2003. The Company does not bear the primary underwriting risk for this business and, therefore, the resulting premiums and claims are not reflected in the Company's reported results.

Pre-tax income for the Commercial Lines Group of \$3.0 million in 2004 increased \$1.7 million, or 131.0%, over the \$1.3 million reported in 2003. Increased revenue, as discussed above, was the primary reason for the increase in pre-tax income, partially offset by additional compensation and production related costs of \$2.1 million attributable to the increased premium volume.

Corporate

Corporate pre-tax loss was \$2.5 million for 2004 as compared to \$2.6 million for 2003. The Company saved \$0.8 million in interest expense in 2004 due to the repayment of a related party note in September 2003. This was partially offset by a \$0.7 million increase in salary and related expenses in 2004.

Fiscal 2003 Versus Fiscal 2002

Income before tax, cumulative effect of change in accounting principle and extraordinary gain was \$0.7 million for 2003, compared to \$36,000 in 2002. The improvement in operating earnings in 2003 reflected better underwriting results for Hallmark and the acquisition of the Commercial Lines Group in December 2002, partially offset by the acquisition of Phoenix. Net income for 2003 included \$8.1 million of extraordinary gain resulting from the acquisition of Phoenix. In consideration for Phoenix, the Company cancelled \$7.0 million of a \$14.85 million note receivable from Millers American Group, Inc. ("Millers"). The Company had valued the note receivable on its balance sheet at its cost of \$6.5 million. As of December 31, 2003, the Company fully reserved for the remaining balance of the note receivable. The gain was calculated as the difference between the fair value of the net assets of Phoenix of \$14.6 million and the \$6.5 million cost of the note receivable from Millers.

The following is additional business segment information for the twelve months ended December 31, 2003 and 2002 (in thousands):

	2003	2002
Revenues		
Personal Lines Group	\$49,665	\$23,999
Commercial Lines Group	19,891	1,561
Corporate	3	237
Consolidated	\$69,559	\$25,797
Pre-tax Income		
Personal Lines Group	\$ 1,950	\$ 1,595
Commercial Lines Group	1,311	3
Corporate	(2,575)	(1,562)
Consolidated	\$ 686	\$ 36

Personal Lines Group

Gross premiums written (prior to reinsurance) for 2003 decreased 16.1% and net premiums written (after reinsurance) increased 66.0% in relation to 2002. The decrease in gross premiums written is primarily due to the change in the reinsurance structure with Dorinco and the county mutual fronting companies (State & County and OACM). Effective April 1, 2003, the Company assumed a 45% share of the non-standard auto business produced by AHGA and underwritten by either State & County or OACM instead of the 100% share it assumed prior to that date. Also, effective April 1, 2003, Dorinco assumed its 55% share of this business directly, where prior to this date the Company retroceded 55% of the business to Dorinco. The decrease in gross premiums written was also impacted by Hallmark's cancellation of unprofitable agents, shift in marketing focus from annual term premium financed policies to six month term direct bill policies and increases in policy rates. These decreases were partially offset by the acquisition of Phoenix in 2003, which contributed \$22.4 million in gross premiums written. The increase in net premiums written is due primarily to the acquisition of Phoenix in 2003, which contributed \$21.6 million in net premiums written.

Revenue for the Personal Lines Group increased 106.9% in 2003 to \$49.7 million from \$24.0 million in 2002. The increase is due mostly to the acquisition of Phoenix, which contributed \$24.3 million in revenue in 2003 and AHGA commission revenue of \$2.5 million from Dorinco on policies effective after March 31, 2003 due to the revised reinsurance structure.

Pre-tax income for the Personal Lines Group increased \$0.4 million in 2003 to \$2.0 million as compared to \$1.6 million in 2002. Improved pricing in 2003 and Hallmark's termination of unprofitable agents in the first quarter of 2003 helped improve underwriting results (excluding Phoenix) as evidenced by a loss ratio of 66.3% in 2003 as compared to 75.9% in 2002. Partially offsetting this improvement was increased salary and related expenses (excluding Phoenix) of \$0.3 million, the discontinuation of the premium finance program which reduced finance charge revenue by \$0.5 million, partially offset by reduced interest expense of \$0.3 million, and the acquisition of Phoenix in 2003 which reported a \$0.4 million pre-tax loss. The results for Phoenix included a loss accrual of \$2.1 million, net of applicable reinsurance, for the settlement of a bad faith claim.

Commercial Lines Group

Revenue for the Commercial Lines Group of \$19.9 million in 2003 was mostly comprised of \$15.0 million of commissions earned on policies serviced by HGA for CNIC. Revenue also included \$4.6 million of processing and service fees earned by ECM for claims processing for CNIC and by FAR for accounting administration for an unaffiliated third party, the contract for which ended in April 2003. The Commercial Lines Group reported revenue of \$1.6 million for the one month ended December 31, 2002, which was mostly comprised of \$1.1 million of commissions and \$0.4 million of processing and service fees. These were new sources of revenue for the Company as a result of the acquisition of the Commercial Lines Group in December 2002.

Pre-tax income for the Commercial Lines Group of \$1.3 million in 2003 was comprised of \$19.9 million in revenue as discussed above and \$18.6 million in other operating costs and expenses. These costs primarily represented expenses associated with the production and servicing of insurance policies for CNIC, the largest component of which was independent retail agent commissions.

Corporate

Corporate pre-tax loss of \$2.6 million in 2003 increased \$1.0 million as compared to \$1.6 million for 2002. Other operating costs and expenses increased \$0.5 million mostly as a result of legal and consulting fees associated with acquisitions and other corporate matters. Additionally, the shift in management structure from 2002 to 2003 increased salary related expenses and other overhead during 2003. Interest expense was increased by \$0.6 million in 2003 due to interest on a related party note payable. Proceeds from this note were used to acquire the Commercial Lines Group and Phoenix. The Company repaid this note in September 2003 from the proceeds of a rights offering of its stock in the third quarter of 2003. Investment income decreased by \$0.2 million due to a note receivable secured by the stock of Phoenix acquired from a financial institution in the fourth quarter of 2002 being satisfied by the acquisition of Phoenix in 2003. Partially offsetting these increased expenses was \$0.3 million of amortization of a \$0.5 million risk premium reserve established in 2003 for Phoenix unpaid loss and LAE. The remainder of this reserve will be amortized into income over the next five years.

Effects of Inflation

Management does not believe that inflation has a material effect on the Company's 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 LAE. The actual effects of inflation on results of operations are not known until claims are ultimately settled. In addition to general price inflation, the Company is exposed to the upward trend in the cost of judicial awards for damages. The Company attempts to mitigate the effects of inflation in the pricing of policies and establishing loss and LAE reserves.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Management believes that interest rate risk, credit risk and equity price risk are the types of market risk to which the Company is principally exposed.

INTEREST RATE RISK

The Company's 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 the Company's fixed income securities as of December 31, 2004 was \$30.8 million. The effective duration of the portfolio as of December 31, 2004 was 4.9 years. Should the market interest rates increase 1.0%, the Company's fixed income investment portfolio would be expected to decline in market value by 4.9%, or \$1.5 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 4.9%, or \$1.5 million, increase in the market value of the fixed income investment portfolio.

CREDIT RISK

An additional exposure to the Company's fixed income securities portfolio is credit risk. Management attempts to manage the credit risk by investing only in investment-grade securities and limiting the Company's exposure to a single issuer. As of December 31, 2004, the Company's fixed income investments were invested in the following: municipal securities – 74.1%; corporate securities – 17.2%; U.S. Treasury securities – 8.6%; and mortgage-backed securities – 0.1%. As of December 31, 2004, all of the Company's fixed income securities were rated investment grade by nationally recognized statistical rating organizations.

The Company is also subject to credit risk with respect to reinsurers to whom it has ceded underwriting risk. Although a reinsurer is liable for losses to the extent of the coverage it assumes, the Company remains obligated to its 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, the Company has used financially strong reinsurers with an A.M. Best rating of “A-” or better. The Company discontinued ceding underwriting risk to reinsurers effective April 1, 2003.

EQUITY PRICE RISK

Investments in equity securities which are subject to equity price risk make up 10.4% of the Company’s portfolio. 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 the Company’s equity securities as of December 31, 2004 was \$3.6 million. The fair value of the Company’s equity securities would increase or decrease by \$1.1 million assuming a hypothetical 30.0% increase or decrease in market prices as of the balance sheet date. This would increase or decrease shareholders’ equity by 3.3%. 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
Unaudited Selected Quarterly Information	29
Report of Independent Registered Public Accounting Firm	50
Report of Independent Registered Public Accounting Firm	51
Consolidated Balance Sheets at December 31, 2004 and 2003	52
Consolidated Statements of Operations for the Years Ended December 31, 2004, 2003 and 2002	53
Consolidated Statements of Stockholders’ Equity and Comprehensive Income for the Years Ended December 31, 2004, 2003 and 2002	54-55
Consolidated Statements of Cash Flows for the Years Ended December 31, 2004, 2003 and 2002	56
Notes to Consolidated Financial Statements	57

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

On October 10, 2003, the Company dismissed PricewaterhouseCoopers LLP (“PWC”) as its independent accountants and retained KPMG LLP as its new independent accountants to audit its financial statements beginning the fiscal year ended December 31, 2003. The information required by Item 304 of Regulation S-K is incorporated by reference from the Company’s Current Report on Form 8-K filed October 17, 2003.

ITEM 9A. CONTROLS AND PROCEDURES.

The Chief Executive Officer and the Chief Financial Officer of the Company have evaluated the Company’s 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. During the most recent fiscal quarter, there have been no changes in the Company’s internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

The information required by Part III, Item 10 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the 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 Part III, Item 11 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the 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.

The information required by Part III, Item 12 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the 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.

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

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES AND REPORTS.

(a)(1) Financial Statements

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

- Report of Independent Registered Public Accounting Firm
- Report of Independent Registered Public Accounting Firm
- Consolidated Balance Sheets at December 31, 2004 and 2003
- Consolidated Statements of Operations for the Years Ended December 31, 2004, 2003 and 2002
- Consolidated Statements of Shareholders' Equity and Comprehensive Income for the Years Ended December 31, 2004, 2003 and 2002
- Consolidated Statements of Cash Flows for the Years Ended December 31, 2004, 2003 and 2002
- Notes to Consolidated Financial Statements

(a)(2) Financial Statement Schedules

Unaudited Selected Quarterly Information	Page 29
Schedule II – Condensed Financial Information of Registrant – Hallmark Financial Services, Inc. (Parent Company Only)	Pages 30-32
Schedule III – Supplemental Insurance Information	Page 33
Schedule IV – Reinsurance	Page 33
Schedule VI – Supplemental Information Concerning Property-Casualty Insurance Operations	Page 34

(a)(3) The exhibits listed in the Exhibit Index appearing at page 36 of this report are filed with or incorporated by reference in this report.

(b) Reports on Form 8-K

Form 8-K filed October 5, 2004. Item 1.01 Entry Into a Material Definitive Agreement. Report announced a new quota share reinsurance agreement between American Hallmark Insurance Company of Texas and Old American County Mutual Fire Insurance Company effective October 1, 2004.

Form 8-K filed November 12, 2004. Item 2.02 Results of Operations and Financial Condition and Item 9.01 Financial Statements and Exhibits. Report contained a press release dated November 11, 2004 announcing Hallmark's earnings for the third quarter ending September 30, 2004.

Form 8-K filed December 21, 2004. Item 1.01 Entry Into a Material Definitive Agreement. Report announced a new general agency agreement between Hallmark General Agency, Inc. and Clarendon National Insurance Company executed December 20, 2004 and retroactive to July 1, 2004.

UNAUDITED SELECTED QUARTERLY INFORMATION

	2004				2003			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Revenue	\$15,773	\$15,650	\$15,646	\$16,052	\$18,720	\$18,045	\$16,366	\$16,428
Income (loss) before extraordinary gain (loss)	1,412	1,493	1,543	1,401	403	435	220	(397)
Extraordinary gain (loss)	–	–	–	–	8,152	(36)	–	(32)
Net income (loss)	\$ 1,412	\$ 1,493	\$ 1,543	\$ 1,401	\$ 8,555	\$ 399	\$ 220	\$ (429)
Basic earnings per share ¹ :								
Income (loss) before extraordinary gain (loss)	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.01	\$ (0.01)
Extraordinary gain (loss)	–	–	–	–	\$ 0.73	–	–	–
Net income (loss)	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.77	\$ 0.04	\$ 0.01	\$ (0.01)
Diluted earnings per share ¹ :								
Income (loss) before extraordinary gain (loss)	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.01	\$ (0.01)
Extraordinary gain (loss)	–	–	–	–	\$ 0.71	\$ (0.01)	–	–
Net income (loss)	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.04	\$ 0.75	\$ 0.03	\$ 0.01	\$ (0.01)

1) The Company issued 25.0 million shares of its common stock during the third quarter of 2003 in connection with its shareholder rights offering.

SCHEDULE II – CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY ONLY)

HALLMARK FINANCIAL SERVICES, INC.

BALANCE SHEET

(In thousands)	December 31, 2004
ASSETS	
Equity securities, available-for-sale, at fair value	\$ 50
Cash and cash equivalents	578
Investment in subsidiaries	36,045
Deferred federal income taxes	983
Other assets	112
	<u>\$37,768</u>
LIABILITIES AND STOCKHOLDERS' EQUITY	
Liabilities:	
Unpaid losses and loss adjustment expenses	\$ 114
Current federal income tax payable	1,033
Accounts payable and other accrued expenses	3,965
	<u>5,112</u>
Commitments and Contingencies	
Stockholders' equity:	
Common stock, \$.03 par value, authorized 100,000,000 shares; issued 36,856,610 shares in 2004	1,106
Capital in excess of par value	19,647
Retained earnings	13,103
Accumulated other comprehensive income	(759)
Treasury stock, 379,319 shares in 2004, at cost	(441)
	<u>32,656</u>
	<u>\$37,768</u>

SCHEDULE II – CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY ONLY) (CONTINUED)

HALLMARK FINANCIAL SERVICES, INC.

STATEMENT OF OPERATIONS

(In thousands)	For the year ended December 31, 2004
Investment income, net of expenses	\$ 3
Undistributed share of net earnings in subsidiaries	6,315
Management fee income	1,850
Total revenues	8,168
Losses and loss adjustment expenses	(106)
Other operating costs and expenses	2,593
Interest expense	51
Total expenses	2,538
Income before income tax	5,630
Income tax benefit	(219)
Net income (loss)	\$5,849

SCHEDULE II – CONDENSED FINANCIAL INFORMATION OF REGISTRANT (PARENT COMPANY ONLY) (CONTINUED)**HALLMARK FINANCIAL SERVICES, INC.
STATEMENT OF CASH FLOW**

(In thousands)	For the year ended December 31, 2004,
Cash flows from operating activities:	
Net income	\$ 5,849
Adjustments to reconcile net income to cash used in operating activities:	
Depreciation and amortization expense	39
Deferred income tax benefit	(914)
Change in unpaid losses and loss adjustment expenses	(106)
Undistributed share of net (earnings) loss of subsidiaries	(6,315)
Change in current federal income tax payable/recoverable	1,169
Change in all other liabilities	(72)
Change in all other assets	(25)
Net cash used in operating activities	(375)
Cash flows from investing activities:	
Purchases of property and equipment	(14)
Net cash used in investing activities	(14)
Cash flows from financing activities:	
Proceeds from exercise of employee stock options	48
Repayment of borrowings	(991)
Net cash used in financing activities	(943)
Decrease in cash and cash equivalents	(1,332)
Cash and cash equivalents at beginning of year	1,910
Cash and cash equivalents at end of year	\$ 578
Supplemental cash flow information:	
Interest paid	\$ (51)
Income taxes recovered	\$ 474

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
2004										
Personal Lines Group	\$1,491	\$19,534	\$6,192	\$–	\$32,445	\$1,372	\$19,243	\$10,176	\$11,881	\$33,067
Commercial Lines Group	5,984	–	–	–	–	11	–	12,112	21,145	–
Corporate	–	114	–	–	–	3	(106)	–	2,593	–
Consolidated	\$7,475	\$19,648	\$6,192	\$–	\$32,445	\$1,386	\$19,137	\$22,288	\$35,619	\$33,067

HALLMARK FINANCIAL SERVICES

SCHEDULE IV – REINSURANCE

(In thousands)

Column A	Column B	Column C	Column D	Column E	Column F
	Gross Amount	Ceded to Other Companies	Assumed From Other Companies	Net Amount	Percentage of Amount Assumed to Net
Life insurance in force	\$ –	\$ –	\$ –	\$ –	
Premiums					
Life insurance	–	–	–	–	
Accident and health insurance	–	–	–	–	
Property and liability insurance	19,028	613	14,030	32,445	43.2%
Title Insurance	–	–	–	–	
Total premiums	\$19,028	\$613	\$14,030	\$32,445	43.2%

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
		Reserves for Unpaid Claims and Claim	Discount if any, Deducted In	Unearned Premiums	Earned Premiums	Net Investment Income	Claims and Claim Adjustment Expenses Incurred Related to (1) (2)	Amortization of Deferred Policy Acquisition Costs	Paid Claims and Claims Adjustment Expenses	Premiums Written
Affiliation With Registrant	Deferred Policy Acquisition Costs	Adjustment Expenses	Column C				Current Year	Prior Years		

(a) Consolidated
property-casualty
entities

2004	\$7,475	\$19,648	\$—	\$6,192	\$32,445	\$1,386	\$20,331	\$(1,194)	\$22,288	\$22,634	\$33,067
------	---------	----------	-----	---------	----------	---------	----------	-----------	----------	----------	----------

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HALLMARK FINANCIAL SERVICES, INC.
(Registrant)

Date:	March 30, 2005	<u>/s/ Mark E. Schwarz</u> Mark E. Schwarz, Chairman and Chief Executive Officer (Principal Executive Officer)
Date:	March 30, 2005	<u>/s/ Mark J. Morrison</u> Mark J. Morrison, EVP and Chief Financial Officer (Principal Financial Officer)
Date:	March 30, 2005	<u>/s/ Jeffrey R. Passmore</u> Jeffrey R. Passmore, SVP and Chief Accounting Officer (Principal Accounting Officer)

In accordance with the Exchange Act, 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 30, 2005	<u>/s/ Mark E. Schwarz</u> Mark E. Schwarz, Director
Date:	March 30, 2005	<u>/s/ James H. Graves</u> James H. Graves, Director
Date:	March 30, 2005	<u>/s/ George R. Manser</u> George R. Manser, Director
Date:	March 30, 2005	<u>/s/ Scott T. Berlin</u> Scott T. Berlin, Director
Date:	March 30, 2005	<u>/s/ James C. Epstein</u> James C. Epstein, Director

EXHIBIT INDEX

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

Exhibit Number	Description
3(a)	Articles of Incorporation of the registrant, as amended (incorporated by reference to Exhibit 3(a) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1993).
3(b)	By-Laws of the registrant, as amended (incorporated by reference to Exhibit 3(b) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1993).
3(c)	Amendment of Article VII of the Amended and Restated Bylaws of Hallmark Financial Services, Inc., adopted July 19, 2002 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2002).
4	Specimen certificate for Common Stock, \$.03 par value, of the registrant (incorporated by reference to Exhibit 4 to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1991).
10(a)	Office Lease for 14651 Dallas Parkway, Suite 900, 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(b)	General Agency Agreement, effective March 1, 1992, between State & County Mutual Fire Insurance Company and Brokers General, Inc. (incorporated by reference to Exhibit 10(b) to Amendment No. 1 on Form 8 to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 1992).
10(c)*	1991 Key Employee Stock Option Plan of the registrant (incorporated by reference to Exhibit C to the definitive Proxy Statement relating to the registrant's Annual Meeting of Shareholders held May 20, 1991).
10(d)*	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(e)*	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(f)	Addendum No. 1 to the 100% Quota Share Reinsurance Agreement, as restated between State & County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas effective November 22, 1994 (incorporated by reference to Exhibit 10(q) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).
10(g)	Second, Third, Fourth and Fifth Amendments to Office Lease for 14651 Dallas Parkway, Suite 900, 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(t) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1995).

Exhibit Number	Description
10(h)	Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas effective July 1, 1996 (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(i)	Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurer (specifically identified as follows: Dorinco, Kemper and Skandia), effective July 1, 1996 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(j)	Guaranty Agreement effective July 1, 1996 provided by Dorinco Reinsurance Company in favor of State & County Mutual Fire Insurance Company (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(k)	Guaranty of Performance and Hold Harmless Agreement effective July 1, 1996 between Hallmark Financial Services, Inc. and Dorinco America Reinsurance Corporation (incorporated by reference to Exhibit 10(f) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(l)	Addendum No. 3 – Termination to 100% Quota Share Reinsurance Agreement between American Hallmark Insurance Company and State & County Mutual Fire Insurance Company (incorporated by reference to Exhibit 10(j) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(m)	100% Quota Share Reinsurance Agreement, effective January 1, 1997, between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc. and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(am) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1996).
10(n)	General Agency Agreement, effective January 1, 1997, between Dorinco Reinsurance Company, State & County Mutual Fire Insurance Company and Vaughn General Agency, Inc. (incorporated by reference to Exhibit 10(an) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1996).
10(o)	Administrative Services Agreement between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc. and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(ao) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1996).
10(p)	Endorsement No. 1, effective July 1, 1996, to the 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas, effective July 1, 1996 (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).
10(q)	Endorsement No. 1, effective July 1, 1997, to the Guaranty Agreement provided by Dorinco Reinsurance Corporation in favor of State & County Mutual Fire Insurance Company, effective July 1, 1996 (incorporated by reference to Exhibit 10(d) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).
10(r)	Endorsement No. 1 – Termination, effective January 1, 1997, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurers (Dorinco Reinsurance Company and Odyssey Reinsurance Corporation), effective July 1, 1996 (incorporated by reference to Exhibit 10(e) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).

Exhibit Number	Description
10(s)	Endorsement No. 1, effective July 1, 1997, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurer (Dorinco Reinsurance Company) effective July 1, 1996 (incorporated by reference to Exhibit 10(h) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).
10(t)	Endorsement No. 2, effective January 1, 1997, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective January 1, 1997 (incorporated by reference to Exhibit 10(bh) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997).
10(u)	Endorsement No. 1, effective January 1, 1997, to the 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc. and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(bi) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997).
10(v)	Endorsement No. 2, effective July 1, 1997, to the 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc., American Hallmark General Agency, Inc. and the Reinsurers (Dorinco Reinsurance Company and Kemper Reinsurance Company) effective July 1, 1997 (incorporated by reference to Exhibit 10(bj) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997).
10(w)	Retrocession Agreement effective March 1, 1998, between American Hallmark Insurance Company of Texas, Dorinco Reinsurance Company and Associated General Agency, Inc. (incorporated by reference to Exhibit 10(bh) to the registrant's annual Report on Form 10-KSB for the fiscal year ended December 31, 1998).
10(x)	Quota Share Retrocession Agreement effective September 1, 1998, between American Hallmark Insurance Company of Texas, Dorinco Reinsurance Company and Van Wagoner Companies, Inc. (incorporated by reference to Exhibit 10(bj) to the registrant's annual Report on Form 10-KSB for the fiscal year ended December 31, 1998).
10(y)	Endorsement No. 5, effective January 1, 1999, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurer (Dorinco Reinsurance Company), effective January 1, 1997 (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1999).
10(z)	Endorsement No. 4, effective January 1, 1999, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurer (GE Reinsurance Company), effective January 1, 1996 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1999).
10(aa)	Endorsement No. 2, effective July 1, 1997, to the 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc. and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(bg) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1999).

Exhibit Number	Description
10(ab)	Endorsement No. 6, effective January 1, 1999, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective January 1, 1997 (incorporated by reference to Exhibit 10(bi) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1999).
10(ac)	Seventh Amendment to Office Lease for 14651 Dallas Parkway, Suite 900, 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 Quarterly Report on Form 10-QSB for the quarter ended June 30, 2000).
10(ad)	Quota Share Retrocession Agreement, effective July 1, 2000, between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2000).
10(ae)	Addendum No. 2 to the Retrocession Contract, effective June 1, 1998, issued to Dorinco Reinsurance Company by American Hallmark Insurance Company of Texas, effective October 1, 1999 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2000).
10(af)	Eighth Amendment to Office Lease for 14651 Dallas Parkway, Suite 900, 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(br) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000).
10(ag)	Quota Share Retrocession Contract between Dorinco Reinsurance Company and American Hallmark Insurance Company of Texas, effective September 1, 2000 (incorporated by reference to Exhibit 10(bs) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000).
10(ah)	Endorsement No. 5, effective July 1, 2000, to the 100% Quota Share Reinsurance Agreement issued to State and County Mutual Fire Insurance Company, effective January 1, 1997 (incorporated by reference to Exhibit 10(bt) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000).
10(ai)	Endorsement No. 4, effective July 1, 2000, to the 100% Quota Share Reinsurance Agreement between State and County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas, effective July 1, 1996 (incorporated by reference to Exhibit 10(bu) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000).
10(aj)	Termination Addendum to the Quota Share Retrocession Agreement, effective May 28, 1999, issued to American Hallmark Insurance Company of Texas by Kemper Reinsurance Company, effective July 1, 1996 (incorporated by reference to Exhibit 10(bv) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000).
10(ak)	Termination Addendum to the Quota Share Retrocession Agreement, effective June 30, 2000, issued to Dorinco Reinsurance Company by American Hallmark Insurance Company of Texas, effective January 1, 1997 (incorporated by reference to Exhibit 10(bw) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000).

Exhibit Number	Description
10(al)	Termination Addendum to the Quota Share Retrocession Contract, effective September 1, 2000, issued to Dorinco Reinsurance Company by American Hallmark Insurance Company of Texas, effective September 1, 1998 (incorporated by reference to Exhibit 10(bx) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2000).
10(am)	Termination Addendum to the Interests and Liability Agreement, effective June 30, 2000, of GE Reinsurance Corporation with respect to the 100% Quota Share Reinsurance Agreement, effective January 1, 1997 (incorporated by reference to Exhibit 10(by) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2001).
10(an)	Termination Endorsement, effective July 1, 2000, to the Guaranty of Performance and Hold Harmless Agreement between Hallmark Financial Services, Inc. and GE Reinsurance Corporation (formerly Kemper Reinsurance Company), effective July 1, 1996 (incorporated by reference to Exhibit 10(cb) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2001).
10(ao)	Termination Endorsement, effective July 1, 2000, to the Guaranty Agreement provided by GE Reinsurance Corporation (formerly Kemper Reinsurance Company) in favor of State and County Mutual Fire Insurance Company, effective July 1, 1996 (incorporated by reference to Exhibit 10(cc) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2001).
10(ap)	Endorsement No. 2, effective July 1, 2000, to the Guaranty Agreement provided by Dorinco Reinsurance Company in favor of State and County Mutual Fire Insurance Company, effective July 1, 1996 (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended March 31, 2001).
10(aq)	Letter of Agreement, dated August 3, 2001, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(f) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2001).
10(ar)	Letter of Agreement, dated August 6, 2001, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(g) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2001).
10(as)	Addendum No. 1 to the Quota Share Retrocession Agreement, effective July 1, 2000, between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective January 1, 2001 (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2001).
10(at)	Addendum No. 2 to the Quota Share Retrocession Agreement, effective July 1, 2000, between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective July 1, 2001 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2001).
10(au)	Endorsement No. 1 to the Guaranty of Performance and Hold Harmless Agreement, effective July 1, 1996 between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company, effective July 1, 2000 (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2001).

Exhibit Number	Description
10(av)	Letter of Agreement, dated November 7, 2001 between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(d) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2001).
10(aw)*	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(ax)	Letter of Agreement, dated January 23, 2002, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(bl) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2001).
10(ay)	Addendum No. 2, entered into January 9, 2001, to the General Agency Agreement, effective March 1, 1992, between State & County Mutual Fire Insurance Company and Brokers General, Inc. (incorporated by reference to Exhibit 10(bo) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2001).
10(az)	Addendum No. 3 to the Quota Share Retrocession Agreement, effective July 1, 2000, between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective June 30, 2001 (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2002).
10(ba)	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(bb)*	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(bc)*	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(bd)	Addendum No. 1 to the Quota Share Retrocession Contract between Dorinco Reinsurance Company and American Hallmark Insurance Company of Texas, effective September 1, 2000 (incorporated by reference to Exhibit 10(bo) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002).
10(be)	Letter of Agreement, dated October 31, 2002, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(bp) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002).
10(bf)	Letter of Agreement, dated December 30, 2002, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(br) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002).
10(bg)	Letter of Agreement, dated December 30, 2002, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(bs) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002).

Exhibit Number	Description
10(bh)	Tenth Amendment to Office Lease for 14651 Dallas Parkway, Suite 900, 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(bi)	General Agency Agreement between Millers General Agency, Inc and Clarendon National Insurance Company, effective August 15, 2001 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended March 31, 2003).
10(bj)	Claims Administration Agreement between Millers General Agency, Inc. and Clarendon National Insurance Company, effective August 15, 2001 (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended March 31, 2003).
10(bk)	Claims Services Agreement between Millers General Agency, Inc. and Effective Claims Management, Inc., effective March 25, 2003 (incorporated by reference to Exhibit 10(d) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended March 31, 2003).
10(bl)	Lease Agreement for 777 Main Street, Suite 1000, Fort Worth, Texas 76102, 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(bm)	Termination Addendum to the Quota Share Retrocession Agreement, effective March 31, 2003 between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2003).
10(bn)	General Agency Agreement by and among American Hallmark General Agency, Inc., State and County Mutual Fire Insurance Company, American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective April 1, 2003 (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2003).
10(bo)	Security Fund Agreement between American Hallmark Insurance Company of Texas and State and County Mutual Fire Insurance Company, effective April 1, 2003 (incorporated by reference to Exhibit 10(d) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2003).
10(bp)	Quota Share Reinsurance Agreement by and among American Hallmark Insurance Company of Texas, American Hallmark General Agency, Inc. and State and County Mutual Insurance Company, effective April 1, 2003 (incorporated by reference to Exhibit 10(e) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2003).
10(bq)	Quota Share Reinsurance Agreement by and among American Hallmark General Agency, Inc., State and County Mutual Insurance Company and Dorinco Reinsurance Company, effective April 1, 2003 (incorporated by reference to Exhibit 10(f) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2003).
10(br)	Technology Processing Services Agreement, effective December 1, 2003 between Phoenix Indemnity Insurance Company and CGI Information Systems & Management Consultants, Inc. (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2003).

Exhibit Number	Description
10(bs)	Policy and Claims Processing Services Agreement, effective September 1, 2003 between Phoenix Indemnity Insurance Company and CGI Information Systems & Management Consultants, Inc. (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2003).
10(bt)	Processing Services Agreement, effective July 1, 2003 between Hallmark General Agency, Inc., Effective Claims Management, Inc. and CGI Information Systems & Management Consultants, Inc. (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2003).
10(bu)	Managing General Agency Agreement, effective October 1, 2003, between Old American County Mutual Fire Insurance Company and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(cl) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003).
10(bv)	Addendum No. 1 to the Managing General Agency Agreement, effective October 1, 2003, between Old American County Mutual Fire Insurance Company and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(cm) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003).
10(bw)	Guaranty Agreement, effective September 1, 2003, between Old American County Mutual Fire Insurance Company and Hallmark Financial Services, Inc. (incorporated by reference to Exhibit 10(cn) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003).
10(bx)	45% Quota Share Reinsurance Agreement, effective October 1, 2003, between Old American County Mutual Fire Insurance Company and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(co) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003).
10(by)	Addendum No. 1 to the 45% Quota Share Reinsurance Agreement, effective October 1, 2003, between Old American County Mutual Fire Insurance Company and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(cp) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003).
10(bz)	55% Quota Share Reinsurance Agreement, effective October 1, 2003, between Old American County Mutual Fire Insurance Company and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(cq) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003).
10(ca)	Blanket Retrocession Agreement, effective October 1, 2003, between Dorinco Reinsurance Company and American Hallmark Insurance Company of Texas (incorporated by reference to Exhibit 10(cr) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003).
10(cb)	Quota Share Reinsurance Agreement dated September 30, 2004 between Old American County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas (incorporated by reference to Exhibit 10 to the registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004).
10(cc)	General Agency Agreement between Hallmark General Agency, Inc. and Clarendon National Insurance Company, effective July 1, 2004 (incorporated by reference to Exhibit 10.1 to the registrant's current report on Form 8-K filed December 21, 2004).
10(cd)*	+ Management Bonus Plan for Fiscal Year 2004 adopted January 26, 2004

Exhibit Number	Description
16	Letter from PricewaterhouseCoopers LLP to Securities and Exchange Commission dated October 15, 2003 (incorporated by reference from the Company's Current Report on Form 8-K filed October 17, 2003).
21+	List of subsidiaries of the registrant.
23.1+	Consent of KPMG LLP
23.2+	Consent of PricewaterhouseCoopers LLP
31(a)+	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(b).
31(b)+	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(b).
32(a)+	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350.
32(b)+	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350.

**Management contract or compensatory plan or arrangement.*

+Filed herewith.

EXHIBIT 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

THE BOARD OF DIRECTORS

HALLMARK FINANCIAL SERVICES, INC.:

We consent to incorporation by reference in the registration statement on Form S-8 (File No. 333-41220) of Hallmark Financial Services, Inc. and subsidiaries of our report dated March 30, 2005, relating to the consolidated balance sheets of Hallmark Financial Services, Inc. and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders' equity and comprehensive income and cash flows for each of the years in the two-year period ended December 31, 2004, which report appears in the December 31, 2004 annual report on Form 10-K of Hallmark Financial Services, Inc.

Our report refers to the January 1, 2003 adoption of the prospective method provisions for stock-based employee compensation.

/s/ KPMG LLP

KPMG LLP

Dallas, Texas

March 30, 2005

EXHIBIT 23.2

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (File No. 333-41220) of Hallmark Financial Services, Inc. of our report dated March 16, 2003 relating to the consolidated financial statements for the year ended December 31, 2002, which report appears in this Form 10-K.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Dallas, Texas

March 30, 2005

EXHIBIT 31(A)

CERTIFICATIONS

I, Mark E. Schwarz, Chief Executive Officer of Hallmark Financial Services, Inc. (the "Company"), certify that:

1. I have reviewed this annual report on Form 10-K of the Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4. The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures [as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)] for the Company and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the Company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and
5. The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Date: March 30, 2005

/s/ Mark E. Schwarz

Mark E. Schwarz, Chief Executive Officer

EXHIBIT 31(B)

CERTIFICATIONS

I, Mark J. Morrison, Chief Financial Officer of Hallmark Financial Services, Inc. (the "Company"), certify that:

1. I have reviewed this annual report on Form 10-K of the Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4. The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures [as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)] for the Company and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the Company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and
5. The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Date: March 30, 2005

/s/ Mark J. Morrison

Mark J. Morrison, Chief Financial Officer

EXHIBIT 32(A)

CERTIFICATION PURSUANT TO 18 U.S.C. § 1350

I, Mark E. Schwarz, Chief Executive Officer of Hallmark Financial Services, Inc. (the “Company”), hereby certify that the accompanying annual report on Form 10-K for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on the date hereof (the “Report”), fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended. I further certify that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 30, 2005

/s/ Mark E. Schwarz
Mark E. Schwarz,
Chief Executive Officer

EXHIBIT 32(B)

CERTIFICATION PURSUANT TO 18 U.S.C. § 1350

I, Mark J. Morrison, Chief Financial Officer of Hallmark Financial Services, Inc. (the “Company”), hereby certify that the accompanying annual report on Form 10-K for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on the date hereof (the “Report”), fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended. I further certify that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 30, 2005

/s/ Mark J. Morrison
Mark J. Morrison,
Chief Financial Officer

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

DESCRIPTION	PAGE NUMBER
Report of Independent Registered Public Accounting Firm	50
Report of Independent Registered Public Accounting Firm	51
Consolidated Balance Sheets at December 31, 2004 and 2003	52
Consolidated Statements of Operations for the Years Ended December 31, 2004, 2003 and 2002	53
Consolidated Statements of Stockholders' Equity And Comprehensive Income for the Years Ended December 31, 2004, 2003 and 2002	54-55
Consolidated Statements of Cash Flows for the Years Ended December 31, 2004, 2003 and 2002	56
Notes to Consolidated Financial Statements	57

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

THE BOARD OF DIRECTORS

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, 2004 and 2003, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the years in the two-year period ended December 31, 2004. 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, 2004 and 2003, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2004, 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, effective January 1, 2003, the Company adopted the prospective method provisions of Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure.

/s/ KPMG LLP

KPMG LLP

Dallas, Texas

March 30, 2005

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS & STOCKHOLDERS OF

HALLMARK FINANCIAL SERVICES, INC.:

In our opinion, the accompanying consolidated statements of operations, of changes in stockholders' equity and of cash flows for the year ended December 31, 2002 present fairly, in all material respects, the results of operations and cash flows of Hallmark Financial Services, Inc. (the "Company") for the year ended December 31, 2002 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 the 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, 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.

As discussed in Note 1, during 2002 the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets."

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Dallas, Texas

March 16, 2003

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands)	December 31,	
	2004	2003
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value	\$28,206	\$25,947
Equity securities, available-for-sale, at fair value	3,580	3,573
Short-term investments, available-for-sale, at fair value	335	335
Total investments	32,121	29,855
Cash and cash equivalents	12,901	10,520
Restricted cash and investments	6,509	5,366
Prepaid reinsurance premiums	–	291
Premiums receivable encumbered by premium financing activity (net of allowance for doubtful accounts of \$–0- in 2004 and \$3 in 2003)	–	43
Premiums receivable	4,103	4,033
Accounts receivable	3,494	3,395
Reinsurance recoverable	3,083	10,516
Deferred policy acquisition costs	7,475	7,146
Excess of cost over fair value of net assets acquired	4,836	4,836
Intangible assets	486	513
Current federal income tax recoverable	–	625
Deferred federal income taxes	5,173	3,961
Other assets	2,330	2,753
	\$82,511	\$83,853
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable	\$ –	\$ 991
Unpaid losses and loss adjustment expenses	19,648	28,456
Unearned premiums	6,192	5,862
Unearned revenue	11,283	10,190
Accrued agent profit sharing	1,875	1,511
Accrued ceding commission payable	1,695	1,164
Pension liability	2,180	1,237
Current federal income tax payable	1,343	–
Accounts payable and other accrued expenses	5,639	7,045
	49,855	56,456
Commitments and Contingencies (Note 13)		
Stockholders' equity:		
Common stock, \$.03 par value, authorized 100,000,000 shares; issued 36,856,610 shares in 2004 and 2003	1,106	1,106
Capital in excess of par value	19,647	19,693
Retained earnings	13,103	7,254
Accumulated other comprehensive loss	(759)	(93)
Treasury stock, 379,319 shares in 2004 and 484,319 shares in 2003, at cost	(441)	(563)
Total stockholders' equity	32,656	27,397
	\$82,511	\$83,853

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)	For the years ended December 31		
	2004	2003	2002
Gross premiums written	\$33,389	\$43,338	\$ 51,643
Ceded premiums written	(322)	(6,769)	(29,611)
Net premiums written	33,067	36,569	22,032
Change in unearned premiums	(622)	5,406	(1,819)
Net premiums earned	32,445	41,975	20,213
Investment income, net of expenses	1,386	1,198	773
Realized losses	(27)	(88)	(5)
Finance charges	2,183	3,544	2,503
Commission and fees	21,100	17,544	1,108
Processing and service fees	6,003	4,900	921
Other income	31	486	284
Total revenues	63,121	69,559	25,797
Losses and loss adjustment expenses	19,137	30,188	15,302
Other operating costs and expenses	35,290	37,386	9,474
Interest expense	64	1,271	983
Amortization of intangible asset	28	28	2
Total expenses	54,519	68,873	25,761
Income before income tax, cumulative effect of change in accounting principle and extraordinary gain	8,602	686	36
Income tax expense	2,753	25	13
Income before cumulative effect of change in accounting principle and extraordinary gain	5,849	661	23
Cumulative effect of change in accounting principle, net of tax	–	–	(1,694)
Extraordinary gain	–	8,084	–
Net income (loss)	\$ 5,849	\$ 8,745	\$ (1,671)
Basic earnings (loss) per share:			
Income before cumulative effect of change in accounting principle and extraordinary gain	\$ 0.16	\$ 0.03	\$ –
Cumulative effect of change in accounting principle	–	–	(0.15)
Extraordinary gain	–	0.44	–
Net income (loss)	\$ 0.16	\$ 0.47	\$ (0.15)
Diluted earnings (loss) per share:			
Income before cumulative effect of change in accounting principle and extraordinary gain	\$ 0.16	\$ 0.03	\$ –
Cumulative effect of change in accounting principle	–	–	(0.15)
Extraordinary gain	–	0.43	–
Net income (loss)	\$ 0.16	\$ 0.46	\$ (0.15)

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, 2004, 2003 and 2002

(In thousands)	No. of Shares	Par Value	Capital In Excess of Par Value	Retained Earnings	Accum. Other Comp. Loss	Treasury Stock	No. of Shares	Total Stockholders' Equity	Comp. Income (Loss)
Balance at December 31, 2001	11,856	\$ 356	\$10,875	\$ 180	—	\$(1,043)	806	\$10,368	
Comprehensive loss:									
Net loss				(1,671)				(1,671)	\$(1,671)
Other comprehensive loss:									
Additional minimum pension liability, net of tax of \$94					(162)			(162)	(162)
Comprehensive loss									<u>\$(1,833)</u>
Balance at December 31, 2002	11,856	\$ 356	\$10,875	\$(1,491)	\$(162)	\$(1,043)	806	\$ 8,535	
Rights offering	25,000	750	9,250					10,000	
Issuance of common stock	1	—						—	
Amortization of fair value of stock options granted			31					31	
Stock options exercised			(463)			480	(322)	17	
Comprehensive income:									
Net income				8,745				8,745	\$ 8,745
Other comprehensive income:									
Additional minimum pension liability					(646)			(646)	(646)
Net unrealized holding gains arising during period					667			667	667
Reclassification adjustment for losses included in net income					88			88	88
Net unrealized gains on securities					<u>755</u>			<u>755</u>	<u>755</u>
Total other comprehensive income before tax					109			109	109
Tax effect on other comprehensive income					<u>(40)</u>			<u>(40)</u>	<u>(40)</u>
Other comprehensive income after tax					69			69	69
Comprehensive income									<u>\$ 8,814</u>
Balance at December 31, 2003	36,857	\$1,106	\$19,693	\$ 7,254	\$(93)	\$(563)	484	\$27,397	

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
AND COMPREHENSIVE INCOME (CONTINUED)

(In thousands)	For the years ended December 31, 2004, 2003 and 2002								
	No. of Shares	Par Value	Capital In Excess of Par Value	Retained Earnings	Accum. Other Comp. Loss	Treasury Stock	No. of Shares	Total Stockholders' Equity	Comp. Income (Loss)
Balance at December 31, 2003	36,857	\$1,106	\$19,693	\$ 7,254	\$ (93)	\$ (563)	484	\$27,397	
Amortization of fair value of stock options granted			28					28	
Stock options exercised			(74)			122	(105)	48	
Comprehensive income:									
Net income				5,849				5,849	\$5,849
Other comprehensive income:									
Additional minimum pension liability					\$(1,198)			(1,198)	(1,198)
Net unrealized holding gains arising during period					438			438	438
Reclassification adjustment for gains included in net income					(218)			(218)	(218)
Net unrealized gains on securities					220			220	220
Total other comprehensive loss before tax					(978)			(978)	(978)
Tax effect on other comprehensive income					312			312	312
Other comprehensive loss after tax					(666)			(666)	(666)
Comprehensive income									\$5,183
Balance at December 31, 2004	36,857	\$1,106	\$19,647	\$13,103	\$ (759)	\$ (441)	379	\$32,656	

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	For the years ended December 31		
	2004	2003	2002
Cash flows from operating activities:			
Net income (loss)	\$ 5,849	\$ 8,745	\$ (1,671)
Adjustments to reconcile net income (loss) to cash provided by operating activities:			
Depreciation and amortization expense	450	621	195
Deferred income tax expense (benefit)	(787)	114	48
Change in prepaid reinsurance premiums	291	8,297	3,061
Change in premiums receivable	(70)	(1,276)	(598)
Change in accounts receivable	(99)	(1,266)	(170)
Change in deferred policy acquisition costs	(329)	(1,340)	(641)
Change in unpaid losses and loss adjustment expenses	(8,808)	(5,097)	(2,422)
Change in unearned premiums	330	(12,785)	(1,242)
Change in unearned revenue	1,093	3,271	183
Change in accrued agent profit sharing	364	944	72
Change in reinsurance recoverable	7,433	12,817	3,942
Change in reinsurance balances payable	–	(3,082)	(662)
Cumulative effect of change in accounting principle	–	–	1,694
Change in current federal income tax payable/recoverable	1,968	(592)	662
Change in accrued ceding commission payable	531	(1,372)	(2,062)
Gain on acquisition of subsidiary	–	(8,084)	–
Change in all other liabilities	(1,661)	419	1,117
Change in all other assets	761	348	443
Net cash provided by operating activities	7,316	682	1,949
Cash flows from investing activities:			
Purchases of property and equipment	(389)	(476)	(254)
Purchase of note receivable	–	–	(6,500)
Acquisition of subsidiary, net of cash received	–	6,945	(2,100)
Premium finance notes repaid, net of finance notes originated	43	11,550	2,147
Change in restricted cash and investments	(3,458)	(4,294)	918
Purchases of debt and equity securities	(6,670)	(19,075)	(12,639)
Maturities and redemptions of investment securities	6,138	8,131	5,858
Net redemptions of short-term investments	344	8,904	6,276
Net cash provided by (used in) investing activities	(3,992)	11,685	(6,294)
Cash flows from financing activities:			
Proceeds from note payable	–	–	8,600
Net repayments to premium finance lender	–	(10,905)	(1,308)
Proceeds from rights offering	–	10,000	–
Proceeds from exercise of employee stock options	48	17	–
Repayment of borrowings	(991)	(9,412)	(27)
Net cash provided by (used in) financing activities	(943)	(10,300)	7,265
Increase in cash and cash equivalents	2,381	2,067	2,920
Cash and cash equivalents at beginning of year	10,520	8,453	5,533
Cash and cash equivalents at end of year	\$12,901	\$ 10,520	\$ 8,453
Supplemental cash flow information:			
Interest paid	\$ (64)	\$ (1,456)	\$ (833)
Income taxes recovered (paid)	\$ (1,700)	\$ (475)	\$ 696

The Company transferred \$2.4 million of fixed maturity investments from restricted investments to debt securities, available-for-sale, during 2004.

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

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

1. ACCOUNTING POLICIES:

GENERAL

Hallmark Financial Services, Inc. (“HFS”) and its wholly owned subsidiaries (collectively, the “Company”) engage in the sale of property and casualty insurance products. The Company’s business involves marketing and underwriting of non-standard personal automobile insurance in Texas, New Mexico and Arizona; marketing commercial insurance in Texas, New Mexico, Idaho, Oregon and Washington; affiliate and third party claims administration; and other insurance related services. The Company pursues its business activities through integrated insurance groups handling non-standard personal automobile insurance (the “Personal Lines Group”) and commercial insurance (the “Commercial Lines Group”).

The Personal Lines Group focuses on providing non-standard automobile liability and physical damage insurance in Texas, New Mexico and Arizona for drivers who do not qualify for or cannot obtain standard rate insurance. The members of the Personal Lines group are a Texas domiciled property and casualty insurance company, American Hallmark Insurance Company of Texas (“Hallmark”); an Arizona domiciled property and casualty insurance company, Phoenix Indemnity Insurance Company (“Phoenix”); a managing general agency, American Hallmark General Agency, Inc. (“AHGA”); an affiliate and third party claims administrator, Hallmark Claims Service, Inc. (“HCS”); and a premium finance company, Hallmark Finance Corporation (“HFC”). The Company discontinued HFC’s premium finance activities in July 2003.

The Commercial Lines Group markets and administers low hazard commercial insurance policies primarily in the rural areas of Texas, New Mexico, Idaho, Oregon and Washington. The members of the Commercial Lines Group are a managing general agency, Hallmark General Agency, Inc. (“HGA”); and a third party claims administrator, Effective Claims Management, Inc. (“ECM”).

PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the accounts and operations of HFS and its subsidiaries. Intercompany accounts and transactions have been eliminated.

BASIS OF PRESENTATION

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”) which, as to Hallmark and Phoenix, 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 market 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 premium and discounts are amortized into earnings using the effective interest method.

Short-term investments consist of a certificate of deposit carried at amortized cost, which approximates market.

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

CASH EQUIVALENTS

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

RECOGNITION OF PREMIUM REVENUES

Insurance premiums and policy fees are earned pro rata over the terms of the policies. Upon cancellation, any unearned premium and policy fee is refunded to the insured. Insurance premiums written include gross policy fees of \$2.7 million, \$3.0 million and \$5.1 million and policy fees, net of reinsurance, of \$2.7 million, \$2.3 million and \$2.1 million for the years ended December 31, 2004, 2003 and 2002, respectively.

RECOGNITION OF COMMISSION REVENUES AND EXPENSES OF THE COMMERCIAL LINES GROUP

Commission revenues and commission expenses related to insurance policies serviced by HGA are recognized during the period covered by the policy. Profit sharing commission is calculated and recognized when the ratio of ultimate losses and loss expenses incurred to earned premium ("loss ratio") as determined by a qualified actuary deviate from contractual thresholds. 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 at 0.5% above and below the provisional loss ratio.

	Treaty Effective Dates			
	7/1/01-6/30/02	7/1/02-6/30/03	7/1/03-6/30/04	7/1/04-6/30/05
Provisional loss ratio	60.0%	59.0%	59.0%	64.2%
Ultimate loss ratio booked to at 12/31/04	57.5%	58.5%	59.0%	62.2%
Effect of actual 0.5% above provisional	\$(199,402)	\$(305,122)	\$(298,457)	\$(44,755)
Effect of actual 0.5% below provisional	\$ 139,581	\$ 201,381	\$ 196,982	\$ 44,755

As of December 31, 2004, the Company recorded a \$0.7 million profit sharing payable for the quota share treaty effective July 1, 2001 through June 30, 2002. The Company received \$2.0 million initial settlement on this treaty in 2004 based on actual incurred loss experience. The payable is the difference between the cash received and the recognized commission revenue based on the estimated ultimate loss ratio. The Company also recorded a \$0.2 million receivable on the quota share treaty effective July 1, 2002 through June 30, 2003 and a \$0.2 million receivable on the quota share treaty effective July 1, 2004 through June 30, 2005.

RECOGNITION OF CLAIM SERVICING FEES

Claim servicing fees are recognized in proportion to the historical trends of the claim cycle. The Company uses 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

The majority of Hallmark's annual insurance premiums were financed through the Company's premium finance program offered by its wholly-owned subsidiary, HFC. Hallmark ceased offering premium financing on new annual term policies in July 2003. Finance charges on the premium finance notes are recorded as interest earned. This interest is earned on the Rule of 78's method which approximates the interest method for such short-term notes.

The Company receives premium installment fees between \$3.00 and \$12.50 per 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 \$3.6 million and \$3.2 million, at December 31, 2004 and 2003, 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 2004, 2003 and 2002 was \$0.4 million, \$0.6 million and \$0.2 million, respectively. Accumulated depreciation was \$2.6 million and \$2.2 million at December 31, 2004 and 2003, respectively.

PREMIUMS RECEIVABLE ENCUMBERED BY PREMIUM FINANCING ACTIVITY

Premiums receivable encumbered by premium financing activity represents payments due to HFC as a result of a secured financing agreement with an unaffiliated third party which are carried at cost net of allowance for doubtful accounts. Hallmark discontinued producing new premium financed annual term policies in July 2003.

PREMIUMS RECEIVABLE

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

DEFERRED POLICY ACQUISITION COSTS AND CEDING COMMISSIONS OF THE PERSONAL LINES GROUP

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 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.

Ceding commissions from reinsurers on retroceded business, which include expense allowances, are deferred and recognized over the period premiums are earned for the underlying policies reinsured. Deferred ceding commissions from this business are netted against deferred policy acquisition costs in the accompanying balance sheet. The change in deferred ceding commission income is netted and included in other operating costs and expenses in the accompanying income statement. During 2004, 2003 and 2002, the Company deferred \$(22.6) million, \$(21.0) million and \$(7.3) million of policy acquisition costs and amortized \$22.3 million, \$20.6 million and \$6.7 million of deferred policy acquisition costs, respectively. The net deferral of acquisition costs were \$(0.3) million, \$(0.4) million and \$(0.6) million for 2004, 2003 and 2002, respectively.

Under Hallmark's reinsurance arrangements, the Company earns ceding commissions based on the reinsurer's loss ratio experience on the portion of policies reinsured. The Company receives a provisional commission as policies are produced as an advance against the later determination of the commission actually earned. The provisional commission is adjusted periodically on a sliding scale based on expected loss ratios.

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, 2004, 2003 and 2002. 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, management believes 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.

AGENT PROFIT SHARING COMMISSIONS

Both the Personal Lines and Commercial Lines Groups annually pay a profit sharing commission to their independent agency force based upon the results of the business produced by each agent. The Company estimates and accrues this liability to commission expense in the year the business is produced.

REINSURANCE

Hallmark is 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.)

INCOME TAXES

The Company files 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.

NET INCOME PER SHARE

The computation of net income 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 8 and 10.)

BUSINESS COMBINATIONS

The Company accounts for business combinations using the purchase method of accounting. 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.

The Company acquired Phoenix effective January 1, 2003. In consideration for Phoenix, the Company cancelled \$7.0 million of a \$14.85 million balance on a note receivable from Millers American Group, Inc. The Company had valued the note receivable on its balance sheet at its cost of \$6.5 million. As of December 31, 2003, the Company fully reserved for the remaining balance of the note receivable.

The calculation of the fair value of the Company's net assets acquired at January 1, 2003 and the determination of excess of fair value of net assets acquired over cost is as follows (in thousands):

Net assets acquired at 1/1/03 (historical basis)	\$11,520
Fair value of acquired identified intangible assets	706
Fair value adjustment to unearned premium	918
Fair value adjustment to loss reserves	(146)
Reversal of valuation allowance on net deferred tax asset acquired	3,365
Fair value of net assets acquired in 1/1/03 before basis adjustments	16,363
Consideration paid in form of debt incurred to complete the acquisition	(6,500)
Excess of fair value of net assets acquired over cost at 1/1/03 before basis adjustments	9,863
Pro rata reduction of assets acquired other than specified exceptions:	
Identified intangible assets	(706)
Deferred policy acquisition costs	(918)
Fixed Assets	(65)
Other Assets	(90)
Excess of fair value of net assets acquired over cost at 1/1/03	\$ 8,084

The results of operations of Phoenix are included in the Consolidated Statement of Operations from the effective date of the acquisition. The pro forma results for the twelve months ended December 31, 2002 as if the Company had acquired Phoenix at January 1, 2002 are as follows (in thousands, except per share amounts):

	2002
Revenues	\$43,143
Loss before cumulative effect of change in accounting principle	\$ (1,397)
Net loss	\$ (3,091)
Basic loss per share	\$ (0.28)
Diluted loss per share	\$ (0.28)

The acquisition of Phoenix was accounted for in accordance with Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS 141"). This statement requires that the Company estimate the fair value of assets acquired and liabilities assumed by the Company as of the date of the acquisition. In accordance with the application of SFAS 141, the Company recognized an extraordinary gain of \$8.1 million for the acquisition of Phoenix in its Consolidated Statement of Operations for the twelve months ended December 31, 2003. The gain is calculated as the difference between the fair value of the net assets of Phoenix of \$14.6 million and the \$6.5 million cost of the note receivable from Millers.

INTANGIBLE ASSETS

On January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets." SFAS 142 supersedes APB 17, "Intangible Assets," and primarily addresses the accounting for goodwill and intangible assets subsequent to their initial recognition. 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, the Company has identified two components of goodwill and assigned the carrying value of these components into two reporting units: the Personal Lines Group, \$2.7 million, and the Commercial Lines Group, \$2.1 million. During 2004 and 2003, the Company completed the first step prescribed by SFAS 142 for testing for impairment and determined that there is no impairment. Prior to the acquisitions of the Commercial Lines Group in December 2002 and Phoenix in January 2003, the Company assigned the carrying value of goodwill to the insurance company reporting unit and the finance company reporting unit. In 2003, as a result of these acquisitions, the Company changed the way it views its operating segments. During 2002, the Company recorded a charge to earnings that is reported as a cumulative effect of change in accounting principle of \$1.7 million to reflect an impairment loss determined by the two step process prescribed by SFAS 142.

Effective December 1, 2002, the Company acquired the Commercial Lines Group. At acquisition, the Company valued the relationships with its independent agents at \$542,580. This asset is classified as an other intangible asset and is being amortized on a straight-line basis over twenty years. The Company recognized \$27,129 of amortization expense for the twelve months ending December 31, 2004 and will recognize \$27,129 in amortization expense for each of the next five years and \$350,416 for the remainder of the asset's life.

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 date(s) of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

FAIR VALUE OF FINANCIAL INSTRUMENTS

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

Investment Securities: Fair values are obtained from an independent pricing service. (See Note 2.)

Notes Payable: The carrying amounts reported in the balance sheet for these instruments approximate their fair values. (See Note 6.)

STOCK-BASED COMPENSATION

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”). The statement amends FASB Statement No. 123 (“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. Effective January 1, 2003, the Company adopted the prospective method provisions of SFAS 148.

At December 31, 2004, the Company had a non-qualified stock option plan for non-employee directors, which is described more fully in Note 10. The Company also had an employee stock option plan that expired in March 2004. Prior to 2003, the Company accounted for these plans under the recognition and measurement provisions of APB Opinion No. 25, “Accounting for Stock Issued to Employees,” and related Interpretations. No stock-based employee compensation cost was reflected in 2002 net income. Effective January 1, 2003, the Company adopted the fair value recognition provisions of SFAS 123. Under the prospective method of adoption selected by the Company under the provisions of SFAS 148, compensation cost is recognized for all employee awards granted, modified, or settled after the beginning of the fiscal year in which the recognition provisions are first applied. Compensation cost is recognized pro rata over the vesting period as the awards vest. Results for prior years have not been restated.

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

	2004	2003	2002
Net income (loss)	\$5,849	\$8,745	\$(1,671)
Add: stock-based employee compensation expenses included in reported net income, net of tax	20	30	–
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(33)	(84)	(32)
Pro forma net income (loss)	\$5,836	\$8,691	\$(1,703)
Net income (loss) per share:			
Basic – as reported	\$ 0.16	\$ 0.47	\$ (0.15)
Basic – pro forma	\$ 0.16	\$ 0.47	\$ (0.15)
Diluted – as reported	\$ 0.16	\$ 0.46	\$ (0.15)
Diluted – pro forma	\$ 0.16	\$ 0.46	\$ (0.15)

RECLASSIFICATION

Certain previously reported amounts have been reclassified to conform to current year presentation. Such reclassification had no effect on net income (loss) or stockholders’ equity.

2. INVESTMENTS:

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

	Years ended December 31,		
	2004	2003	2002
Debt securities	\$1,127	\$ 752	\$421
Equity securities	109	189	5
Short-term investments	82	102	163
Cash equivalents	82	171	186
	1,400	1,214	775
Investment expenses	(14)	(16)	(2)
Net investment income	\$1,386	\$1,198	\$773

No investment in any entity or its affiliates exceeded 10% of stockholders' equity at December 31, 2004 or 2003.

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
At December 31, 2004				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 2,752	\$ 3	\$ 93	\$ 2,662
Corporate debt securities	5,278	24	12	5,290
Municipal bonds	19,788	443	2	20,229
Mortgage backed securities	23	2	—	25
Total debt securities	27,841	472	107	28,206
Equity securities	3,015	569	4	3,580
Total debt and equity securities	\$30,856	\$1,041	\$111	\$31,786
At December 31, 2003				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 5,004	\$ 23	\$ 45	\$ 4,982
Corporate debt securities	1,122	—	—	1,122
Municipal bonds	19,339	525	21	19,843
Mortgage backed securities	—	—	—	—
Total debt securities	25,465	548	66	25,947
Equity securities	3,396	326	149	3,573
Total debt and equity securities	\$28,861	\$ 874	\$215	\$29,520

The amortized cost and estimated market value of investments in debt and equity securities with a gross unrealized loss position at December 31, 2004 (in thousands) is as follows:

	Amortized Cost	Market Value	Gross Unrealized Loss
1 Equity Position	\$ 31	\$ 27	\$ (4)
6 Bond Positions	7,323	7,216	(107)
	<u>\$7,354</u>	<u>\$7,243</u>	<u>\$(111)</u>

All of the \$0.1 million unrealized loss recorded at December 31, 2004 is less than twelve months old and is considered a temporary decline in value.

The amortized cost and estimated market value of debt securities at December 31, 2004 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	Market Value
Due in one year or less	\$ —	\$ —
Due after one year through five years	10,068	9,934
Due after five years through ten years	17,750	18,247
Due after ten years	—	—
Mortgage-backed securities	23	25
	<u>\$27,841</u>	<u>\$28,206</u>

At December 31, 2004 and 2003, investments in debt securities with an approximate carrying value of \$100,000 were on deposit with the Texas Department of Insurance (“TDI”) as required by insurance regulations.

Proceeds from investment securities of \$0.1 million and \$6.4 million during 2004 and 2003, respectively, were from maturities, bond calls and prepayments of mortgage-backed securities.

3. RESTRICTED CASH AND INVESTMENTS:

The Company has cash and investments held in trust accounts to secure the credit exposure of State & County Mutual Fire Insurance Company (“State & County”) and Old American County Mutual Fire Insurance Company (“OACM”) from their quota share reinsurance treaties with Hallmark. These funds are recorded on the Company’s balance sheet at fair value, with unrealized gains and losses reported as accumulated other comprehensive income, a component of shareholders’ equity. The market value of these funds as of December 31, 2004 was \$6.3 million.

The amortized cost and estimated market value of cash and investments in debt securities held in trust for State & County and OACM (in thousands) by category as of December 31, 2004 is as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Municipal bonds	\$2,561	\$45	\$-	\$2,606
Corporate debt securities	-	-	-	-
Total debt securities	\$2,561	\$45	\$-	\$2,606
Cash				3,711
Total funds held in trust for State & County and OACM				<u>\$6,317</u>

The amortized cost and estimated market value of cash and investments in debt securities held in trust for State & County and OACM (in thousands) by category as of December 31, 2003 is as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Municipal bonds	\$4,500	\$96	\$-	\$4,596
Corporate debt securities	507	-	-	507
Total debt securities	\$5,007	\$96	\$-	\$5,103
Cash				(3)
Total funds held in trust for State & County and OACM				<u>\$5,100</u>

The amortized cost and estimated market value of investments in debt securities held in trust for State & County and OACM (in thousands) as of December 31, 2004 by contractual maturity are as follows:

	Amortized Cost	Market Value
Due in one year or less	\$ -	\$ -
Due after one year through 5 years	-	-
Due after 5 years through 10 years	2,561	2,606
Due after 10 years	-	-
	<u>\$2,561</u>	<u>\$2,606</u>

The Company also has funds held for Dorinco Reinsurance Company ("Dorinco") and the State of Kentucky in cash of \$192 thousand as of December 31, 2004 and funds held for Dorinco in cash of \$266 thousand as of December 31, 2003.

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:

	2004	2003	2002
Balance at January 1	\$28,456	\$17,667	\$20,089
Plus acquisition of Phoenix at January 1	–	10,338	–
Less reinsurance recoverables	7,259	9,256	12,170
Net Balance at January 1	21,197	18,749	7,919
Incurred related to:			
Current year	20,331	29,724	15,125
Prior years	(1,194)	464	177
Total incurred	19,137	30,188	15,302
Paid related to:			
Current year	10,417	21,895	9,119
Prior years	12,217	5,845	5,691
Total paid	22,634	27,740	14,810
Net Balance at December 31	17,700	21,197	8,411
Plus reinsurance recoverables	1,948	7,259	9,256
Balance at December 31	\$19,648	\$28,456	\$17,667

The \$1.2 million favorable development in prior accident years recognized in 2004 represents normal changes in actuarial estimates which had a \$0.8 million favorable impact on reinsurance recoverable. The 2003 increase in current year incurred includes a \$2.1 million settlement of a bad faith claim, net of reinsurance, and adverse development primarily related to newly acquired business.

5. REINSURANCE:

For policies originated prior to April 1, 2003, Hallmark assumed the reinsurance of 100% of the Texas non-standard auto business produced by AHGA and underwritten by State & County and retroceded 55% of the business to Dorinco. Under this arrangement, Hallmark remained obligated to policyholders in the event that Dorinco did not meet its obligations under the retrocession agreement. From April 1, 2003 through September 30, 2004, Hallmark assumed the reinsurance of 45% of the Texas non-standard automobile policies produced by AHGA and underwritten either by State & County (for policies written from April 1, 2003 through September 30, 2003) or OACM (for policies written from October 1, 2003 through September 30, 2004). During this period, the remaining 55% of each policy was directly assumed by Dorinco. Under these reinsurance arrangements, Hallmark was obligated to policyholders only for the portion of the risk assumed by Hallmark. Effective October 1, 2004, Hallmark assumes and retains the reinsurance of 100% of the Texas non-standard automobile policies produced by AHGA and underwritten by OACM. Phoenix underwrites its own policies and does not cede any portion of the business to reinsurers.

Under Hallmark's prior reinsurance arrangements, the Company earned ceding commissions based on Dorinco's loss ratio experience on the portion of policies reinsured by Dorinco. The Company received a provisional commission as policies were produced as an advance against the later determination of the commission actually earned. The provisional commission is adjusted periodically on a sliding scale based on expected loss ratios.

The following table shows premiums directly written, assumed and ceded and reinsurance loss recoveries by period (in thousands):

	Twelve Months Ended December 31,		
	2004	2003	2002
Written premium:			
Direct	\$18,941	\$22,359	\$ –
Assumed	14,448	20,979	51,643
Ceded	(322)	(6,769)	(29,611)
Net written premium	\$33,067	\$36,569	\$22,032
Earned premium:			
Direct	\$19,028	\$23,067	\$ –
Assumed	14,030	34,380	52,486
Ceded	(613)	(15,472)	(32,273)
Net earned premium	\$32,445	\$41,975	\$20,213
Reinsurance recoveries	\$ 163	\$11,071	\$21,161

6. NOTES PAYABLE:

Effective March 11, 1997, the Company entered into a loan agreement with Dorinco, whereby the Company borrowed \$7.0 million to contribute to HFC. Proceeds from this loan were used by HFC primarily to fund premium finance notes. The loan agreement provided for a seven-year term at a fixed interest rate of 8.25%. This note was repaid in September 2004.

7. SEGMENT INFORMATION:

The Company pursues its business activities through integrated insurance groups managing non-standard automobile insurance (the “Personal Lines Group”) and commercial insurance (the “Commercial Lines Group”). The members of the Personal Lines Group are Hallmark, an authorized Texas property and casualty insurance company; Phoenix, an authorized Arizona property and casualty insurance company; AHGA, a managing general agency; and HCS, a claims administrator. Effective December 1, 2002, the Company purchased the Commercial Lines Group. The members of the Commercial Lines Group are HGA, a managing general agency, and ECM, a third party claims administrator. The Company changed the segment structure in 2003 with the acquisitions of Phoenix and the Commercial Lines Group. Prior year information has been restated for the new structure.

The following is additional business segment information for the twelve months ended December 31, 2004, 2003 and 2002 (in thousands):

	2004	2003	2002
Revenues			
Personal Lines Group	\$39,555	\$49,665	\$23,999
Commercial Lines Group	23,563	19,891	1,561
Corporate	3	3	237
Consolidated	\$63,121	\$69,559	\$25,797
Depreciation Expense			
Personal Lines Group	\$ 266	\$ 218	\$ 144
Commercial Lines Group	144	370	37
Corporate	13	6	–
Consolidated	\$ 423	\$ 594	\$ 181
Interest Expense			
Personal Lines Group	\$ 14	\$ 389	\$ 689
Commercial Lines Group	–	1	1
Corporate	50	881	293
Consolidated	\$ 64	\$ 1,271	\$ 983
Tax Expense			
Personal Lines Group	\$ 2,403	\$ 432	\$ 218
Commercial Lines Group	569	420	1
Corporate	(219)	(827)	(206)
Consolidated	\$ 2,753	\$ 25	\$ 13
Pre-tax Income			
Personal Lines Group	\$ 8,109	\$ 1,950	\$ 1,595
Commercial Lines Group	3,028	1,311	3
Corporate	(2,535)	(2,575)	(1,562)
Consolidated	\$ 8,602	\$ 686	\$ 36

The \$8.1 million extraordinary gain reported in 2003 from the acquisition of Phoenix was attributed to the Corporate segment.

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

	December 31,	
	2004	2003
Assets		
Personal Lines Group	\$63,136	\$68,247
Commercial Lines Group	18,557	13,365
Corporate	818	2,241
Consolidated	\$82,511	\$83,853

8. EARNINGS PER SHARE:

The Company has adopted the provisions of Statement of Financial Accounting Standards No. 128 ("SFAS No. 128"), "Earnings Per Share," 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:

	2004	2003	2002
Numerator for both basic and diluted earnings per share:			
Income before cumulative effect of change in accounting principle and extraordinary gain	\$5,849	\$ 661	\$ 23
Cumulative effect of change in accounting principle	–	–	(1,694)
Extraordinary gain	–	8,084	–
Net income	\$5,849	\$8,745	\$(1,671)
Denominator, basic shares	36,448	18,518	11,049
Effect of dilutive securities:			
Stock options	240	269	78
Denominator, diluted shares	36,688	18,787	11,127
Basic earnings (loss) per share:			
Income before cumulative effect of change in accounting principle and extraordinary gain	\$ 0.16	\$ 0.03	\$ –
Cumulative effect of change in accounting principle	–	–	(0.15)
Extraordinary gain	–	0.44	–
Net income	\$ 0.16	\$ 0.47	\$ (0.15)
Diluted earnings (loss) per share:			
Income before cumulative effect of change in accounting principle and extraordinary gain	\$ 0.16	\$ 0.03	\$ –
Cumulative effect of change in accounting principle	–	–	(0.15)
Extraordinary gain	–	0.43	–
Net income	\$ 0.16	\$ 0.46	\$ (0.15)

Options to purchase 125,000, 126,000 and 1,532,000 shares of common stock at prices ranging from \$0.85 to \$1.00, \$0.75 to \$1.00, and \$0.44 to \$1.00 were outstanding at December 31, 2004, 2003 and 2002, respectively, but were not included in the computation of diluted earnings per share because the inclusion would result in an antidilutive effect in periods where the option exercise price exceeded the average market price per share for the period.

9. REGULATORY CAPITAL RESTRICTIONS:

Hallmark's 2004, 2003 and 2002 net income and stockholders' equity (capital and surplus), as determined in accordance with statutory accounting practices, were \$1.5 million, \$2.0 million and \$0.4 million, and \$11.5 million, \$10.0 million and \$8.4 million, respectively. The minimum statutory capital and surplus required for Hallmark by the TDI is \$2.0 million. Texas state law limits the payment of dividends to stockholders by property and casualty insurance companies. The maximum dividend that may be paid without prior approval of the Commissioner of Insurance is limited to the greater of 10% of statutory policyholders surplus as of the preceding calendar year end or the statutory net income of the preceding calendar year. Hallmark paid a dividend of \$0.2 million in 2004 to HFS that was declared in 2003. Based on surplus at December 31, 2004, Hallmark could pay a dividend of up to \$1.5 million to HFS during 2005 without TDI approval.

Phoenix's 2004 and 2003 net income (loss) and stockholders' equity (capital and surplus), as determined in accordance with statutory accounting practices, were \$3.4 million and \$(0.3) million, and \$14.0 million and \$10.1 million, respectively. The minimum statutory capital and surplus required for Phoenix by the Arizona Department of Insurance ("AZDOI") is \$1.5 million. Arizona insurance regulations generally limit distributions made by property and casualty insurers in any one year, without prior regulatory approval, to the lesser of 10% of statutory policyholders surplus as of the previous year end or net investment income for the prior year. The maximum dividend that may be paid in 2005 without prior approval of the AZDOI is \$0.8 million. Phoenix did not pay any dividends to HFS during 2004 in order to strengthen policyholders' surplus.

The National Association of Insurance Commissioners ("NAIC") requests property/casualty insurers to file a risk-based capital ("RBC") calculation according to a specified formula. The purpose of the NAIC-designed 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. Hallmark's 2004, 2003 and 2002 adjusted capital under the RBC calculation exceeded the minimum requirement by 412%, 186% and 143%, respectively. Phoenix's 2004 and 2003 adjusted capital under the RBC calculation exceeded the minimum requirement by 254% and 117%, respectively.

10. STOCK OPTION PLANS:

The Company's 1994 Key Employee Long Term Incentive Plan (the "Employee Plan") and 1994 Non-Employee Director Stock Option Plan (the "Director Plan") both expired in 2004. As of December 31, 2004, there were incentive stock options to purchase 683,500 shares of the Company's common stock outstanding under the Employee Plan and non-qualified stock options to purchase 525,000 shares of the Company's common stock outstanding under the Director Plan. In addition, as of December 31, 2004, there were outstanding non-qualified stock options to purchase 150,000 shares of the Company's common stock granted to certain non-employee directors outside the Director Plan in lieu of fees for service on the Company's board of directors in 1999. The exercise price of all such outstanding stock options is equal to the fair market value of the Company's common stock on the date of grant.

Options granted under the 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. Options granted under the 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 years from the date of grant. All options granted under the 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.

A summary of the status of the Company's stock options as of December 31, 2004, 2003 and 2002 and the changes during the years ended on those dates is presented below:

	2004		2003		2002	
	Number of Shares of Underlying Options	Weighted Average Exercise Prices	Number of Shares of Underlying Options	Weighted Average Exercise Prices	Number of Shares of Underlying Options	Weighted Average Exercise Prices
Outstanding at beginning of the year	1,263,500	\$0.58	2,379,000	\$0.50	2,679,000	\$0.49
Granted	475,000	\$0.59	205,000	\$0.67	200,000	\$0.43
Exercised	(105,000)	\$0.45	(575,000)	\$0.39	—	—
Forfeited	(275,000)	\$0.45	(745,500)	\$0.49	(500,000)	\$0.41
Expired—	—	—	—	—	—	—
Outstanding at end of the year	1,358,500	\$0.62	1,263,500	\$0.58	2,379,000	\$0.50
Exercisable at end of the year	744,000	\$0.63	1,051,500	\$0.56	1,973,000	\$0.50
Weighted average fair value of all options granted		\$0.34		\$0.36		\$0.22

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	2004	2003	2002
Expected Term	5.00	5.00	5.00
Expected Volatility	67.45%	61.05%	53.37%
Risk-Free Interest Rate	3.12%	2.97%	4.91%

The following table summarizes information about stock options outstanding at December 31, 2004:

Range of Exercise Prices	Options Outstanding		Weighted Avg. Exercise Price	Options Exercisable	
	Number Outstanding at 12/31/04	Weighted Avg. Remaining Contractual Actual Life		Number Exercisable at 12/31/04	Weighted Avg. Exercise Price
\$.37 to \$.57	632,500	4.6	\$.50	257,500	\$.40
\$.58 to \$.69	600,000	3.8	\$.67	373,000	\$.68
\$.70 to \$ 1.00	126,000	2.5	\$.97	113,500	\$.98
\$.37 to \$ 1.00	<u>1,358,500</u>	4.1	\$.62	<u>744,000</u>	\$.63

11. RETIREMENT PLANS

Certain employees of the Commercial Lines Group were participants in a defined benefit 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 and weighted-average assumptions, and plan assets for the retirement plan as of and for the twelve months ending December 31, 2004 and 2003 and for the one month ending December 31, 2002 (in thousands) using a measurement date of November 30. The Company acquired this plan on December 2, 2002 with the acquisition of the Commercial Lines Group.

	12 Months Ending 12/31/04	12 Months Ending 12/31/03	1 Month Ending 12/31/02
Assumptions (end of period):			
Discount rate used in determining benefit obligation	5.75%	6.00%	6.50%
Rate of compensation increase	N/A	N/A	N/A
Reconciliation of funded status (end of period):			
Vested benefit obligation	\$(13,052)	\$(12,482)	\$(11,756)
Accumulated benefit obligation	(13,081)	(12,517)	(11,758)
Projected benefit obligation	(13,081)	(12,517)	(11,758)
Fair value of plan assets	10,901	11,280	11,154
Funded status	\$ (2,180)	\$ (1,237)	\$ (604)
Unrecognized net obligation	–	–	–
Unrecognized prior service cost	–	–	–
Unrecognized actuarial (gain)/loss	2,086	887	268
Prepaid/(accrued) pension cost	\$ (94)	\$ (350)	\$ (336)
Changes in projected benefit obligation:			
Benefit obligation as of beginning of period	\$ 12,517	\$ 11,758	\$ 11,794
Interest cost	752	762	64
Actuarial liability (gain)/loss	830	1,085	(4)
Benefits paid	(1,018)	(1,088)	(96)
Benefit obligation as of end of period	\$ 13,081	\$ 12,517	\$ 11,758
Change in plan assets:			
Fair value of plan assets as of beginning of period	\$ 11,280	\$ 11,154	\$ 11,446
Actual return on plan assets (net of expenses)	388	1,214	(196)
Employer contributions	251	–	–
Benefits paid	(1,018)	(1,088)	(96)
Fair value of plan assets as of end of period	\$ 10,901	\$ 11,280	\$ 11,154
Net periodic pension cost:			
Service cost – benefits earned during the period	\$ –	\$ –	\$ –
Interest cost on projected benefit obligation	752	762	64
Expected return on plan assets	(764)	(749)	(76)
Amortizations			
Net obligation/(asset)	–	–	–
Unrecognized prior service cost	–	–	–
Unrecognized (gain)/loss	7	–	–
Net periodic pension cost (credit)	\$ (5)	\$ 13	\$ (12)
Discount rate	6.00%	6.50%	6.50%
Expected return on plan assets	7.00%	7.00%	8.00%
Rate of compensation increase	N/A	N/A	N/A

The expected benefit payments under the plan are as follows (in thousands):

2005	\$ 910
2006	\$ 919
2007	\$ 916
2008	\$ 896
2009	\$ 883
2010-2014	\$4,321

As of December 31, 2004, the fair value of the plan assets was composed of cash and cash equivalents of \$0.3 million, bonds and notes of \$4.4 million and equity securities of \$6.2 million. As of December 31, 2003, the fair value of the plan assets was composed of cash and cash equivalents of \$0.4 million, bonds and notes of \$5.2 million and equity securities of \$5.7 million. The Company recorded a \$2.2 million pension liability at December 31, 2004, of which, \$2.1 million was additional minimum pension liability.

The investment objectives of the Company 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 yr.) average inflation rate as measured by the consumers price index. The Company has prohibited all investments in options, futures, precious metals, short sales and purchase on margin. In 2003, management instructed an asset allocation of 50% to 55% in equity securities to take a more conservative investment strategy.

To develop the expected long-term rate of return on assets assumption, the Company considered 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 7% long-term rate of return on assets assumption.

The Company estimates it will contribute \$0.1 million to the defined benefit cash balance plan during 2005.

The following table shows the weighted-average asset allocation for the defined benefit cash balance plan held as of December 31, 2004 and 2003.

	12/31/04	12/31/03
Asset Category:		
Debt securities	41%	46%
Equity securities	57%	51%
Other	2%	3%
Total	100%	100%

The Company sponsors a defined contribution plan. Under this plan, employees may contribute a portion of their compensation on a tax-deferred basis, and the Company may contribute a discretionary amount each year. The Company contributed \$0.1 million for each of the twelve months ended December 31, 2004 and 2003.

12. INCOME TAXES:

The composition of deferred tax assets and liabilities and the related tax effects (in thousands) as of December 31, 2004 and 2003, are as follows:

	2004	2003
Deferred tax liabilities:		
Deferred tax liabilities:		
Deferred policy acquisition costs	\$(2,715)	\$(2,429)
Profit sharing commission	(74)	(357)
Agency relationship	(208)	(188)
Goodwill	(59)	–
Unrealized holding gains on investments	(312)	(239)
Guaranty assessment fund	–	(39)
Fixed asset depreciation	(131)	(130)
Loss reserve discount	(27)	(53)
Other	(93)	(286)
Total deferred tax liabilities	\$(3,619)	\$(3,721)
Deferred tax assets:		
Unearned premiums	\$ 421	\$ 379
Deferred ceding commissions	3,182	2,839
Pension liability	806	421
Net operating loss carryforward	1,796	1,796
Allowance for bad debt	189	141
Unpaid loss and loss adjustment expense	846	489
Goodwill	1,700	1,782
Rent reserve	126	133
Investment impairments	188	207
Unearned revenue	289	81
Risk premium reserve	42	75
Other	91	223
Total deferred tax assets	\$ 9,676	\$ 8,566
Net deferred tax asset before valuation allowance	\$ 6,057	\$ 4,845
Valuation allowance	884	884
Net deferred tax asset	\$ 5,173	\$ 3,961

A valuation allowance is provided against the Company's deferred tax asset to the extent that management does not believe it is more likely than not that future taxable income will be adequate to realize these future tax benefits. This allowance was \$0.9 million at December 31, 2004 and December 31, 2003. The valuation allowance is provided against a net operating loss carryforward subject to limitations on its utilization. Based on the evidence available as of December 31, 2004, management believes that it is more likely than not that the remaining net deferred tax assets will be realized. However, this assessment may change during 2005 if the Company's financial results do not meet management's current expectations.

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, 2004, 2003 and 2002, is as follows:

	2004	2003	2002
Computed expected income tax provision (benefit)			
at statutory regulatory tax rate	\$3,013	\$ 233	\$ 12
Meals and entertainment	6	5	1
Tax exempt interest	(309)	(122)	–
Dividends received deduction	33	(28)	–
State taxes (net of federal benefit)	(19)	(6)	–
Other	29	(57)	–
Income tax provision (benefit)	\$2,753	\$ 25	\$ 13
Current income tax provision (benefit)	\$3,540	\$ (89)	\$(32)
Deferred tax provision (benefit)	(787)	114	45
Income tax provision (benefit)	\$2,753	\$ 25	\$ 13

Approximately \$0.1 million of the 2004 current income tax provision results from tax deductible goodwill from the Phoenix acquisition.

The company has available, for federal income tax purposes, unused net operating loss of approximately \$5.3 million at December 31, 2004. The losses were acquired as part of the Phoenix acquisition and may be used to offset future taxable income. Utilization of the losses is limited under Internal Revenue Code Section 382. Due to this limitation, the company believes that \$2.6 million of the net operating loss carryforwards may expire unutilized. Therefore, a valuation allowance of \$2.6 million has been established against these net operating loss carryforwards. The Internal Revenue Code has provided that effective with tax years beginning September 1997, the carryback and carryforward 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	2,700
	\$5,300

13. COMMITMENTS AND CONTINGENCIES:

The Company has 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 \$1.2 million, \$1.3 million and \$0.8 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Future minimum lease payments (in thousands) under noncancellable operating leases as of December 31, 2004 are as follows:

Year	
2005	\$1,100
2006	1,037
2007	1,007
2008	928
2009	375
2010 and thereafter	563
Total minimum lease payments	\$5,010

From time to time, assessments are levied on the Company 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, the Company capitalizes the assessments as they are paid and amortizes the capitalized balance against its premium tax expense. There were no assessments during 2004, 2003 or 2002.

14. CONCENTRATIONS OF CREDIT RISK:

The Company maintains cash equivalents in accounts with four financial institutions in excess of the amount insured by the Federal Deposit Insurance Corporation. The Company monitors the financial stability of the depository institutions regularly, and management does not believe excessive risk of depository institution failure exists at December 31, 2004.

The Company is also subject to credit risk with respect to reinsurers to whom it has ceded underwriting risk. Although a reinsurer is liable for losses to the extent of the coverage it assumes, the Company remains obligated to its 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, the Company has used financially strong reinsurers with an A.M. Best rating of "A-" or better. The Company discontinued ceding underwriting risk to reinsurers effective April 1, 2003.

The Company's reinsurance coverage has been substantially provided by Dorinco since July 1, 2000. Effective October 1, 2004, the Company does not utilize any quota share reinsurance. Substantially all of the Company's reinsurance recoverable balance at December 31, 2004 is due from two reinsurers.

CORPORATE INFORMATION

BOARD OF DIRECTORS

Mark E. Schwarz

Chairman of the Board, President & CEO

Scott T. Berlin

Director, Brown, Gibbons, Lang & Company

James C. Epstein

Chairman, EWI RE, Inc.

James H. Graves

Partner, Erwin, Graves & Associates, LP

George R. Manser

Chairman, Concorde Holding Co.

MANAGEMENT TEAM

Mark E. Schwarz

Chairman of the Board, President & CEO

Mark J. Morrison

Executive Vice President, Chief Financial Officer

Brookland F. Davis

President of Personal Lines Group

Kevin T. Kasitz

President of Commercial Lines Group

Richard N. Gibson, FCAS, MAAA

Chief Actuary

Gregory P. Birdsall

Chief Information Officer

CORPORATE HEADQUARTERS

Hallmark Financial Services, Inc.

777 Main Street

Suite 1000

Ft. Worth, Texas 76102

(817) 348-1600

www.hallmarkgrp.com

INDEPENDENT AUDITORS

KPMG LLP

717 North Harwood Street

Suite 3100

Dallas, Texas 75201

STOCK SYMBOL

Hallmark Financial Services, Inc. common stock is listed on the American Stock Exchange under the symbol "HAF.EC".

TRANSFER AGENT

Securities Transfer Corporation

2591 Dallas Parkway

Suite 102

Frisco, Texas 75034

(469) 633-0101

LEGAL COUNSEL

McGuire, Craddock & Strother

Dallas, Texas

STOCKHOLDER MEETING

The annual meeting of stockholders will be held at 10:00 a.m. CDT on May 26, 2005 at 777 Main Street, 11th floor, Ft. Worth, Texas.